



**THE
MANUAL
OF
IDEAS**

TM

Value-oriented Equity Investment Ideas for Sophisticated Investors

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"If our efforts can further the goals of our members by giving them a discernible edge over other market participants, we have succeeded."

Investing In The Tradition of Graham, Buffett, Klarman

Year IV, Volume VI
July 1, 2011

When asked how he became so successful, Buffett answered:
"We read hundreds and hundreds of annual reports every year."

Top Ideas In This Report

[REDACTED] (Nasdaq: [REDACTED])	34
Dell (Nasdaq: DELL)	74
[REDACTED] (NYSE: [REDACTED])	86

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About The Manual of Ideas

Our goal is to bring you investment ideas that are compelling on the basis of value versus price. In our quest for value, we analyze the top holdings of top fund managers. We also use a proprietary methodology to identify stocks that are not widely followed by institutional investors.

Our research team has extensive experience in industry and security analysis, equity valuation, and investment management. We bring a "buy side" mindset to the idea generation process, cutting across industries and market capitalization ranges in our search for compelling equity investment opportunities.

THE "MAGIC FORMULA" ISSUE

- ▶ Snapshot of 100 "cheap" and "good" companies, based on Joel Greenblatt's formula in *The Little Book*
 - ▶ Exclusive Q&A with Joel Greenblatt
 - ▶ 20 companies profiled by *MOI* research team
- ▶ Proprietary selection of three candidates for investment
 - ▶ Plus: Superinvestor holdings update
- ▶ Plus: Ori Eyal on Fannie Mae and Freddie Mac Preferreds
- ▶ Plus: Exclusives with Josh Tarasoff and Sahm Adrangi

"Magic formula" companies mentioned in this issue include
Actuate, Aeropostale, Almost Family, Amedisys, America's Car-Mart, Amerigroup, Amtech Systems, Analog Devices, Apollo Group, Applied Materials, Argan, Bridgepoint Education, Broadcom, BSQUARE, CA, Capella Education, Career Education, Cephalon, CF Industries, Cherokee, Cirrus Logic, Cisco Systems, Comtech Telecommunications, Continucare, Corinthian Colleges, Cray, Cubic, Cubist Pharma, Dell, Deluxe, DepoMed, DeVry, Dolby Laboratories, Dun & Bradstreet, ePlus, Forest Labs, GameStop, Gilead Sciences, Global Sources, Grand Canyon Education, GT Solar, H&R Block, Impax Labs, Intel, InterDigital, ITT Educational, i2 Global Communications, Jazz Pharmaceuticals, KLA-Tencor, Lam Research, Lender Processing Services, Lexmark, Lincoln Educational, LML Payment Systems, LTX-Credence, Magellan Health, Majesco, Marvell Technology, Metropolitan Health, Microsoft, MIND C.T.I., Motorcar Parts, Northrop Grumman, Nova Measuring, Oshkosh, PDL BioPharma, PMC-Sierra, Power-One, Pre-Paid Legal, Providence Service, Qlogic, Research In Motion, Rigel Pharmaceuticals, SanDisk, SciClone Pharma, Strayer Education, SuperGen, Synaptics, Take-Two, TeleNav, Teradyne, Tessera Technologies, Transition Therapeutics, Trimeris, Unisys, United Online, USA Mobility, USANA Health Sciences, Veeco Instruments, ViroPharma, Walter Energy, and more.

(analyzed companies are underlined)

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Editorial Commentary

This month we focus on equity ideas that score highly based on the “magic formula” stock screening methodology, popularized in Joel Greenblatt’s *The Little Book That Beats The Market*. The “magic formula” looks for companies that are (i) “cheap” on the basis of trailing operating income to enterprise value, and (ii) “good” on the basis of trailing operating income to capital employed in the business. The goal is to pay a low price for companies likely to reinvest capital at high rates of return.

Inside, we are pleased to bring you an exclusive Q&A session with the most well-known advocate of “magic formula” investing, famed investor Joel Greenblatt.

