Eidelman Virant
CAPITAL

Quarterly Letter — December 2012

1/2/2013

Dear Clients and Friends,

For the last four years, negative macroeconomic concerns have filled the news headlines related to fiscal cliff concerns in the U.S., Europe's sovereign crisis, and the economic slowdown in China. In the face of all this negativity, the S&P 500 posted its fourth year in a row of solid gains. The S&P 500 and Russell 2000 indices both appreciated approximately 16.0% in 2012. We think 2013 could be another positive year for the stock market and our specific value investments.

I outlined our broad optimistic view on stocks in last quarter's letter "The Coming Stock Shortage." In summary: 1) There are only a limited number of world class companies in which to invest, 2) High-quality equities can be used as a bond substitute for generating income, and 3) Increased demand for investment income due to low interest rates could drive equities to much higher levels. In addition, modest valuations, positive momentum, and easy monetary policy bode well for another positive year.

The same scary headlines are sure to persist throughout the coming year. While the first part of the fiscal cliff has been resolved (tax cuts), the mandated spending cuts will entail a fresh round of chest pounding and House Republicans will likely use the debt ceiling to create new deadlines to solve some of these issues. The truth is that even a complete repeal of the Bush tax cuts along with the automatic spending cuts would have only raised 50% of the dollars needed to eliminate our 2013 budget deficit ($550 million of $1.1 trillion deficit). In other words, our government has a long way to go to get its budget in order. Nevertheless, we think the market will continue to climb a "wall of worry."

So how do we best take advantage of the positive market environment we see for 2013? We will continue to look for value wherever we can find it in the market. Sometimes value can manifest in a whole industry such as financial companies recovering from the U.S. subprime housing debacle. Other times, opportunity arises through short-term inefficiencies such as a spin-off, restructuring, or change in the tax code. In the fourth quarter of 2012, we were actively buying stocks that we believed to be temporarily depressed due to tax-loss selling.

At the end of the year, investors often dump stocks to recognize the loss for tax purposes. In addition, funds engage in what is known as "window dressing," where they sell poor performing investments so they don't look as bad to their clients at the end of the year. Because these reasons to sell are temporary and aren't related to the company's underlying fundamentals, such stocks often bounce back in January when such selling disappears with the birth of a new year. We attempt to exploit this inefficiency by buying financially strong companies that we believe are temporarily depressed due to tax-loss selling and window dressing. This "year-end" strategy has been one of our most effective investment tactics over time. This year, however, there was a twist. As I'll talk about in the next section, "Reverse Tax Selling", the biggest gainers may also be temporarily depressed due to investors taking gains in 2012 to avoid higher taxes in the future. For this reason, we have bought some "reverse year-enders."

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As we look at 2013, our favorite themes are as follows:

- Select Banks

  Although the financial stocks finished the year up nearly 30%, we think they have more room to go. Banks have continued to clean up non-performing loans and are poised to start raising dividends as industry regulation clarifies. Even with asset and earnings improvement, some bank stocks with great franchises can still be purchased for book value, which is cheaper than starting a new bank from scratch. For more detail, see our 4th quarter 2011 letter entitled "The Case for Bank Stocks."

- Gold mining stocks

  With gold equities trading at extremely cheap levels relative to the price of gold, we think the prospects for gold mining stocks look bright. Gold mining companies should benefit from cheaper energy costs, smarter capital allocation strategies, and the broader positive fundamentals for gold. As governments increasingly spend beyond their means and utilize non-traditional monetary policy (printing money), we believe gold prices will continue to go up. Even if gold prices decline a bit, gold mining stocks have the potential to generate high returns on capital and pay healthy dividends. For more detail, see our 2nd quarter 2012 letter entitled "A Gold Mine."

- High-quality dividend paying stocks

  With interest rates remaining low, investors need to boost income from other sources. High-quality dividend paying stocks are liquid, provide earnings consistency, and remain at attractive valuation levels. We believe long-term asset allocation shifts will begin moving back from bonds to stocks, thereby increasing stock prices. For more detail, see our 4th quarter 2012 letter entitled "High-Quality Stock Shortage?"

In addition to the above themes, we are constantly looking for special situations and market inefficiencies that could potentially generate superior investment returns. Some of our biggest winners have come from management turnarounds, distressed bonds with good asset coverage, and preferred stocks that have temporarily suspended interest payments. Such investments have not only added return, but have provided valuable diversification benefits as many of these situations worked out independently of the broad market averages. We think the combination of these themes and our opportunistic approach to any unexpected changes position us for success in the new year.

