Dear Clients and Friends,

The S&P 500 index recorded another 5.5% gain in the third quarter, bringing the year-to-date S&P 500 gain to 19.5%. Despite concerns around Federal Reserve "tapering", looming U.S. debt ceiling, and the U.S. government shutdown, the stock market continued higher. The combination of good economic news and inflows from low-interest rate bearing fixed income accounts continues to drive equity prices upward. A common statement we hear from clients is: "the soaring stock market doesn't seem to make sense in light of a mediocre economy." The reality is U.S. economic fundamentals continue to improve. Household net worth, corporate profits, consumer confidence, housing prices and manufacturing have been hitting new highs every month. Continued unemployment declines, narrowing U.S. budget deficits, low inflation, and low interest rates have contributed to a good stock market environment. We still view U.S. stocks as the most favorable area to grow wealth in the long run and we are confident that our analysis and portfolio selection can construct portfolios that give our clients the best chance for success.

On October 9th, President Obama nominated Janet Yellen to succeed Ben Bernanke as the next Chairman of the U.S. Federal Reserve. Since Federal Reserve policies have driven interest rates to record low levels and thus driven stocks and other assets to new highs, a new chairperson is worthy of discussion. The bottom line is that Yellen will continue those policies initiated under Bernanke. Yellen said back in April "I believe progress on reducing unemployment should take center stage" for Fed policymakers "even if maintaining that progress might result in inflation slightly and temporarily exceeding 2%" – the Fed's target rate. In other words, the Federal Reserve will continue its low interest rate policies further into the future. Such policies will continue to support current stock valuations and may drive them even higher.

While stock valuations now trade above their historical average (currently 18x vs. 50-year Value Line median of 16x), we believe low inflation and interest rates justify current levels. Warren Buffett was also recently quoted saying "stocks are more or less reasonably priced." In such times, it is more important than ever to find companies with good competitive positions, clean balance sheets, and strong management teams at reasonable valuations.

In this letter, I'm going to discuss how we evaluate management incentives to help find investment winners for our clients. I'll show that companies with significant executive stock ownership, insider buying, activism, and strong management execution have outperformed over time. Our ideal situation is to find a company with a great product or service that has languished under poor management, but just hired a new CEO who "gets it." If a new incentivized CEO with a proven track record takes the reins and institutes a high performance culture, often times the company's earnings and stock price jumps to new highs.

There are always opportunities in the market and we will continue to work hard to take advantage. We remain optimistic that executing on our investment philosophy will give us the best chance to help our clients achieve their financial goals. If you have any questions, comments, or topics you would like discussed in future quarterly letters, please email me at tom@eidelmanvirant.com.

Sincerely,

Tom Eidelman, CFA
Vice President

INCENTIVES MATTER… A LOT

A key component to the Eidelman Virant investing philosophy is that incentives matter… a lot. Company management often does what they are incentivized to do. In other words, if they get a big bonus to grow sales by 10%, they will do their best to grow sales by 10%. We want to make sure that management interests are aligned with shareholders because stocks in such companies have outperformed in aggregate over time.

Large Insider Ownership

The best alignment of interest and incentives is when a company's management owns a significant amount of stock far in excess of what they earn in salary. This ties their success directly to that of the shareholder. If the stock price does well, we all do well. This is most pronounced in owner operated companies because the founder often still owns a significant amount of the company. Horizon Asset Management did a study and found that 18 of the 20 companies in the S&P 500 that were owned and operated by the founder outperformed the S&P 500 index by 12% per year. To show how little their salary affects these owners, look no further than Apple's CEO, Steve Jobs, who paid himself an annual salary of just one dollar. Clearly, his financial motivation came from his ownership of 5.5 million shares worth about $2.75 billion today of which he never sold one share. Even if a company isn't owned and operated by the founder, we look for top management to have their net worth heavily invested in the company they run.

Insider Buying

Likewise, we look for companies whose top management are actively buying more of their company's stock. The SEC requires company management to report all purchases and sales of company stock. We scour these reports for potential investment ideas. As Wall Street legend Peter Lynch said: "Insiders might sell their shares for any number of reasons, but they buy them for only one: they think the price will rise." Company management who has been through good times and bad, has the best understanding of their market and competitive position, and a thorough understanding of their corporate valuation buys when they think the stock will rise. Historical backtesting shows that investing in such stocks where insiders were buying significantly outperformed the market. See Chart A.

Chart A: Insider Buy Stocks Outperform

Activity	Return	Market	Difference
Insider Buys	26.3%	7.1%	19.2%
Insider Sells	4.9%	5.3%	-0.4%

Source: InsiderScore evaluated 5,095 buy inflections and 3,395 sell inflections from Jan' 04—Mar '12 for all non-financial companies. Market is performance of ETFs excluding financial companies.