In a slight modification of Greenblatt’s original methodology, which takes into account *trailing* operating income, we consider companies that rank highly based on one or more of the following inputs: trailing operating income, consensus EPS estimates for the current fiscal year, and consensus EPS estimates for next fiscal year. Since EPS numbers, unlike operating income numbers, do not normalize for the effects of leverage, our forward EPS-based methodology only includes companies with modest or no net financial leverage.

The reason we keep coming back to the “magic formula” as a way of generating investment ideas is simple: It works. In fact, we are unaware of any other easily replicable quantitative investment approach that rivals the outperformance of the “magic formula.” Consider the following partial track record:

MAGIC FORMULA PERFORMANCE VS. S&P 500 INDEX, 1999-2011*

(performance in %)	'99	'00	'01	'02	'03	'04	'05	'06	'07	'08	'09	'10	YTD
Magic Formula	16	9	36	-21	52	28	22	13	15	-36	43	13	15
S&P 500 Index	15	-9	-12	-22	29	11	5	16	6	-37	30	15	8

* Data from 1999-2008 reflects the net performance of the Formula Investing Model Portfolio. 1999 data is from October 1, 1999 through December 31, 1999. Data since 2009 reflects the Formula Investing U.S. Value Direct Composite returns (net) of actual accounts. 2009 data is from May 1, 2009 through December 31, 2009. Data from January 1, 2009 through April 30, 2009 is not available. However, it appears the “magic formula” strategy outperformed during that four-month period, as the Model Portfolio was up 46% while the S&P 500 Index was up 19% from January 1, 2009 through September 30, 2009. Year-to-date 2011 performance numbers are for the period from January 1, 2011 through May 31, 2011. Source: Formula Investing, www.formulainvesting.com

Why We Like “Magic Formula” Investing

- **Advocated by superinvestor Joel Greenblatt**, who managed the Gotham Partners hedge fund from 1985-1994, reporting a compounded annual returns of 50% (after expenses, before fees). While reliable data on Greenblatt’s track record since 1995 is not available, he has likely continued his record of strong outperformance.
- **Simple.** Greenblatt’s “magic formula” gives equal weight to price (pre-tax unlevered earnings yield) and quality (return on capital employed). This simple screen stands in stark contrast to most quantitative methods.
- **Makes sense.** Few investors would prefer a bad business to a good one, and few would purposely ignore the price of a stock. It makes intuitive sense that good companies available at good prices should outperform.

Why the “Magic Formula” Will Continue to Work

- **“Institutional imperative” makes adherence to the strategy difficult.** It is much safer from a career standpoint to be “wrong” when everyone else is losing money than to be “wrong” when everyone is making money. During the 1988-2004 period studied in *The Little Book*, the “magic formula” handily beat the S&P 500, yet the strategy experienced two non-overlapping three-year periods of underperformance.
- **Investors have a hard time turning off their emotional biases.** A look at the list of candidates generated by the “magic formula” is likely to make an investor’s stomach churn. Many companies on the list are either in out-of-favor industries or have company-specific issues, such as regulatory scrutiny, accounting irregularities, management turnover, or deteriorating operating momentum. While many investors may agree conceptually that buying high-ROIC companies when they are out of favor is a path to long-term outperformance, a smaller number is actually willing to follow such a strategy. As a quantitative method, the “magic formula” is sanguine about picking a headhunting firm during a recession or a laser eye surgery provider when the media is questioning the safety of laser eye surgery. Professional investors legitimately want to use the “magic formula” list as a starting point from which to do further research and ultimately make a subjective judgment regarding an investment. Unfortunately, the subjective judgment is frequently tainted by emotional bias.
- **The “magic formula” never runs out of investment candidates.** Several value strategies have become *de facto* obsolete over time. For example, whereas Ben Graham successfully searched for so-called “net nets” more than a half-century ago, such stocks have become quite rare today. As a result, few professional investors can build their businesses around “net nets.” By contrast, the “magic formula” simply ranks public companies relative to each other. There is no absolute cheapness requirement.
- **Investors tend to remain skeptical of winning strategies even after long periods of outperformance.** Investors generally struggle with the notion that a simple quantitative strategy can systematically outperform the best efforts of large numbers of securities analysts and portfolio managers.

