Eidelman Virant
CAPITAL

Quarterly Letter — December 2013

1/9/2014

Dear Clients & Friends,

What a great year! Improving global economic growth and stimulative Fed policies proved fruitful for the stock market. The S&P 500 Index recorded a gain of 32% for 2013. Conversely, the Barclays U.S. Aggregate Bond Index suffered a 2% loss. Other assets such as commodities (-8%), REITS (+3%), emerging market equities (-3%), long-term U.S. government bonds (-11%), foreign bonds (-5%), cash (0%), and gold (-28%) also fared relatively poorly. One money manager summed it up best when he said "the more colors you had on your asset allocation pie chart in 2013, the worse you did." Fortunately, we steered our clients in the right direction by trumpeting our individual stock investments, particularly in view of their favorable valuations relative to bonds. So enough about last year, what do we see for 2014?

We remain optimistic for our portfolios entering 2014. While equity valuations as a whole have crept above historical averages (Value line PE of 18.5x vs. 16x historically), stocks remain historically undervalued relative to bonds. In need of higher returns, we anticipate investors continuing to increase allocations from bonds to stocks, which could continue to drive stock prices upward. Our biggest concerns are related to high levels of bullishness on Wall Street. Historically, such high levels of optimism (Investors Intelligence 60% bullish vs. 14% bearish) have acted as a headwind for stock prices until sentiment normalizes. While we are hopeful for the market overall, we are particularly optimistic about our clients' portfolios. We've constructed portfolios of companies with strong competitive positions, low debt levels, talented management and below average valuation measures. We remain confident that such a portfolio can continue to earn attractive risk-adjusted returns.

One stock we recently added to portfolios was Kingstone (Ticker: KINS). Kingstone is a 127-year old insurance company focusing on homeowners insurance in New York. Kingstone is benefiting from an industry exodus from New York as Allstate and State farm are leaving to lower their overall coastal exposure following hurricane Sandy. We think Kingstone is a well-run, profitable business in the right place at the right time. We have confidence in CEO Barry Goldstein's sales management experience combined with aligned incentives as he holds a 15% ownership stake. Given our earnings estimate of $.90 per share and an industry average P/E multiples of 11x, we think KINS shares could be worth $10 per share, a 38% premium to the current price.

Our goal is to construct a diversified portfolio of investments that meet our strict criteria of quality, management, and value to each of our client's risk profile. I honestly believe we have the strongest team in our history at Eidelman Virant to find and capitalize on opportunities in the market. All of us strive to learn and be better managers of your capital every day.

Because it was such an outstanding year, I thought it was the perfect time to talk about what I've learned from John Virant since merging with the Virant team four years ago. In the next section, I'll give some insight into the philosophies that have contributed to John's long-term success, what I've learned, and how we hope to take even better advantage of these lessons in the future.

If you have any questions or comments, please contact me at tom@eidelmanvirant.com

Sincerely,

Tom Eidelman, CFA

WHAT I'VE LEARNED FROM JOHN VIRANT

John Virant has accumulated an impressive long-term investment track record. Along with successfully managing individual accounts, John has managed Pinetree Partners, LP since 1988. Such outstanding performance spawned some clients to nickname him "the King." I can tell you that this has not gone to his head and he still works hard every day and worries enough about the market for all of us.

What's the Secret?

If you asked John Virant "What is the secret to your investment success?" He is likely to shrug his shoulders and say "I don't know, I just buy good companies." If you're lucky he may give you a little more detail like "I look for a good story," or "I look for companies with big upside." While this is true, working closely with John has given me unique insight into the method behind the magic. Underneath, is a disciplined investment strategy based on academically sound principals and time-tested experience.

It Starts with Good Ideas

John spends the majority of his time looking for individual investments ideas. In addition to his own internal database of stocks he has owned throughout the years, John has relationships with top institutional analysts in multiple industries. He debates their top ideas and evaluates the rationale behind the analyst's favorite investment ideas.

John's favorite investment attributes include undervalued assets, strong cash flow, new management, industry consolidation, and M&A activity. In addition, he looks for a catalyst that will drive the stock upward. Often times this includes activist involvement, spinoff, reverse stock split, or reorganization to realize the potential value. The right combination of these factors eventually culminates to give him a "warm fuzzy feeling," which gives him the confidence to buy and stay with the trend.

Sector Rotation

TV Host Jim Cramer likes to say "There is always a bull market somewhere, and I will try to find it for you." John lives by a similar motto and looks for trends in groups. Recent examples include industry consolidation in the airline industry, resurgence of railroads, and reorganization within cable and media. Even in a volatile overall market environment, certain groups can flourish based on improving industry fundamentals.

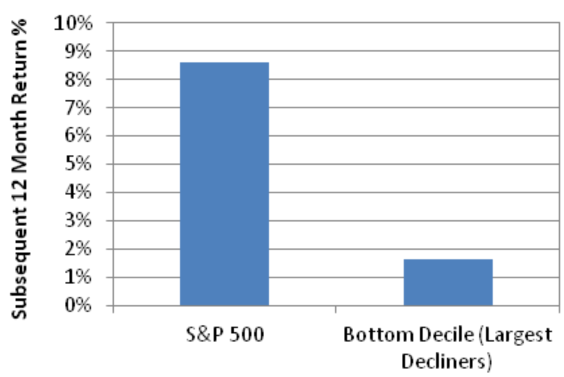
Focus on your Best Ideas

John believes in focusing on his best ideas. As I wrote about in my June 2013 quarter letter entitled "Optimal Diversification," John follows many of the investment greats in owning 20-30 positions. If you own too many stocks, you don't know them that well and you are "flying blind."

Risk Management

One of the keys to John's success and perhaps the area that I most seek to emulate is his approach to risk management. John often cuts investment losses short before they get too big. Unlike other investors who hold onto losing investments too long hoping to break even, avoid taking a loss, or anchoring in their stubborn belief of some alternative outcome, John has little tolerance for an investment "not acting right." Studies show that John has been very right with this approach. Historically, stocks that have experienced big declines continue to underperform the stock market (See Chart).

Worst Price Performers Continue to Underperform



Source: Ned Davis Research (Jan-85-Dec-13)

Conclusion

Combining the best practices and ideas of the Virant team and Eidelman team has made our combined team even stronger. Every member of our team came up with outstanding ideas in 2013 to the benefit of all of our clients. We are confident that through continued hard work, adhering to successful investment principles, and working together will give us the best chance to provide our clients with superior investment returns in the future.

Disclosures

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