Activism Unlocks Value

Another ownership group whose incentives align with shareholders are activists. Activists are funds that look for undervalued companies, purchase sizeable positions, and use their influence to enact material change in the company. Their influence can force tough decisions such as closing or selling divisions, changing management, or even putting the whole company up for sale. Studies have shown that when activists get involved, future returns are increasingly favorable. A study by S&P Capital IQ concluded that twelve months after the disclosure of activist involvement, the strategy produced an average excess return of 14%.

Red Lion Hotels (Ticker: RLH) owns, operates, and franchises 52 midscale hotels throughout the Pacific Northwest. RLH has operated inefficiently around the breakeven level for the past few years and has consequently seen its stock sink below the value of its real estate liquidation value. The entire market value of Red Lion hotels is now $100m, while their most valuable Bellevue, WA property has been appraised at $40m alone. To realize the value, real estate activist Columbia Pacific acquired a 28% ownership stake and voted in new board members who have since instituted management changes with the goal to turn around the company and potentially sell it at a higher price. We think they will be successful.

CEO changes

New management can come in with a fresh perspective, mandate for change, and often implement strategic initiatives resulting in better execution and positive results. On average, stocks of companies that replaced their CEO's have outperformed the market by 5.3% in the subsequent year in developing countries from 1987-2011. These companies also saw improvement in ROE and ROA in their first three years under new CEOs.

A recent example we encountered was struggling technical services company Furmanite (FRM). When newly appointed CEO Charlie Cox met us in our office on 9/11/12, his company was experiencing many execution challenges, poor communication, and low morale in a business whose key asset is their service people. Furmanite provides a mission critical service of fixing leaks in refineries and underwater on navy ships. Charlie Cox instituted the "Orange Code" to create clear goals, open communication, demand excellence, and most importantly recognize and reward employees to achieve these goals. Within one year, their operating margins have more than doubled and the company has experienced a remarkable turnaround.

Profit Sharing

In addition to management incentives, we look for companies who implement a financial reward system where <u>everyone</u> in the company gets rewarded if the company does well. We particularly like companies who give bonuses, profit sharing, or even stock to everyone including the secretaries in the company. Microsoft became famous for their millionaire secretaries as they granted stock option awards to secretaries at the onset of their company. Once these employees feel they have skin in the game, they often come up with meaningful ideas that can lead to big rewards for the company.

Based in the Pacific Northwest, Alaska Airlines (ALKS) has been the most profitable U.S. airline based on return on capital and #1 or #2 in on-time delivery despite flying the harsh Alaska terrain. Their key is doing all the little things right. When we recently sat down with Alaska Airlines CFO, Branden Peterson, we weren't too surprised to find out they award 15% of their profits to their employees including their pilots. They even give an extra $100 month to everyone if they hit their monthly on time, safety, and profitability objectives. They have created a high performance culture which has successfully flowed through to the bottom line.

Strong Execution

Like Furmanite and Alaska Airlines, companies that set goals for employees, align those goals with broader strategies, and monitor performance, tend to outperform their peers in the stock market, according to a study from HR software provider SuccessFactors Inc. While we have anecdotally seen such a correlation, this report based on 153 publicly traded SuccessFactors customers quantified the link between diligent management execution and shareholder returns.

Improper Incentives: Sales Growth

Misaligned incentives can be detrimental to a company's operating performance and share price. The most common mistake we encounter is when a company board incentivizes a management to boost sales growth. While it makes sense on the surface, it leads to unintended consequences. There are two easy ways to grow sales: 1) Sell more products or services at a lower cost via discounting thus reducing profits or 2) Make an acquisition. While an acquisition would lead to management attaining their bonuses, numerous academic studies have concluded that company acquisitions tend to overbid and destroy shareholder value. Such findings have been interpreted as evidence of empire building (Jensen, 1986), misaligned personal objectives of CEOs (Morch, Shleifer, and Vishny, 1990), or CEO overconfidence (Roll, 1986; Malmendier & Tate, 2008). A more recent study evaluated the share performance of bidders in close merger contests. This study showed that stocks of the winning bidders underperformed the stocks of the losing bidders by 50% over the following three years (Malmedier & Moretti, 2012).

Conclusion

Ensuring that management's incentives are aligned with shareholders is a key factor in our investment evaluation. Many times, such facts are buried in the proxy statements of companies or omitted altogether as they are taken for granted as standard practice. Our analysis and incorporation of management incentives is a key tool we use in pursuit of our goal to achieve superior investment performance for our clients.

Disclosures

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