Our Proprietary Selection Process

The Manual of Ideas has developed a process that seeks to improve upon the already impressive performance of the “magic formula” screen. Our methodology recognizes that not every investment should be approached with the same set of questions. Security analysis should be tailored to the type of opportunity examined. For example, an investor analyzing a company that trades at a large discount to net cash and tangible book value might inquire whether the company can be liquidated without major asset impairments, not whether the company’s long-term competitive position is favorable. On the other hand, an investor analyzing a company that trades well above book value and at a high multiple of earnings must examine prospects for sustained rapid earnings growth.

The performance of the “magic formula” screen can be improved if one asks questions that take into account the nature of the selections. Of particular concern is the fact that the “magic formula” favors firms exhibiting high returns on capital employed. Such companies are generally not cheap based on the liquidation value of their assets. Instead, they might be cheap based on earning power. As a result, a crucial determination when evaluating the selections is whether they exhibit above-average returns on capital for transitory reasons or for reasons that have some permanence. Warren Buffett calls this “moat”; others may know it as sustainable competitive advantage. It is also crucial whether a business operates in a growing industry that allows the company to reinvest a portion of FCF at high rates of return.

We seek out companies whose earnings yield is likely to increase over time if the stock price remains unchanged. Such companies not only sustain high returns on capital, but also grow earnings by reinvesting cash in the business. As they generate high returns, such companies need to reinvest only a portion of FCF in order to grow. As a result, they generally have cash available for dividends and stock repurchases. Buybacks executed at “good” prices accelerate EPS growth and value creation.

In order to narrow down the list of “magic formula” companies to the most promising investments, we use a number of subjective criteria. These “positive” criteria include sustainability of competitive advantage, management quality and industry growth. We also take into account the following negative criteria (as Charlie Munger might say, “Invert!”):

- **Pro forma adjustments:** We eliminate companies that would not be on the list if their financial statements were adjusted to reflect true operating performance (may include companies recently engaged in large M&A).
- **Capital reinvestment:** We avoid companies with virtually no opportunity for high-return reinvestment of capital (e.g., industries in decline).
- **Threats to key revenue source:** We avoid companies dependent on one customer or contract, if loss of the latter has become a real possibility (circumstances may include acquisition of major customer, ongoing re-bid process for large contract, or loss of patent protection).
- **Cyclicity:** We avoid capital-intensive businesses that generate high ROIC only during cyclical upswings in their respective industries.
- **Faddishness:** We avoid companies providing a product or service that has a reasonably high likelihood of being a fad.
- **Insider selling:** We avoid stocks with heavy insider selling, particularly if such selling occurred at prices equal to or below the recent market price.
- **Alignment of interests:** We avoid companies with major CEO conflicts of interest or corporate governance abuses.
- **Value proposition:** We avoid companies that offer a questionable value proposition to their end customers.
- **M&A rollups:** We avoid companies that have meaningful integration risks due to major reliance on acquisition-driven growth.



Exclusive Q&A with Joel Greenblatt

We recently had the pleasure of interviewing famed investor Joel Greenblatt whose *Little Book That Beats The Market* popularized what is now often referred to as the “magic formula” approach to investing. Greenblatt founded Gotham Capital in 1985 and has amassed one of the best long-term track records in the investment business. He is co-CIO of Gotham Asset Management, a professor on the adjunct faculty of Columbia Business School, the former chairman of a Fortune 500 company, and a member of the investment boards of the University of Pennsylvania and UJA. Along with Blake Darcy, Joel is a major force behind Formula Investing, an investment firm that seeks to make the “magic formula” approach more widely accessible to institutional and retail investors. He holds BS and MBA degrees from the Wharton School.

The Manual of Ideas: Congratulations on the recent launch of the Formula Investing mutual funds and the publication of your third book, *The Big Secret for the Small Investor*. What is your vision for value-weighted indexing?