Thank you for your continued business and we wish you a happy new year!

Sincerely,

Tom Eidelman, CFA
Vice President

REVERSE TAX SELLING

Taxes are going up in 2013. Capital gain tax rates are set to increase from 15% to 20% on January 1st, 2013 and an additional 3.8% Obamacare tax is due to kick in for investors with more than $200,000 in income. With taxes slated to rise, many clients called us in 2012 to say "take gains now." For many clients, this was the prudent course of action, especially if we were looking to sell that particular security in the near term and their income was above $200,000. Our clients weren't the only ones looking to save some money. With a large quantity of investors rushing to sell their stocks with the largest unrealized capital gains, some of the stocks with the largest 3-year gains suffered steep 4th quarter losses.

Because of this unique circumstance, we believe a reverse tax-selling effect may be taking place. Apple (AAPL) and Ross Stores (ROST) are two companies whose stocks have more than doubled over the last few years, but have sold off more than 20% in the 4th quarter of 2012 (See Chart A). We believe some of the sell-off could have been due to tax gain selling. For this reason, these stocks may be due for a quick rebound when this selling abates.

Chart A: Reverse Year Enders

Company	Ticker	Price*	3-Yr Gain**	% from Q4 High
Apple	AAPL	$ 532.2	260%	-24.5%
Ross Stores	ROST	$ 54.1	170%	-23.6%
Charter	CHTR	$ 76.2	114%	-8.6%
S&P 500	SPY	$ 142.4	36%	-3.8%

**Price as of 12/31/12*
***3-Yr Gain from Sept '09 - Sept '12*

Our typical stock positions are held for at least a year, however, these stocks may be held for a shorter time period due to this year's unique tax legislation. Two of our two favorite "reverse year -ender" holdings are as follows:

Apple (AAPL) – Price ($532)

Apple designs consumer electronic devices, including iPhones, MacBooks (PCs), iPads, and Ipods. Due to its innovative products and enthusiastic customer base, Apple has grown annual profits from $2 billion to $46 billion over the past six years. Despite a meteoric rise in Apple's stock price of 260% over the past 3 years and a 5-year estimated growth rate of 20%, the stock still trades at a reasonable valuation relative to its estimated earnings (EPS). Trading at just 11x 2012 EPS estimates, Apple trades at a 13% discount to the S&P 500 average of 12.6x. While AAPL shares have sold off more than 20% surrounding analyst downgrades and fizzling news that China Mobile would sell the iPhone 5, we believe the selloff is more likely a result of tax selling. The recent price sell off could provide a great opportunity to acquire AAPL shares at a temporarily depressed price.

Ross Stores (ROST) – Price ($54)

Ross Stores is one of the largest off-price retailers of brand-name apparel and home accessories, second only to their competitor TJ Maxx (TJX). The company operates about 1,050 Ross Dress for Less stores which offers merchandise at prices 20%-60% below those of most department and specialty stores. Ross continues to benefit from weaker consumer spending and a value-conscious mindset. Ross stores believes they have the capacity to double the number of stores over time (they are still 1/3 the size of TJ Maxx). Over the past 10 years, the company has grown sales and earnings at 15% compounded, while maintaining an extremely high average return on capital of 30% over this period. Analysts expect such growth to continue for the foreseeable future. Shares of Ross stores (ROST) trade at a reasonable valuation multiple of 13.8x next year's earnings estimate. We think recent share price weakness is due to tax selling and offers a great opportunity to acquire shares.

Disclosures

This newsletter is for informational purposes only and does not constitute a complete description of our investment advisory services. Some of our clients have long positions in Apple (AAPL), Ross Stores (ROST), and Charter Communications (CHTR). This newsletter is in no way a recommendation of any security or a solicitation or offer to sell investment advisory services. This newsletter should not be construed as advice to buy or sell any particular security. This newsletter is not definitive investment advice and should not be relied on as such. It does not take into account any investors' particular investment objectives, tax status, or investment horizon. No recommendation or advice is being given as to whether any investment or strategy is suitable for a particular investor. Any forward-looking statements speak only as of the date they are made, and Eidelman Virant Capital assumes no duty to and does not undertake to update forward-looking statements. Certain investment mentioned in this newsletter may not have been held by clients of, or recommended by, Eidelman Virant Capital. Past performance is not indicative of future results.