

Intended Consequences

It's hard enough for investors to know the full extent of the risks they're taking, let alone to choose the right ones to take. Curtis Macnguyen excels at both.

As might be expected from the youngest of ten children whose family immigrated to the U.S. from Vietnam when Saigon fell in 1975, Curtis Macnguyen learned early the value of being resourceful. "My personality has always been to play all the angles and look out for all the risks," he says.

Such traits have served Macnguyen exceedingly well as an investor. His Ivory Capital now manages \$3.1 billion and its flagship fund since 1998 has earned an annualized 11.8% return, vs. -0.5% for the S&P 500.

While braced for an uncertain and risky market environment, Macnguyen today sees opportunity in such areas as wireless communications, natural gas and tires. One key downside bet: regional banks. [See page 2](#)

INVESTOR INSIGHT



Curtis Macnguyen
Ivory Capital

Investment Focus: Seeks companies trading at least 30% below or above the prices at which their cash flows would result in a 15% annual return over time.

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Investor Insight: Curtis Macnguyen

Ivory Capital's Curtis Macnguyen – with colleagues Neil Chudgar, Brad Lundy and Avery Son – describes why a true bull market is unlikely to be close at hand, the key risk factors to which he wants his portfolio to be immune, why he took a rare activist stance with Yahoo, and why he believes Vodafone, Goodyear, Loews and regional banks are mispriced.

Your first real investing experience came at one of the hot hedge fund firms of the 1990s, Siegler, Collery & Co. How did your time there inform your strategy?

Curtis Macnguyen: The founders were ex-bankers, very focused on analyzing companies in detail from a bottoms-up perspective. They had a traditional value-investor focus, trying to buy companies trading well below intrinsic value and shorting those trading well above it. I certainly learned a lot from them in terms of hard-core fundamental analysis, which we try to apply at Ivory as well.

The primary difference in our approach is in how we manage risk. We focus on managing the spread risks between our longs and shorts so that we don't have significant exposure to unintended bets. We want our returns to derive from our skill as analysts and not from all the other factors that can create price volatility. In other words, the goal is for our longs and shorts to move relatively in sync with each other while we wait for fundamental catalysts to revalue our longs upward and our shorts downward.

We tag every stock in our portfolio for more than 40 possible spread-risk factors on which stock prices can diverge dramatically. The factors include common ones like sector exposure, market cap, liquidity, leverage and dividend rates, and maybe less-obvious ones like exposure to China or the constitution of the shareholder base. At any given time, for example, we'll know that 16% of our longs and 13% of our shorts are in highly leveraged companies. We'll know our exposure to companies that should perform well in an inflationary environment versus those that won't. With 40 different factors, it's impossible to balance every exposure, but fortunately only a few risk factors matter in any given market – those are the ones we try to neutralize.

Don't price disparities based on the types of factors you mention balance out over time?

CM: That's true, but if your fundamental analysis left you long cheap “bricks-and-mortar” companies and short overvalued Internet and telecom companies in 1998-99, you could have easily gone out of business – regardless of how “right” you were – as the relative performance of those sectors diverged dramatically. In a world of short-term capital, you can lose your business before you're proven correct.

We're just trying to be sensitive to the fact that many other factors can determine stock prices besides fundamental value. In 2002 and also late last year, highly leveraged companies were severely punished by the market, only to be bid up significantly when the market subsequently rebounded. There are long periods where value can outperform growth and vice versa. Last year, if you owned anything that was illiquid – not just in stocks, but in any asset class – you would have lost a disproportionate amount of money even if the security was fundamentally sound.

Sometimes value investors can get caught up in the intellectual rightness of what they're doing and ignore risks that can hurt them. We like to think our approach is more practical – it certainly helps reduce volatility.

To which risks are you most attuned at the moment?

CM: One of the most important risks is potentially higher inflation, accompanied by higher interest rates. We're very cognizant of our exposure to stocks with high dividends or to certain types of financials, both of which would perform poorly in a higher rate environment.



Curtis Macnguyen

Early Activism

As a young analyst for investment bank Gleacher & Co. in the early 1990s, Curtis Macnguyen got his first inside look at the hedge fund business when Gleacher reviewed the potential for Julian Robertson to sell a partial ownership stake in Tiger Management. “Aside from the unbelievable economics, I particularly liked that hedge funds were all about being right,” Macnguyen says. “Investment banking was all about working backward to justify a predetermined answer, which was exactly what I didn't want to do.”