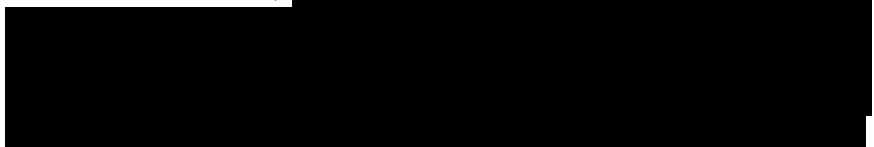
Joel Greenblatt: I think value-weighted indexing makes so much sense — that is, placing more weight in those stocks that appear to be at bargain prices, rather than larger market caps or other weighting measures — that eventually logic will take over and many of the large investment firms will design their own value weighted indexes over time. I can’t imagine that this won’t be a very accepted way of creating indexes within a few years.

MOI: One of the reasons “magic formula” investing should continue to outperform is the fact that investors have a hard time sticking with the approach during long periods of underperformance. Have you considered value-weighted indexing in a closed-end vehicle to avoid capital flight at times of greatest investment opportunity?

Greenblatt: In short, I think a closed end vehicle would be wonderful for value weighted indexes. Equity closed end funds, however, have not been particularly popular in recent years but I do believe they are very well suited to value investing strategies, especially value weighted indexes.

MOI: You shared the simple yet powerful magic formula in *The Little Book That Beats the Market* in 2005. To what extent do the Formula Investing funds make tweaks to the magic formula as described in the book? For example, have you considered using forward consensus earnings estimates instead of trailing earnings, or eliminating any sectors beyond financials, such as miners or oil companies?

Greenblatt: There are a number of “tweaks” in the Formula Investing funds that we have created. First,



“In our experience, eliminating the [“magic formula”] stocks you would obviously not want to own eliminates many big winners.”

100 "Magic Formula" Stocks, by Industry

Companies that rank highly on "magic formula" criteria, using trailing earnings or forward earnings estimates

