Eidelman Capital Management

Quarterly Letter **September 2008**

Dear Clients & Friends,

It has been a wild ride in the stock market and there is a lot to talk about. I'm going to start with some commentary on recent market action, then explain the root cause of the "credit crisis" and how we plan to capitalize on this opportunity, and finally provide a brief analysis on China and what was behind our timely and profitable investments in the China UltraShort Index (FXP).

The S&P 500 stock market index lost 9% in the 3rd quarter, ending with one of the market's most volatile months ever. A slew of bankruptcies, including Lehman Brothers, Fannie Mae, AIG, and Washington Mutual, have shaken investor confidence. Congress rushed to pass a $700 billion bailout plan to add liquidity and confidence to the credit markets. While such measures may do the trick, we believe the record volatility will continue. Fortunately, such volatility plays right into our strengths of individual stock selection.

Our strategy of investing in companies with strong free cash flow, positive momentum, and low valuations helped avoid owning all of the above financial companies. We were skeptical of their extraordinarily high returns on equity (ROE), high debt levels, and complex balance sheets. Much of their business is what we call a "black box," which means they make much of their money using "proprietary trading," or other intentionally opaque methods to protect their secret money making machine.

Our special situations fared well over the last quarter, benefiting from our negative outlook on oil and China. In last quarter's newsletter, I discussed the meteoric rise in oil and how we were positioning to benefit from a potential decline in the price of oil. Surprisingly, oil dropped even faster than we anticipated, falling from $145 to under $100 a barrel. As a result, analyst earnings estimates for American and Continental Airlines have been dramatically increased. We also took advantage of the bursting stock market bubble in China by buying the FXP, the UltraShort China ETF on 8/8/08. I will go into more detail later.

Historically, we have thrived in volatile and down markets because we place emphasis on value and capitalize on inefficiencies in the market as they arise. Right now, we believe the baby is being thrown out with the bathwater, resulting in some great companies trading for extremely attractive prices. It is in times like these where we plant the seeds of future winners.

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So what are our latest and greatest investment ideas? We are interested in strong regional banks and other financial companies that will benefit from the above big financial firms going out of business. There are also assets that are being indiscriminately sold by these troubled firms that we are looking to opportunistically buy. I will expand on this further in the next section called "The Credit Crisis Opportunity."

We realize these are unnerving times for investors, but such conditions have historically been the best times to invest. Our favorite sentiment indicators including percentage of bullish investors, consumer confidence, volatility index, and mutual fund cash ratios are all indicating peak levels of pessimism. Such indicators combined with low valuations give us optimism for our future investment returns. We urge all our clients to keep a long term perspective as we capitalize on the current turmoil to best position for future investment success.

Sincerely,

Tom Eidelman
Vice President

THE CREDIT CRISIS OPPORTUNITY

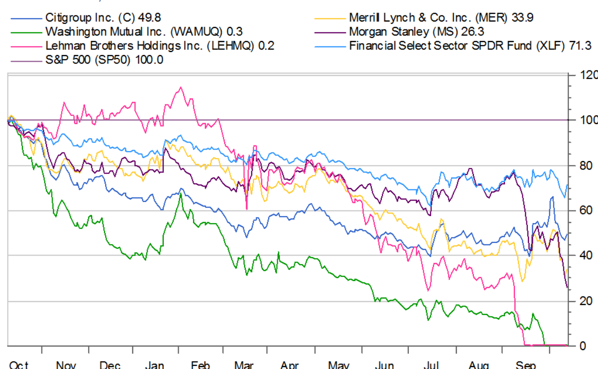
BY TOM EIDELMAN

There is an old expression, "If you owe the bank a thousand dollars, that's your problem. If you owe the bank a million dollars, that's the bank's problem." While most banks are facing difficulties from a lousy real estate market and soft economy, banks with lots of leverage and subprime loans are in big trouble. With many investors selling their stocks and bonds indiscriminately due to fear surrounding the credit crisis, we are looking to capitalize by: 1) buying mortgage-backed securities (MBS) and 2) buying "good" banks. First, let me explain what created this opportunity.