Prior to leaving Gleacher to join hedge fund firm Siegler, Collery & Co. in 1993, Macnguyen and several then-analyst colleagues – including Glenview Capital founder Larry Robbins and Oak Hill Advisors' senior partner Scott Kruse – formed an informal group to analyze and pick stocks for their own accounts. “The first investment we made was in Clearly Canadian, which made fruit-flavored water that we liked to drink at lunch and saw showing up in stores,” he says. “We were so into it that after we bought the stock we started calling retailers to tell them we loved the brand and they should stock it. I don't know if that helped, but what did we know?”

Because of the threat of inflation, we're limiting net exposure to companies without pricing power or that are vulnerable to higher raw-materials prices.

Another risk we're paying a lot of attention to today is exposure to China. The health of the Chinese economy has increasingly broad implications, for the economic health of other emerging markets, for commodity prices, for Western companies expanding in emerging markets, etc. While China's economy has held up relatively well in the global downturn as a result of the government's massive fiscal stimulus program and increased bank lending, we think there's a decent chance the Chinese authorities may need to apply the brakes on fiscal and monetary policy later this year, which could trip up economic growth. We're not saying that's going to happen, but we've positioned our portfolio to be neutral to China exposure so we're not hurt if this scenario ends up playing out.

What do you look for in individual stock ideas?

CM: Basically we have to answer three questions: Is it mispriced, why is it mispriced, and what's going to make the mispricing go away? If we can't adequately answer those questions, we either haven't done enough work or it's probably not a great idea.

To answer the first question, we arrive at a fundamental value for each company we analyze, which is essentially the price at which its cash flows or asset values provide an adequate, risk-adjusted cash-on-cash return. For a moderate-growth business with moderate leverage in a normal interest rate environment, that return over time would be roughly 15% per year. Against that fundamental value, we typically want our shorts to be at least 30% overvalued and our longs to trade at a 30% discount or higher.

I'd argue that the second question – why something is mispriced – is too often ignored by value investors. The general thinking is that it doesn't really matter – if you're right that something is mispriced, it will eventually take care of

itself. We think it matters because you can conceivably avoid a lot of pain waiting for truth to prevail if you have a good read on why it currently doesn't. This was something I learned from my Siegler, Collery days. We thought Amazon.com was a great short in 1998, but never really tried to understand why people were willing to pay so much more for it than we thought it was worth.

Can you generalize about why things do get mispriced?

CM: There are so many reasons that it's hard to generalize. Financial complexity

ON COMPLEXITY:

If we think we can get a handle on what's going on, the fact that others shy away can provide opportunity for us.

is one. People talk about investing only in easy-to-understand businesses, but we're not afraid of tackling complicated financial analysis. If we think we can get a handle on what's going on, the fact that others tend to shy away from these situations can provide an opportunity for us.

We also often find opportunity when the shareholder base is turning over. We'll speak later about Vodafone [VOD:LN], but one reason we think it's inexpensive is because growth investors are cycling out of it after a few disappointing quarters, while value investors haven't yet focused on how cheap it is.

Markets often confuse cause and effect. Last quarter McKesson [MCK] shares sold off 20% after the [drug-distribution] company made negative comments with respect to current customer pricing and margins. The market took it as a widespread industry pricing issue and analysts materially lowered estimates, while we thought it was likely a conservative posture tied to one ongoing negotiation with its largest customer, CVS Caremark. The shares have since come

back as people figured that out and the CVS contract was renewed.

Talk about the importance of catalysts.

CM: We're generally of the school that "a bargain that stays a bargain is not a bargain." We may buy something just because it's cheap, but it's very unlikely to be a core position without a data point or two that we think should move the stock.

We're often betting on eventual earnings upside that exceeds market expectations. That's the case with Goodyear [GT], which we believe could beat earnings estimates significantly in fiscal 2010 (and which we'll also speak about later). It's still the case with McKesson, where we believe there's material upside from today's price [of around \$51], which is around 10x our 2010 earnings estimate and doesn't adequately reflect the potential for higher prescription-drug utilization under healthcare reform, dramatically increased spending on healthcare information technology (in which McKesson is a big player), and the addition of some important new contracts resulting from retail-pharmacy consolidation.

It's often also event-driven. Earlier this year we substantially added to our position in WellPoint [WLP] after the shares were hit by concerns over regulatory reform and the size of Medicare rate increases. One key catalyst was our belief that there was a real probability the company would sell its pharmacy benefits management [PBM] business, and given the valuation disparity between managed-care stocks and PBMs, the deal would be extremely accretive for WellPoint. The sale happened in April, to Express Scripts, which is one of the reasons WellPoint stock has gone from \$30 to \$50.

