Eidelman Capital Management

Quarterly Letter — March 2009

Dear Clients & Friends,

The first quarter of 2009 was another wild one for the financial markets. It seemed every day the market either plunged on bad economic news or surged as the government announced a new rescue program. At the low, the S&P 500 dropped 26% to 675 as blue chip companies General Electric, Bank of America, and Citigroup dropped to unprecedented low levels. Just as it seemed there was no hope in sight, the market rallied back 8.5% in March, recording its best monthly performance since 2002. Despite the March surge, the S&P 500 finished the quarter down 11.7%.

Everyone I talk to wants to know: What do all these new government initiatives (TARP, TALF) mean for the economy? Is all this government spending going to cause inflation? And most importantly, What should I do with my stock market investments? I'm going to answer these questions in the next section entitled "Q&A," but I want to give you the punch line right now. No matter what economic, government, or macroeconomic events occur, we firmly believe that the most prudent course of action is to focus on buying great individual investments.

The more fear clouds investors' moods, the more bargain opportunities exist. The market has now declined so much that some companies are trading for less than two-thirds of their liquidation value. We have purchased some of these companies using an investment strategy which I will explain further in the section called "The Return of Benjamin Graham."

We are also finding bargains in the bond markets. Two issues which we recently bought for our clients are Nuveen Auction Rate Preferred Securities (ARPS) and SLM Senior Notes 6% 2043 (Sallie Mae Student Loan Company). We believe both issues are priced to return in excess of 20% annually with excellent downside protection. As the economy continues to weaken, we expect to find even more value opportunities in the credit markets.

We don't want to sugar coat the current economic situation. There are valid concerns surrounding the state of our financial institutions, auto industry, and capital markets. There are even big problems that haven't been talked about as much like underfunded pension liabilities and weakness in commercial real estate. But even in light of these challenges, we truly believe that a diversified portfolio of undervalued stocks and bonds will provide the best avenue for wealth accumulation over the coming years.

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Looking at the big picture of stock market history, the best times to invest have been when valuations were low, investor sentiment was pessimistic, the economy was in recession, and there were few new IPOs being offered. In short, the best time to buy was when nobody wanted to invest in stocks. While we cannot predict the market bottom, stocks are near their cheapest valuations in 20 years, the consumer sentiment index is at an all-time 40-year low, the economy experienced its largest contraction in 27 years, and in the first quarter of 2009 the global IPO market set a new record low for number of new deals sold since 1995. By our measures, the market is currently experiencing pessimistic sentiment and favorable valuations. If history repeats itself, these factors indicate above average investment returns for the future.

Sincerely,

Tom Eidelman
Vice President

QUESTION & ANSWER (Q&A)
WITH TOM EIDELMAN

What does the stimulus plan mean for the economy?

The stimulus funds will probably help the economy in the short run, but bring down long-term growth. This is a tradeoff that the government is willing to make. Due to the stimulus, the congressional budget office (CBO) estimates economic growth (GDP) to be a couple percent above what would otherwise be for 2009 & 2010, but act as a small drag on growth beyond 2014. The main benefit is on employment, where the CBO estimates an additional two million jobs will be created or saved per year through 2011 due to the stimulus.

What is TARP? Will it help the banks and the credit markets?

The TARP program is a $1 trillion investment in banks and complicated credit investments. Like any investment, the outcome is uncertain, but the goal is to earn a good return. It is possible that the government could actually make money on these investments, but more likely, they will lose a small percentage.

The reason the government implemented these programs in the first place is because private investment wouldn't buy bank shares or "toxic assets" at offered prices. If nobody in the private sector would buy them, we think it's because they didn't offer a good perceived return on investment.

The beneficiaries of TARP funds will be bank employees and bondholders. Bank common stock shares will slightly benefit because banks will be less likely to run out of money in the short run, however, the success of a financial company's stock will be determined by what percentage of their loans go bad and not by how much assistance they receive from the government. For this reason, we are only investing in financial stocks with a high capitalization ratio, with few bad loans, and trading at a reasonable price.

Is all this government spending going to cause inflation?

The short answer is: Not now, but maybe later.

There is much concern that our government has spent so much money that we'll never be able to pay it all back without just printing more money and thus causing inflation.

Let's look at the numbers and see if this is a valid concern. The gross national debt is roughly $11 trillion or $100k per household. The U.S. budget deficit is estimated to add an additional $1-2 trillion per year to the total. These debt levels may sound insurmountable, but before we sell all our dollars and buy gold, let's compare this debt load with historical levels and with other countries.