Subprime + Leverage = Big Trouble

Investment banks including Bear Stearns and Lehman brothers employed loads of debt to buy mortgage-backed securities (MBS), including subprime mortgages. From their Feb 2008 10-K SEC filing, Lehman leveraged up more than 35 times to buy $786.4 billion worth of MBS (including subprime and other assets) with only $21.8 billion of common equity. When the value of these MBS declined just 3%, their entire net worth was wiped out and Lehman was forced to declare bankruptcy. Chart A shows a group of the most heavily leveraged companies compared to the Financial sector index (XLF).

Chart A



Domino Effect

So what happens when big financial institutions like Lehman Brothers go bankrupt and are forced to sell billions of dollars of mortgage-backed securities (MBS) in the open market? The price of these MBS falls dramatically. This fall in price then impacts other banks like Washington Mutual because they own the same assets. Washington Mutual is then forced to liquidate many of their MBS assets causing the whole process to repeat all over again.

MBS Opportunity

Because of forced liquidation or fears of a potential bankruptcy, many financial firms are scrambling to raise cash. Many mortgaged backed securities (MBS) are being sold by these troubled financial companies with little regard to price. In some cases, there are AAA mortgage assets being sold at garage sale prices because there are so many companies trying to unload them, few buyers, and urgency to get rid of them.

While many of these MBS are complex, we are scrounging through the prospectuses for a diamond in the rough. We believe these assets at the core of the credit crisis may represent some of the best buys.

Alt-A Example

One such example is a formerly AAA-rated residential mortgaged-backed security (RMBS) consisting of Alt-A mortgages. Alt-A mortgages carry less risk than subprime but more than conventional mortgages. One particular RMBS bond trades for 70 cents and has 8% credit protection, which means this bond will only start to lose money after the lower tranches take the first 8% of losses.

But such losses would only occur if the bond is bought at 100. At 70, investors get another 30% credit protection plus all the interest accrued before losing any money.

So what would have to happen to lose even one penny on this investment? 72% of all loans would have to default, with a loss severity of 50% on each default. This is an Armageddon type scenario which we do not think is possible. With only 5% of the whole MBS currently 60 days or more delinquent, we believe this bond will likely get paid in full and pay 10% while we wait. If such a bond rises to say 90 in 5 years as the credit crisis abates, investors could achieve a 15% annual return over 5 years with very little risk.

Good Banks at a Great Price

Another potential opportunity is buying "good" quality banks. With hundreds of banks littered with subprime and construction loans, some investors are panicking and indiscriminately selling ALL of their financial stocks driving down the prices of even the "good" banks. What do I mean by a "good" bank? A solid bank has a diversified portfolio of loans and operates in areas with a stable economy and real estate market. As a result, they should have low levels of non-performing loans and charge-offs. We are looking to buy "good" banks at great values.

One example of a "good" bank at a low price is Pulaski Bank (PULB, $8.00) here in St. Louis. Pulaski has been one of the most profitable and fastest growing banks in the country, growing earnings in excess of 17% a year for 10 years. We met with the CEO and CFO and feel they have a solid grasp of their loan portfolio and have a track record of selling out banks at big premiums to book value. With a proven track record, strong franchise, and a relatively low percentage of non-performing loans, we believe Pulaski shares deserve to trade at a significant premium to its $7.50 tangible book value.

Summary

We are working hard to capitalize on the fear permeating the financial industry. Specifically, we are looking to buy discounted mortgage-backed securities (MBS) and good quality banks that others may have fearfully sold with little regard to price. We are confident that if we stick to our investment principles, these and other ideas can help us achieve superior investment results.

BEIJING OLYMPICS 8-8-08

What is the FXP?

Our investment in the China Ultrashort Index (FXP) was unorthodox, but extraordinarily successful. Similar to the Dow Jones Industrial Average in the US, China has a Xinhau Index made up of China's 25 biggest companies. The FXP is called the "UltraShort" index because when the Xinhau 25 goes down 5%, the FXP index goes UP 10%. In other words, it performs twice the opposite performance of the China Index. This FXP investment allowed us to profit when the China stock market bubble popped.

We hold our typical investments at least one year because it usually takes at least that long for our investments to appreciate up to our estimate of fair value. What made our FXP investment unique was that in just two months we bought, sold, and profited three different times! So what was behind our three profitable trades in the FXP and why did we think China's stock market was riding for a fall?