Industry	Company / Ticker	Recent	YTD	Market	Enter.	LTM	LTM	P/E	P/E (Est.)		EV/ LTM	Price/ Tang.	Insider
		Price	Price			Value	Value		EBIT/ EV	EBIT/ Capital			
		(\$)	Δ	(\$mn)	(\$mn)			FY	FY	FY			
Aerospace and Defense	Cubic / CUB	47.63	1%	1,274	997	11%	>99%	18x	16x	15x	.8x	4.1x	0%
	Northrop / NOC	64.69	10%	18,936	18,895	16%	50-99%	10x	10x	9x	.5x	>99x	1%
Autos and Trucks	Oshkosh / OSK	26.35	-25%	2,400	3,121	28%	>99%	3x	8x	7x	.3x	nm	0%
	Motorcar Parts / MPAA	14.67	13%	183	188	14%	>99%	15x	13x	9x	1.2x	1.6x	0%
	TRW Automotive / TRW	52.57	0%	6,497	7,216	18%	50-99%	8x	7x	7x	.5x	18.5x	1%
Biotech and Drugs	ACADIA Pharma / ACAD	1.52	27%	80	35	43%	>99%	4x	nm	nm	.8x	2.1x	0%
	Cephalon / CEPH	79.71	29%	6,075	5,977	14%	>99%	15x	10x	14x	2.1x	7.0x	1%
	Cubist Pharma / CBST	34.96	63%	2,096	1,667	na	nm	23x	41x	22x	2.6x	3.3x	0%
	DepoMed / DEPO	7.86	24%	422	287	23%	>99%	>99x	5x	>99x	3.6x	3.4x	0%
	Forest Labs / FRX	38.68	21%	11,069	7,218	19%	>99%	11x	11x	32x	1.6x	2.3x	1%
	Gilead Sciences / GILD	39.54	9%	31,116	32,608	12%	>99%	12x	10x	9x	4.1x	7.2x	1%
	Impax Labs / IPXL	20.37	1%	1,330	980	21%	50-99%	5x	20x	16x	1.1x	2.6x	1%
	Jazz Pharma / JAZZ	29.23	49%	1,191	1,167	6%	>99%	35x	10x	7x	6.7x	>99x	1%
	Par Pharma / PRX	32.48	-16%	1,176	892	16%	>99%	12x	10x	10x	.9x	3.2x	2%
	PDL BioPharma / PDLI	5.81	-7%	812	1,175	28%	>99%	11x	5x	4x	3.4x	nm	0%
	POZEN / POZN	4.50	-32%	135	78	na	>99%	6x	nm	nm	1.1x	2.4x	1%
	Rigel Pharma / RIGL	8.13	8%	558	403	9%	>99%	11x	nm	nm	3.2x	3.7x	0%
	SciClone / SCLN	5.07	21%	293	225	10%	>99%	12x	10x	7x	2.6x	3.4x	0%
	SuperGen / SUPG	2.90	11%	175	50	33%	>99%	11x	17x	12x	.9x	1.4x	0%
	Transition Thera. / TTHI	2.72	40%	63	42	30%	>99%	nm	na	na	9.0x	2.1x	0%
Trimeris / TRMS	2.55	4%	57	10	>99%	>99%	3x	na	na	.4x	1.1x	0%	
ViroPharma / VPHM	17.28	0%	1,313	965	24%	>99%	12x	15x	31x	2.2x	5.1x	0%	
Business Services	Deluxe / DLX	22.71	-1%	1,168	1,875	15%	>99%	8x	7x	7x	1.3x	nm	1%
	Dun & Bradstreet / DNB	74.99	-9%	3,705	4,512	9%	>99%	15x	12x	11x	2.7x	nm	1%
	Global Sources / GSOL	9.58	1%	323	200	13%	>99%	16x	12x	11x	1.0x	3.7x	0%
	LML Payment / LMLP	3.22	-8%	91	64	29%	>99%	9x	na	na	1.3x	4.3x	0%
	United Online / UNTD	5.66	-14%	502	654	17%	>99%	10x	7x	7x	.7x	nm	5%
Commodities	CF Industries / CF	136.06	1%	9,726	10,207	14%	50-99%	25x	9x	10x	2.6x	4.2x	0%
	China N.E. Petro / NEP	3.28	-43%	116	44	>99%	50-99%	2x	4x	3x	.4x	1.0x	0%
	Walter Energy / WLT	108.07	-15%	6,725	6,793	9%	50-99%	15x	7x	7x	4.3x	9.8x	1%
Comms Equipment	Comtech / CMTL	25.16	-9%	655	266	43%	50-99%	13x	12x	24x	.3x	1.3x	2%
	Harris / HRS	44.34	-2%	5,640	6,828	14%	50-99%	10x	9x	9x	1.3x	53.7x	0%
	InterDigital / IDCC	35.19	-15%	1,596	1,069	19%	>99%	10x	14x	12x	2.7x	6.5x	1%
	RIM / RIMM	27.75	-52%	14,579	12,190	37%	>99%	4x	na	na	.6x	2.1x	0%
	TeleNav / TNAV	15.31	110%	637	426	na	nm	18x	15x	17x	2.5x	3.6x	7%
Comms Services	IDT Corp. / IDT	24.75	-4%	569	333	8%	>99%	26x	10x	9x	.2x	2.8x	18%
	j2 Global / JCOM	27.76	-4%	1,277	1,153	9%	>99%	15x	12x	11x	4.5x	14.7x	4%
	USA Mobility / USMO	15.35	-14%	339	368	16%	>99%	4x	na	na	1.6x	7.5x	2%
Computers	Cray / CRAY	6.12	-15%	221	99	29%	>99%	14x	17x	18x	.3x	1.5x	4%
	Dell / DELL	16.02	18%	30,203	23,334	18%	>99%	12x	8x	8x	.4x	29.5x	13%
	Cisco Systems / CSCO	14.97	-26%	82,338	55,720	15%	>99%	11x	9x	9x	1.4x	3.0x	0%
	Lexmark / LXX	27.75	-20%	2,199	1,579	29%	50-99%	6x	6x	7x	.4x	1.9x	1%
	Unisys / UIS	24.24	-6%	1,043	829	43%	>99%	7x	15x	7x	.2x	nm	1%
	SanDisk / SNDK	40.94	-18%	9,759	8,521	18%	>99%	8x	9x	9x	1.8x	1.7x	0%
Healthcare	Almost Family / AFAM	27.77	-28%	260	205	24%	>99%	8x	10x	10x	.6x	3.5x	10%
	Amerigroup / AGP	62.92	43%	3,121	2,525	20%	>99%	12x	14x	14x	.4x	3.2x	2%
	Amedisys / AMED	27.66	-17%	815	839	19%	>99%	7x	9x	9x	.5x	13.9x	1%
	Continuicare / CNU	4.27	-9%	259	214	18%	>99%	12x	10x	9x	.7x	3.7x	0%
	Magellan Health / MGLN	52.32	11%	1,673	1,179	20%	>99%	13x	14x	13x	.4x	3.3x	1%
	Metro Health / MDF	4.84	8%	199	152	28%	>99%	8x	8x	8x	.4x	2.8x	4%