With Yahoo [YHOO], we made it one of our largest positions late last year when the stock went below \$10. It was not only incredibly cheap on a standalone basis – our analysis was that we were buying Yahoo's display and search advertising business for less than 1x operating income – but we also thought the economics of doing a deal on the search side with Microsoft were so compelling. At a

price we believed Microsoft could easily justify, we thought Yahoo could potentially get cash upfront and *increase* its EBITDA as a result of the sale. I couldn't come up with another company that had similar dynamics.

As the stock rallied, did you keep waiting for the deal, which was just announced?

CM: In a perfect world in which Microsoft paid a significant upfront amount to Yahoo for the search business and Yahoo used the cash to buy back stock, we thought the shares could be worth at least \$24. As time went on we concluded the perfect world was unlikely to happen, and as the stock went above \$15 the upside and downside were more in balance. We were virtually out of the name when the deal was announced.

How do you incorporate downside into your buy and sell decisions?

CM: For each position we define a downside price at which the stock would trade if everything about our thesis turned out to be wrong. In deciding whether to put something into the portfolio, we'll assign probabilities and look at the expected value, but the downside is particularly important in sizing the position. We don't want to lose more than 100 basis points in return in any one position, so if our downside is 20% below the current price, say, we'd put on no more than a 5% position. If we've correctly controlled the downside, we can create a portfolio with a lot of cheap call options on the longs and put options on the shorts.

Is your shorting driven by the desire to balance risks of specific longs?

CM: Our shorts are designed to balance key spread risks, but the vast majority are also meant to be stand-alone money makers. Fundamentally we're looking for the inverse of what we're looking for in longs, but because there are more ways to get hurt on shorts than longs, we typically keep the position sizes smaller and pay even more attention to liquidity and how

crowded the trade is. There's no worse feeling than being stuck in a short as it's going up.

Given your focus on balancing risks, do you typically run your portfolio close to market-neutral?

CM: We're usually 60-80% gross long and 30-50% gross short, with a typical net long exposure of 20-30%. Today our total gross exposure is very low – we're about 38% long and 28% short, so our net exposure is only 10%.

ON TODAY'S MARKET:

The key to making money is to patiently wait for opportunities with short-term catalysts or resulting from big dislocations.

What does that say about your macro views on the market?

CM: We wrote in our latest investor letter about several negative undercurrents that could undermine the economy's ability to reach full potential over the next several years, including below-trend consumer spending, the risk of inflation from excessive quantitative easing, capital-constrained balance sheets in many parts of the world, an overheating Chinese economy that might have to be reined in, and an increase in regulatory and tax burdens as a result of changes in government policy.

In a market with all these potentially negative and serious macro factors, our gross and net exposures are likely to remain low. You don't want to be a sitting duck waiting for your fundamental catalysts to play out while all these macro factors might swing your stocks wildly and, in some cases, overwhelm any fundamental catalysts you're counting on.

We don't think this recent rally is the start of a new bull market. The immune system of the economy and markets is very weak. Even with a low immune sys-

tem there may be periods in which you look and feel healthy, but when something bad happens, you don't have the strength to withstand it. Our view is that we are apt to experience periods of economic weakness and uncertainty for years to come.

The key to making money in this type of market is to be patient and basically wait for two things: opportunities with short-term fundamental catalysts, and opportunities resulting from big dislocations. With the former, you need to be smart about sizing up the potential and not be afraid to take profits off the table. With the latter, it means waiting for periods like February and early March of this year when everyone thought the world was going to end. The market is prone to polarized views and we want to take advantage of those, like buying Motorola in March for \$3 per share when it had \$1.50 per share of cash and two valuable-enough businesses that we were being paid \$3-4 a share to own the wireless-handset business. Given our low gross exposure, we have lots of cash to take advantage of these types of severe dislocations.

Have you been active in fixed income?

CM: We started buying some distressed debt in December, but after prices started taking off we didn't feel like chasing it. We've actually sold some of our positions and have less than 1% of the portfolio in fixed income now. We have a list of attractive names and are prepared to step back in if prices come off, which we believe is more likely than not.

Walk through your specific equity investment case for Vodafone.

CM: Vodafone generates 90% of its revenues from providing wireless services – directly in Europe, Asia-Pacific, Africa and the Middle East and through a 45% ownership of Verizon Wireless in the U.S. Roughly 60% of its operating profit is generated in Western Europe, 30% comes from Verizon Wireless and the remainder is from emerging markets.

During 2008 and into the first half of 2009, VOD's stock fell 40% from its highs due to a weakening macro environment, relative underperformance in certain markets, and fears around competition and price cutting in mature European markets. In addition, the Verizon Wireless acquisition of Alltel in early 2009 has caused a delay in the payment of material dividends from the joint venture. As a result of all that, growth-oriented investors have rotated out of the stock.