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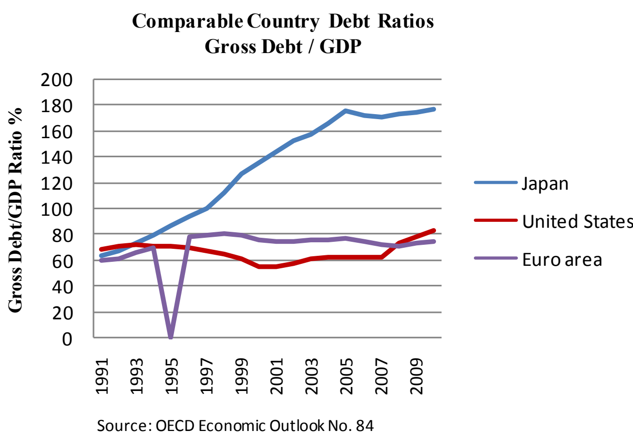
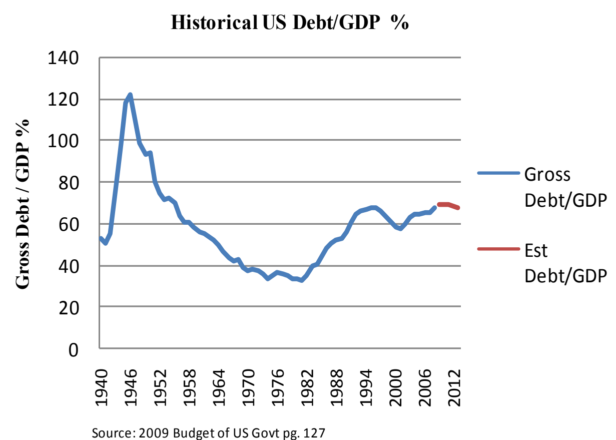
Since our economy is much bigger than it was in the past and is significantly larger than other countries, the best way to compare debt loads is to calculate it as a percentage of total economic output (GDP). The current national debt represents 78% of GDP. While our debt is at an elevated level, we believe it is still manageable. The two key reasons we believe this are:

- Japan's Debt/GDP ratio is currently twice that of the U.S. and has grown from 88% to 170%, and they have actually experienced deflation over this time period. See Chart A.
- U.S. Debt/GDP level was 120% during WWII, and we were able to bring it down. See Chart B.





While current debt levels are manageable in the short run, the country faces some daunting budgetary challenges in the longer term, specifically, the promised benefits under the current Medicare and Social Security entitlement programs. In the long term, these programs are a bigger concern than current national debt and deficit levels. While these long-term challenges will need to be solved, we believe the current debt level is manageable and will not cause a dramatic increase in inflation in the near term.

What's the bottom line? How should we invest?

Because macroeconomic outcomes are nearly impossible to predict, at the end of the day, we take the approach that anything can happen. The success of our investments will not be determined by whether the economic stimulus plan works or not, we see inflation vs. deflation, or the TARP plan jumpstarts lending. While we incorporate all these factors into our analysis, in the end, we select individual investments which we believe are trading below their intrinsic value. Investing in a diversified portfolio of such value investments will give us the best chance of achieving superior investment returns.

THE RETURN OF BENJAMIN GRAHAM

Benjamin Graham (1894-1976) is considered the father of "value investing" and one of the greatest investors of all time. Graham accumulated a compounded annual investment return in excess of 21% from 1936-1956. He taught and mentored numerous successful investors, including Warren Buffett, who went on to equally impressive investment careers and attribute much of their success to the value principles of Benjamin Graham.

As I studied Graham, I was surprised to find out that his favorite and most profitable strategy for picking stocks stemmed from a pretty simple formula. After first learning about it, I couldn't wait to get to work and research stocks that met his criteria. To my disappointment, I discovered that no such stocks passed his test anymore. He lived in a different time when stocks were cheaper. I thought: here's an investment formula that earned 20%+ investment returns for 50 years, but since stocks no longer traded at such cheap levels, the formula was antiquated….that is, until now.

Due to the severity of the recent market decline, there are now many stocks that pass the Graham screen. While only a starting point for our analysis, we believe Graham's philosophy and formula may prove to be just as profitable as in the past.

So what were the principles that Mr. Graham practiced? What was his magic formula? And can we really employ them to attain investment success in today's market?

Margin of Safety

Graham said the secret to sound investment is obtaining a "margin of safety." A margin of safety refers to the difference between the price paid and what price an investment should be worth. Because fair value is difficult to accurately compute, the margin of safety gives the investor room for error. It also protects the investor from both poor decisions and downturns in the market.