Industry	Company / Ticker	Recent	YTD	Market Value (\$mn)	Enter. Value (\$mn)	LTM	LTM	P/E Last FY	P/E (Est.)		EV/ LTM Sales	Price/ Tang. Book	Insider Own.
		Price (\$)	Price Δ			EBIT/ EV	EBIT/ Capital		This FY	Next FY			
Industrial	Argan / AGX	9.90	7%	135	51	33%	>99%	14x	na	na	.3x	1.8x	2%
	Power-One / PWER	8.10	-21%	839	652	49%	>99%	8x	8x	7x	.6x	2.7x	3%
Personal Services	H&R Block / HRB	15.40	29%	4,701	4,996	14%	>99%	11x	11x	10x	1.3x	nm	0%
	Pre-Paid Legal / PPD	66.43	10%	650	575	na	nm	10x	na	na	1.3x	6.0x	7%
	Providence / PRSC	13.05	-19%	169	282	18%	>99%	7x	9x	9x	.3x	nm	2%
Retail and Related	Aeropostale / ARO	17.36	-30%	1,401	1,262	27%	>99%	7x	11x	9x	.5x	4.0x	1%
	Am. Car-Mart / CRMT	29.03	7%	308	365	13%	>99%	11x	10x	9x	1.0x	1.7x	1%
	Cherokee / CHKE	17.12	-9%	146	144	8%	>99%	20x	na	na	4.7x	22.8x	8%
	Exceed Company / EDS	5.12	-38%	130	-9	nm	50-99%	3x	3x	3x	nm	0.5x	0%
	GameStop / GME	26.44	16%	3,740	3,593	19%	>99%	10x	9x	8x	.4x	5.8x	1%
	USANA Health / USNA	28.28	-35%	445	411	17%	>99%	10x	10x	9x	.8x	4.7x	52%
Schools	Apollo / APOL	41.67	6%	5,901	5,058	27%	>99%	11x	9x	13x	1.0x	5.6x	3%
	Bridgepoint / BPI	22.64	19%	1,197	897	28%	>99%	11x	9x	9x	1.3x	4.3x	0%
	Capella / CPLA	43.19	-35%	679	494	19%	>99%	12x	12x	13x	1.2x	3.4x	6%
	Career Ed. / CECO	20.37	-2%	1,581	1,183	29%	>99%	10x	8x	9x	.6x	3.7x	2%
	Corinthian / COCO	4.14	-21%	350	514	34%	50-99%	3x	5x	14x	.3x	1.9x	1%
	DeVry / DV	55.86	16%	3,843	3,243	15%	>99%	14x	12x	12x	1.7x	6.1x	2%
	Grand Canyon / LOPE	12.85	-34%	577	574	14%	>99%	13x	12x	10x	1.5x	4.4x	9%
	ITT / ESI	75.63	19%	2,123	1,932	32%	>99%	7x	7x	10x	1.2x	26.4x	1%
	Lincoln / LINC	15.34	-1%	346	340	36%	>99%	5x	9x	10x	.5x	2.8x	5%
Strayer / STRA	121.27	-20%	1,485	1,494	na	nm	13x	14x	14x	2.3x	20.3x	1%	
Semis	Amtech Systems / ASYS	17.56	-30%	168	101	37%	>99%	17x	7x	7x	.8x	1.9x	1%
	Analog Devices / ADI	36.58	-3%	10,961	8,436	13%	>99%	16x	13x	12x	3.1x	3.3x	1%
	Applied Materials / AMAT	12.41	-12%	16,360	13,257	18%	>99%	18x	9x	9x	1.4x	2.5x	1%