At today's price [of around £1.20] the stock trades at only 8.4x fiscal 2010 earnings, 4.6x estimated EBITDA on an enterprise-value basis, and with a free-cash-flow yield of around 10%. But if you look closer, it's even cheaper than that. Including Vodafone's share of Verizon Wireless' \$12 billion in annual free cash

flow, the FCF yield on Vodafone is around 15%. That makes no sense to us. That kind of yield usually means the company is levered to the risk of bankruptcy, or owns declining assets with big structural problems – neither of which is the case with Vodafone.

What will make the market excited again about Vodafone?

Neil Chudgar: We believe some of the competitive concerns in Europe will prove to be overdone. Vodafone was perceived as a higher-priced carrier in Europe, so the market got spooked as it lowered prices to defend market share. Now that Vodafone is in the middle or even low end of the pricing spectrum, margin comparisons going forward are

likely to be more favorable. On top of that, we think there's likely to be consolidation in certain of the company's European markets, which should help rationalize competition. It's a bit off the radar right now, but Vodafone should also incrementally benefit from competitors' exclusivity periods ending for Apple's iPhone in a few key markets in Western Europe. So far Vodafone has only been able to sell the iPhone in Italy.

Concerns over mature markets have overshadowed Vodafone's emerging-markets business, where we see significant upside. Developing markets generate more than 20% of the company's proportionate revenue, but less than 10% of adjusted operating profit. As Vodafone becomes more established in these markets and spends less per incremental revenue dollar to build the businesses, profitability should materially increase.

Another aspect we expect the market to eventually get a handle on is how aggressively the company has been cutting costs. They've identified £1 billion in cost savings that should be realized over the next two fiscal years and we see potential for them to increase the cost-reduction goal with the mid-year earnings release in November. In the U.S., companies' top lines are mostly horrible, but the market is rewarding them for beating earnings by cutting costs. If Vodafone starts to get similar credit, it will certainly help the valuation.

CM: Finally, and maybe most importantly, as Verizon Wireless repays debt we expect it to pay a significantly higher dividend to its joint owners by 2010 or 2011. By mid-2010, overall leverage at Verizon Wireless will fall below 1x. Even after accounting for spending to build out its 4G network, we don't see what other uses Verizon Wireless could have for its free cash flow other than a large dividend increase. Given its already leading market position, we doubt current leadership at the Department of Justice or Federal Communications Commission would allow them to make another acquisition in the U.S.

INVESTMENT SNAPSHOT

Vodafone

(London: VOD:LN)

Business: Global mobile telecommunications company providing communications services in the U.S. (in partnership with Verizon), Europe, Africa and the Far East.

Share Information

(@7/29/09, Exchange Rate: \$1 = £0.611):

Price	£1.19
52-Week Range	£0.96 – £1.48
Dividend Yield	7.3%
Market Cap	£62.59 billion

Financials (FY2009)

Revenue	¥41.02 billion
Operating Profit Margin	14.3%
Net Profit Margin	7.5%

Valuation Metrics

(Current Price vs. TTM):

	VOD	S&P 500
P/E	20.4	51.0

VOD:LN HISTORY



THE BOTTOM LINE

As growth investors rotate out of its stock, the market is not recognizing the company's Verizon Wireless stake, mature-market resiliency, emerging-market upside and cost-cutting efforts, says Curtis Macnguyen. He believes accurate recognition of the Verizon stake – prompted by a dividend – would alone result in a 50% higher share price.

Sources: Company reports, other publicly available information

What upside do you see from the current share price?

CM: The easiest way to look at it is on a free-cash-flow-yield basis. Assuming conservatively that this collection of assets deserves a 10x free-cash-flow multiple, just adequately valuing the Verizon wireless stake would result in the FCF yield going from 15% to 10%, generating 50% upside in the stock. At a 12.5x multiple – an 8% FCF yield – there’s 70% upside. And that’s just from the Verizon Wireless catalyst – everything else we consider to be free options.

Is there an argument to be made for their selling the Verizon Wireless stake back to Verizon?

CM: Verizon has said they’d like to control 100% of Verizon Wireless, but the problem for Vodafone is that an outright sale would result in a huge tax bill they don’t want. We actually think a not-unlikely outcome is that Verizon one day tries to buy all of Vodafone, which would allow them to expand outside the U.S. in addition to enjoying claim on all of the Verizon Wireless cash flows. We’re not counting on that, but it’s an interesting thing to consider.

Is Vodafone’s balance sheet in good health?

CM: The company’s leverage is in line with peers; total leverage, including the Verizon Wireless stake, is around 2.0x EBITDA.