The Bull in China

For the last 20 years, China has experienced unprecedented economic growth. China's economy has grown at a compounded rate of 10% versus only 3% for rest of the world. This boom started in 1978 when China began to make major reforms to its economy after decades of economically devastating communist policies. The Chinese government has continued to progress towards social and economic freedom by opening up to foreign investment.

Tom & Rob travel to China

Intrigued by China's economic growth and rich cultural history, Rob Bertman and I traveled to China for 3 weeks in the summer of 2006. We could see that the economic growth was real and nearly everyone there was proud and excited. The cities were bustling, the skyline was full of construction cranes, and everyone was talking about the coming Olympics.

When we returned from China, we researched many Chinese companies. Unfortunately, we thought the price for these stocks were too high. The China index had already doubled in the previous year was trading at 20 times earnings, a premium to its historical average and to the rest of Asia's stock markets. We decided not to invest.

The China Bubble

The Chinese stock market proceeded to skyrocket. The China stock index soared from $25.80 the day we got back from China to a high of $71.00 just over a year later, a whopping 175% return. Well, if we thought China stocks were too over priced in 2006, we thought they had reached bubble proportions in 2007 (See Chart A).

Chart A

Here are some facts on the Chinese stock market in October of 2007:

- The Chinese stock market was the most expensive stock market in the world trading at 48 times earnings and 6.4 times book value.
- China led the world in initial public offerings (IPOs), raising more than twice that of the U.S.
- The average first-day return for Chinese IPOs was 192%
- Chinese A-shares, restricted only for mainland investors, traded at a 40% premium to Hong Kong-listed H-shares of the SAME companies.

Just Plain Silly

The news coming out of China was outrageous. There were reports of Chinese investors picking stocks based solely on having the lucky number "8" in their cusip trading symbols. IPO trading gains became so routine that one CEO of a major Chinese company grumbled when his company rose only 87% in its debut. "The stock price was within expectations, but I'm not totally satisfied," he said. Also, a local Chinese employment agency reported that 10% of maids in Shanghai resigned because they made more money trading stocks.

Hearing the Bell Ring

There's an old expression that "they don't ring a bell at the top" of a stock market. While we believed last year that the China market was extremely overvalued, we were still concerned that it could go even higher. What we needed to know was *when* the China market would hit its peak and when investor sentiment would be the most optimistic.

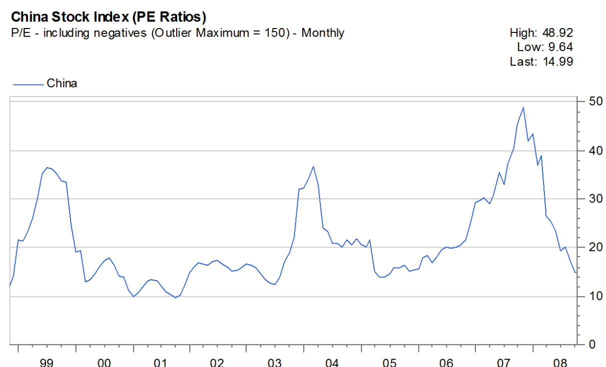
The answer was staring us right in the face: 8/8/08 at 8:08 pm. It was our belief that the Olympics was the event that everyone was looking forward to. It was the catalyst for building hundreds of new hotels, restaurants, highways, and trains. It was our hypothesis that after the Olympics, enthusiasm as well as real investment would fade.

The Party Ends

After the Olympics, the Chinese economy and stock market underwent a steep decline which is still continuing as I write this letter. Since China is one of the biggest consumers of steel, copper, oil, shipping, and other commodities, world demand for all of these commodities has dramatically declined as well.

The Chinese stock market has now declined to 15x earnings (See Chart B), which we believe is close to fair value. While the China economy may continue to deteriorate, we are content to sell our FXP investment after profitably milking it three different times.

Chart B



Summary

While unorthodox, our investment in the FXP allowed us to profit from the Chinese stock market bubble during one of the most tumultuous times in US stock market history. We will continue to work hard to find and implement such ideas to add additional performance to your portfolios.