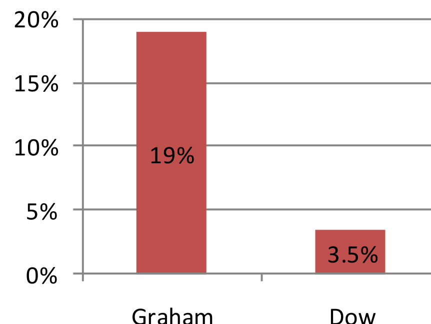
The Secret Formula:
Buy at a Discount to Liquidation Value

To evaluate the true worth of a company, Graham used the liquidation value approach. He reasoned that the value of a company is at least worth the money raised by hypothetically going out of business, selling all assets, and paying off all debts. As a calculation, it is current assets minus total liabilities, giving no credit to a company's fixed assets like property and equipment.

Graham's favorite formula was to buy stocks trading below two-thirds of the company's liquidation value, thus providing the desired margin of safety.

Graham said. "It always seemed, and still seems, ridiculously simple to say that if one can acquire a diversified group of common stocks at a price less than the applicable net current assets alone-after deducting all prior claims, and counting as zero the fixed and other assets, the result should be quite satisfactory. They were so in our experience, for more than thirty years. We must have earned an average of some 20 percent per year from this source."

Graham also conducted a 50-year research study from (1925-1976) and found that stocks that met his criteria earned an average of 19% per year before dividends compared to 3.5% for the DJIA (7.5% including dividends). See Chart.



Applying Graham's Approach Today

We believe Graham's value principles are still relevant today. Since 1999, stocks that met his criteria returned an average of 28% annually (see chart). It must be noted that there were few stocks available and thus those returns would have been hard to attain in the real world. What excites me most is that right now there are 76 companies—more candidates than have existed for 10 years and enough ideas to be selective and pick our favorites.

Benjamin Graham's Formula Stocks

Date	# of Stocks	12-Month Return	
		Graham	S&P 500
Dec-99	9	68%	24%
Dec-00	19	-3%	2%
Dec-01	35	27%	-8%
Dec-02	57	15%	-19%
Dec-03	15	90%	35%
Dec-04	9	96%	16%
Dec-05	8	16%	10%
Dec-06	6	-2%	17%
Dec-07	9	5%	7%
Dec-08	40	-28%	-39%
Mar-09	76	?	?
Avg	**26**	**28.3%**	**4.5%**

Graham Stocks = Stocks trading below liquidation value

Liquidation Value = (current liabilities minus total liabilities)

Taking Graham to the Next Level

The Graham formula is only a first step. It puts some great candidates on our radar so we can then follow up with rigorous analysis of each individual company. While just the start, we need analyze the quality and quantity of assets, free cash flow and earning power, and industry competitiveness. We believe combining Graham's philosophy with our experience and research will uncover some great investment opportunities.

Here are two examples that might interest Graham today:

Hardinge (HDNG) $2.79

Hardinge manufactures machine tools, specializing in high-precision, computer-controlled, metal-cutting machines. The company's products are distributed to most of the industrialized markets around the world, and in 2008 approximately 69% of sales were from outside of North America. The recent drop off in industrial demand has resulted in a 4th quarter sales decline of 21%, orders declining 51%, and a 2008 EPS loss of $1.12 compared to a $1.41 gain for 2007. Clearly the near term earnings outlook is not rosy, and analysts estimate HDNG to lose another $.20 per share in 2009. But what about their assets and long term outlook? HDNG has a large tangible book value ($13.65), including $8.20 in liquidation value and very little net debt. The stock currently trades at a substantial 65% discount to Graham's liquidation value calculation.

PC Connection (PCCC) $3.80

PC Connection is a direct marketer of a range of IT products including Computers, Network Equip, Peripherals, etc. PCCC experienced a slowdown as 4th quarter sales declined 10% year over year. However, they remained profitable even in the tough 4th quarter and earned a respectable $.56 per share in 2008. This year appears tougher as analysts expect them to only earn a small profit of $.20 per share. PCCC has a tangible book value of $6.85, including a net current asset value of $6.00, which includes a nice sum of cash in the bank ($47m) and little debt. At the current price, PCCC is trading at a 35% discount to liquidation value.

Conclusion

Everything old is new again. Thanks to the recent market decline, a record number of companies pass Benjamin Graham's strict value screen. This strategy has yielded extraordinary investment results and presents a great opportunity to take advantage of the currently depressed market.