The biggest risk here is probably the margin pressure that might result from a continued bad economy. We just think that’s more than built into the stock price at these levels, leaving us with several nice catalysts on the upside.

Describe your interest in back-from-the-brink tire company Goodyear?

Brad Lundy: Goodyear, Michelin and Bridgestone are by far the three largest global players in tires, controlling at least a majority share of most geographic mar-

kets. Goodyear is #1 in the U.S., with 23% of the market, and has a 15% share worldwide.

Goodyear’s business can be broken down into four basic quadrants. They sell both passenger and truck tires, to original-equipment [OE] and replacement customers. The passenger/truck revenue split is 75/25 and the replacement/OE split is also 75/25. In terms of the four quadrants, then, the passenger replacement business is the biggest, accounting for more than 55% of revenues. From a profitability standpoint, the replacement market has higher margins and is the real driver of the business.

As you might expect in a cyclical business, tire sales have been terrible. To cite just a couple numbers from the U.S., sales of passenger replacement tires have been running roughly 20% below normal, while sales of original-equipment truck tires are off 50% year-over-year. Adding insult to injury, Goodyear’s earnings have been hit by significantly higher raw materials costs: Because of a six to nine month lag in price changes hitting the books, this year’s first quarter showed a more than \$300 million year-to-year increase in raw materials costs, with another \$100 million rise expected in the second quarter.

INVESTMENT SNAPSHOT

Goodyear
(NYSE: GT)

Business: One of three global leaders, with Michelin and Bridgestone, in the manufacture and sale of tires, with production facilities in 25 countries around the world.

Share Information
(@7/29/09):

Price	13.89
52-Week Range	3.17 – 23.10
Dividend Yield	0.0%
Market Cap	\$3.35 billion

Financials (TTM):

Revenue	\$18.08 billion
Operating Profit Margin	1.2%
Net Profit Margin	(-3.1%)

Valuation Metrics

(@7/29/09):

	GT	S&P 500
Trailing P/E	n/a	51.0
Forward P/E Est.	11.9	16.3

Largest Institutional Owners

(@3/31/09):

Company	% Owned
Fidelity Mgmt & Research	15.0%
Eton Park Capital	9.5%
Vanguard Group	4.1%
Barclays Global Inv	3.5%
State Street Corp	3.3%

Short Interest (as of 7/10/09):

Shares Short/Float	7.1%
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GT PRICE HISTORY



THE BOTTOM LINE

The cyclically battered company is poised to show significant earnings gains as demand increases for passenger replacement tires and original-equipment truck tires at the same time raw materials costs decline, says Brad Lundy. At an 8x multiple of his \$3-per-share estimate of normalized earnings, the shares would trade at \$24.

Sources: Company reports, other publicly available information

We take it you don't think things can get much worse.

BL: We think Q2 earnings will be the low point. As long as you drive your car, you will eventually need to replace your tires, regardless of the economic environment. The important metric for a company like Goodyear is actual miles driven, which has historically been a great proxy for replacement demand. Miles driven in the U.S. are down 3-4% annually since 2007, but late last year replacement demand began falling at a mid-teens rate. That delinking over time should not exist. There have been no structural changes in tire technology that would indicate a change in how quickly tires need to be replaced.

Down the road, whether it starts next quarter or next year, you're going to see replacement demand increase rapidly. Just to make up for delayed demand, we'd expect a 25-30% increase in replacement-tire unit sales in the U.S. The dynamic is similar in foreign markets. If demand doesn't snap back, it will be because miles driven continues to decline. That number has actually turned positive in the latest month reported.

Another catalyst we see is on the truck side. The average age of trucks on the road in the U.S. is hitting a multi-decade high, to the point that sales of heavy-duty trucks could increase by 30% next year without pushing the overall average age down. We're not saying volume will rebound right away, but it eventually has to come back and when it does the upside leverage is high for Goodyear – unlike in the passenger market, sales of OE truck tires are very profitable.

The final earnings kick will come from a significant reduction in raw materials costs. Mapping out price changes in the materials Goodyear uses – synthetic rubber, natural rubber, carbon black and steel – we expect to see a 35-40% cost savings over the next 12 to 18 months. Pricing may be pressured as that happens, but not nearly to the extent of the savings – in the higher end of the market where Goodyear competes, pricing is relatively inelastic. That will be even more true if replacement demand rises sharply.

With Goodyear's shares having rebounded to around \$13.90 – from nearly \$3 in March – has the market already priced in a recovery?

CM: We believe that in a normalized environment the company can earn at least \$3 per share. Put even an 8x multiple on that, and there's 70% upside. While the materials savings are already teed up, it's obviously harder to judge when the gap between miles driven and

ON NATURAL GAS:

With supply falling and little spending to replenish it, as demand returns it's no great leap to expect prices to go up.

replacement orders starts to close or the truck cycle turns. Our best guess is for normal to return starting in 2010.

How significant is the threat of low-priced competition from Asia?

BL: Most of the Chinese competition is in the lower end of the market and they don't have the technology, dealer networks or brands to truly compete with Goodyear selling \$100-150 tires.

One potential upside for Goodyear is that the International Trade Commission has recommended that the Obama administration impose a 55% tariff on Chinese tires coming into the U.S. That would wipe out much of the roughly 20% of the replacement market Chinese imports have. Given the potential impact on the market, we're surprised this is getting so little attention from investors. But even if it doesn't happen, we don't see these guys as a direct threat to Goodyear.

The stock swoon earlier this year was driven largely by liquidity concerns. Have those been adequately resolved?

CM: When the market was in free fall, there were concerns that Goodyear

wouldn't be able to refinance \$500 million in debt maturing this year. Since then, they've raised \$1 billion through a bond offering and now have roughly \$1.9 billion in cash and a revolving credit line of another \$1 billion in place. They now have ample liquidity.

BL: They do still have \$2.7 billion in underfunded U.S. and offshore pension obligations. The cash contribution against that will be \$350 million or so this year, and likely a couple hundred million more than that next year. That's not a great aspect of the story, but we believe they have plenty of liquidity to meet those obligations and we have reflected the incremental pension costs in our \$3-per-share normalized earnings number.

Offsetting that to a certain extent is the company's ongoing overhead-cost savings initiative. They've realized \$1.9 billion of annual savings so far – by shutting high-cost plants, consolidating distribution and shifting suppliers – and have another \$550 million to go over the next three quarters. The market probably hasn't given them much credit for that, given how bad everything else has looked.

What makes sometime value-investor favorite Loews [L] interesting today?

CM: We normally don't buy holding companies trading at a discount to net asset value because you never know when that discount is going to close. But what surprised me when Brad pitched me on it was how the company had transformed itself to such a degree that we're actually able to structure our bet as an excellent way to play the cycle in natural gas.

Address the bet on natural gas first.

CM: Natural gas prices are at multi-year lows, which has set off a dramatic cut-back in industry capital spending at the same time depletion rates for the U.S. market are as high as 30%. With supply falling and little spending on tap to replenish it, as demand eventually comes back it's no great leap to expect gas prices to go up. We looked at all the publicly

traded natural gas names like Chesapeake Energy [CHK] and Anadarko [APC] in order to play that, and none were as undervalued as Loews.

Walk through how something like Loews supports that bet.

BL: Loews' three publicly traded investments are large stakes in Diamond Offshore Drilling [DO], an oil-and-gas services firm, Boardwalk Pipeline [BWP], a natural gas pipeline, and CNA Financial [CNA], a casualty insurance company. The private investments are HighMount, a large natural gas exploration and pro-

duction company, a general-partner interest in Boardwalk Pipeline, and various other investments, including the Loews hotel chain. There is also about \$4 per share in cash on the books.

We're not interested in CNA Financial, so have shorted that out. Diamond Offshore has moved up significantly from the market bottom, so we've shorted that out as well. That leaves us with the non-public assets – the most important of which is the holding in HighMount – and the public stake in Boardwalk Pipeline, a stable regulated business operating with take-or-pay contracts that currently pays close to a 9% dividend yield.

How are you valuing the pieces you effectively own?

BL: At a conservative \$2 per proved Mcf in the ground – publicly traded comps go for closer to \$2.50 per Mcf – the HighMount stake is worth \$6-7 per share. The public Boardwalk shares are worth another \$6 per share. The GP interest in Boardwalk is worth another \$1 per share, as is the hotel group. Add in the \$4 per share in cash, and we're getting almost \$20 per share in value for roughly \$5 per share after netting out our shorts.

Just for kicks, how does your estimate of net asset value per share compare with Loews' current share price of \$29?

BL: We think the whole thing has a net asset value in the low-\$40s. That discount isn't nearly as interesting as the one for our trade, but it's still more than you'd expect given the track record of the Tisch family in running the company. They've delivered a compounded return to Loews shareholders since 1981 of nearly 19%, which is more than twice the return on the S&P 500 over that time. They've proven time and again they'll act to recognize shareholder value over the long term. You could argue that track record is worth a premium to net asset value.

You've done well with a relative-value trade of going long money-center banks and short regional ones. Describe the original thesis behind the trade.

Avery Son: Market valuations for smaller regional banks held up surprisingly well in 2008, despite the turmoil in the credit markets. When we first put this trade on in December, the regional banks we shorted were down just 5% year-to-date, on average, and were trading at a price/tangible book multiple of 2.6x. In comparison, the long side of the trade – which at the time consisted of just JPMorgan – was down 33% year-to-date and traded at just north of 1x tangible book.

The consensus view at the time was that these regional banks had minimized their exposure to the problematic loan

INVESTMENT SNAPSHOT

Loews

(NYSE: L)

Business: Holding company controlled by the Tisch family with primary assets in energy exploration, development, services and distribution, as well as insurance.

Share Information

(@7/29/09):

Price	28.98
52-Week Range	17.40 – 49.32
Dividend Yield	0.8%
Market Cap	\$12.61 billion

Financials (TTM):

Revenue	\$12.70 billion
Operating Profit Margin	11.4%
Net Profit Margin	25.4%

Valuation Metrics

(@7/29/09):

	L	S&P 500
Trailing P/E	4.2	51.0
Forward P/E Est.	7.2	16.3

Largest Institutional Owners

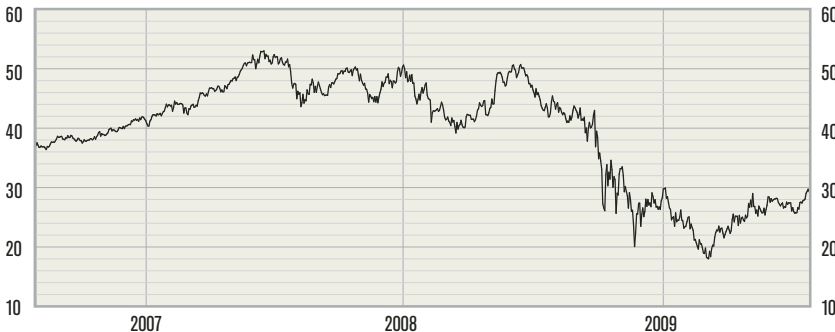
(@3/31/09):

Company	% Owned
Davis Selected Adv	11.2%
NWQ Inv Mgmt	3.6%
State Street Corp	3.1%
Neuberger Berman	3.1%
Barclays Global Inv	2.9%

Short Interest (as of 7/10/09):

Shares Short/Float	1.1%
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L PRICE HISTORY



THE BOTTOM LINE

After shorting out its exposures to insurance and oil-and-gas services, Curtis Macnguyen believes the company's stock is an excellent way to play an eventual rebound in natural-gas prices. He estimates that the remaining assets to which he's exposed are on a normalized basis worth nearly four times the effective price he's paying.

Sources: Company reports, other publicly available information

areas plaguing money center banks, such as residential mortgages and consumer finance. They also had largely avoided investments in the toxic securitizations like CDOs and non-prime mortgage-backed securities on which big banks were taking huge writedowns.

Our basic thesis was that the relative valuation discrepancy between money-center and regional banks was a result of the incorrect assumption that consumer and non-consumer credit cycles occur concurrently. In fact, we saw huge looming credit issues with non-consumer loans, to which regional banks were relatively more exposed. That led us to establish short positions in a basket of small regional banks against long positions in selected money center banks.

The trade is working, as shares of money-center banks have outperformed so far this year. Is the thesis still intact?

CM: Yes, although rather than the original balanced trade, we're now more short the regional banks than long the money centers. The big banks have raised capital and there are tentative signs of stabilization in consumer credit trends.

The alpha is more likely to be on the short side going forward. The deterioration in non-consumer credit we're playing for – which will disproportionately hit the regional banks – should really start to accelerate this quarter and is likely to grow into next year.

Describe the characteristics of the banks you're long and the banks you're short?

CM: On the long side, we currently own Bank of America [BAC], SunTrust [STI] and JPMorgan [JPM]. Roughly two-thirds of their lending exposure is consumer and one-third commercial – in the form of construction and development (C&D), commercial and industrial (C&I) and commercial real estate loans. In the highest-risk segment of the market, C&D loans, these banks grew their exposure roughly 15% per year as the credit bubble inflated from 2005 to 2007.

On the other side of the trade, we're

short a basket of around 20 banks with market caps between roughly \$1 to \$2 billion. We have avoided the super-regionals primarily because the shorts tend to be all over them and because the valuations already reflect credit concerns. For the banks we're short, around 65% of their lending exposure is non-consumer. For such supposedly less-aggressive banks, they grew the riskiest parts of their loan book extremely quickly – their C&D loans compounded at 28% per year from 2005 to 2007.

The valuation spreads have narrowed, but our shorts still trade at an average of 1.9x tangible book, vs. 1.6x for JPMorgan, 1.2x for B of A and 0.8x for SunTrust.

Why are you so negative on non-consumer loan quality going forward?

AS: Among the variety of questions in its regular survey of senior loan officers, the Federal Reserve asks whether the lenders are tightening or loosening underwriting standards. We've found that historically there is a strong correlation, on a lagged basis, between the survey responses and the level of non-consumer loan charge-offs. For example, when the officers say they are tightening C&I lending standards, roughly 12 months later C&I loan chargeoffs start to rise. The lag is a bit longer for commercial real estate loans, closer to 18 months. As we tracked the survey results over the course of 2008, we

INVESTMENT SNAPSHOT

Long Money-Center Banks/Short Regional Banks

Betting that regional-bank stocks will fare poorly relative to their money-center counterparts, Ivory Capital has employed a relative-value trade: long JPMorgan, Bank of America and SunTrust, and short a basket of 20 smallish regional banks.

Representative Long

Bank of America (BAC)

Share Information

((@ 7/29/09):

Price 13.52
52-Week Range 2.53 - 39.50

Proxy for Shorts

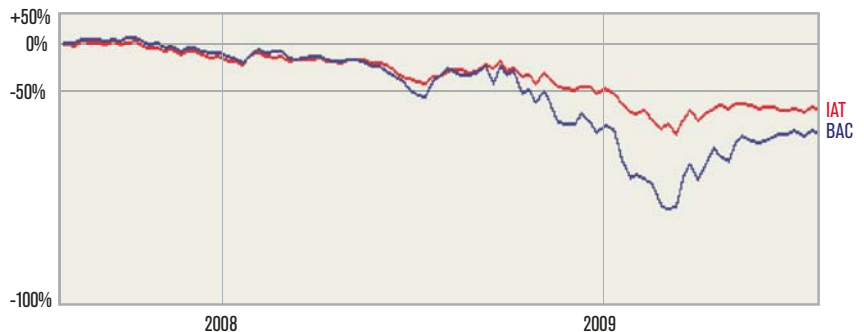
iShares/DJ US Regional Banks (IAT)

Share Information

((@ 7/29/09):

Price 18.29
52-Week Range 10.86 - 42.00

BAC VS. IAT PRICE HISTORY



THE BOTTOM LINE

With higher valuations and greater exposure to increasingly shaky non-consumer credit areas, regional-bank stocks should underperform those of money-center banks regardless of the economy's course, says Curtis Macnguyen. He believes his basket of shorts could reach a trough valuation of 1x tangible book value, from 1.9x today.

started to see these metrics hit trough levels, which implied we were going to see a real down cycle in non-consumer areas in 2009. The more recent survey results just confirm that the problem is likely to extend into next year.

Where can you imagine regional-bank valuations going?

CM: As the reality of the non-consumer credit cycle hits, we wouldn't be surprised to see the group trade closer to a historical trough valuation of 1x tangible book. We also believe several regionals will find they're short of capital as losses develop. When we apply the parameters of the government's stress test, roughly one-third of the banks in our basket look like they need material additional capital. One already did a raise, after which we covered that particular short.

You've written about putting considerable effort into making your research and analysis processes more efficient. What have you done?

CM: We've tried to set up an internal system that makes all of the blocking and tackling easier and allows real-time access to all information on prospective and existing positions. Every idea has to be logged in, showing the working thesis and the relevant financial information or models we have so far. One of my jobs is to screen the initial theses to make sure we're focused on the right ideas. Someone may come up with a sum-of-the-parts idea that I've been pitched many times over the years and nothing has ever happened, so I'll kill it before the analyst spends a month on it. Because we're proactive in managing spread risks, we may also put on the back burner certain ideas that increase exposure to a particular factor. The system is open to the entire team, so we're constantly learning from everyone's insights and also their mistakes.

At the end of the day you have to have the DNA to make the right risk/reward assessments, but the more systematic you can make the investment process, the more time you can spend on trying to generate alpha.

Has anything about the past 12 months in the market surprised you?

CM: I wouldn't say it was a surprise, but we have been reminded how tough it is to create absolute returns in a macro-dominated market. We make money when our longs go up and our shorts go down, but if everything is highly correlated and moves exactly the same way – as was the case from September to March – it's tough to generate alpha. As I said earlier, it's important to be patient and pick your spots in these types of markets, which I think we've done quite well.

A lot of what has happened has just reinforced how important it is to minimize unintended bets. Long/short funds typically don't blow up because they made a bunch of wrong fundamental stock picks. They blow up because they're overexposed to correlated sectors, or they own too many leveraged companies, or they have too many illiquid positions. These are "explanations" you see all the time in funds' letters to investors. That's exactly what we try to avoid. **VII**