	Broadcom / BRCM	31.61	-27%	16,908	15,323	8%	>99%	16x	11x	11x	2.2x	4.5x	1%
	Cirrus Logic / CRUS	13.51	-15%	881	685	12%	50-99%	5x	11x	9x	1.9x	2.1x	0%
	GT Solar / SOLR	13.43	47%	1,691	1,453	na	>99%	11x	8x	7x	1.6x	18.0x	0%
	Intel / INTC	21.19	1%	112,349	102,508	16%	50-99%	11x	9x	9x	2.3x	3.6x	0%
	KLA-Tencor / KLAC	38.10	-1%	6,397	5,304	18%	>99%	31x	8x	9x	2.9x	2.8x	0%
	Kulicke and Soffa / KLIC	10.20	42%	734	554	32%	>99%	5x	5x	6x	.7x	2.4x	2%
	Lam Research / LRCX	42.43	-18%	5,282	4,047	20%	>99%	16x	7x	8x	1.9x	2.5x	1%
	LTX-Credence / LTXC	8.49	15%	421	274	18%	>99%	22x	8x	7x	1.2x	2.4x	3%
	Marvell Tech / MRVL	13.21	-29%	8,077	5,809	15%	>99%	10x	9x	8x	1.6x	3.0x	0%
	Nova Measuring / NVMI	10.19	23%	238	177	12%	>99%	12x	na	na	2.0x	3.5x	0%
	PMC-Sierra / PMCS	7.09	-17%	1,655	1,520	5%	>99%	20x	11x	9x	2.4x	5.2x	1%
	Qlogic / QLGC	15.39	-10%	1,612	1,228	11%	>99%	12x	10x	9x	2.1x	3.4x	0%
Teradyne / TER	13.78	-2%	2,555	1,854	23%	>99%	8x	8x	7x	1.2x	2.3x	0%	
Tessera / TSRA	15.70	-29%	803	303	42%	>99%	14x	14x	13x	1.0x	1.5x	1%	
Veeco / VECO	50.28	17%	2,048	1,443	23%	>99%	8x	9x	12x	1.5x	2.7x	1%	
Software	Actuate / BIRT	5.26	-8%	242	199	10%	>99%	24x	12x	10x	1.5x	6.9x	5%
	BSQUARE / BSQR	5.98	-32%	63	43	18%	>99%	11x	12x	10x	.4x	2.6x	6%
	CA / CA	21.59	-12%	10,954	9,381	13%	>99%	13x	10x	9x	2.1x	nm	0%
	Dolby Labs / DLB	42.70	-36%	4,774	3,987	11%	>99%	17x	16x	15x	4.3x	3.7x	0%
	ePlus / PLUS	24.04	2%	205	159	27%	>99%	9x	7x	na	.2x	1.1x	1%
	Lender Processing / LPS	20.42	-31%	1,764	2,972	na	nm	6x	6x	5x	1.2x	nm	2%
	Majesco / COOL	3.18	313%	130	112	11%	>99%	nm	9x	8x	1.5x	5.4x	6%
	Microsoft / MSFT	24.26	-13%	204,579	166,344	16%	>99%	12x	9x	9x	2.7x	5.1x	7%
	MIND C.T.I. / MNDO	2.77	11%	52	37	15%	>99%	11x	na	na	1.8x	3.6x	0%
	Synaptics / SYNA	26.06	-11%	893	649	12%	>99%	17x	10x	10x	1.3x	2.6x	0%
	Take-Two / TTWO	14.49	18%	1,256	1,083	7%	50-99%	23x	36x	6x	1.0x	5.4x	1%

Dell (Nasdaq: DELL) – owned by Centaur, Fairfax, IVA, Southeastern, Weitz

Technology: Computer Hardware, Member of S&P 500

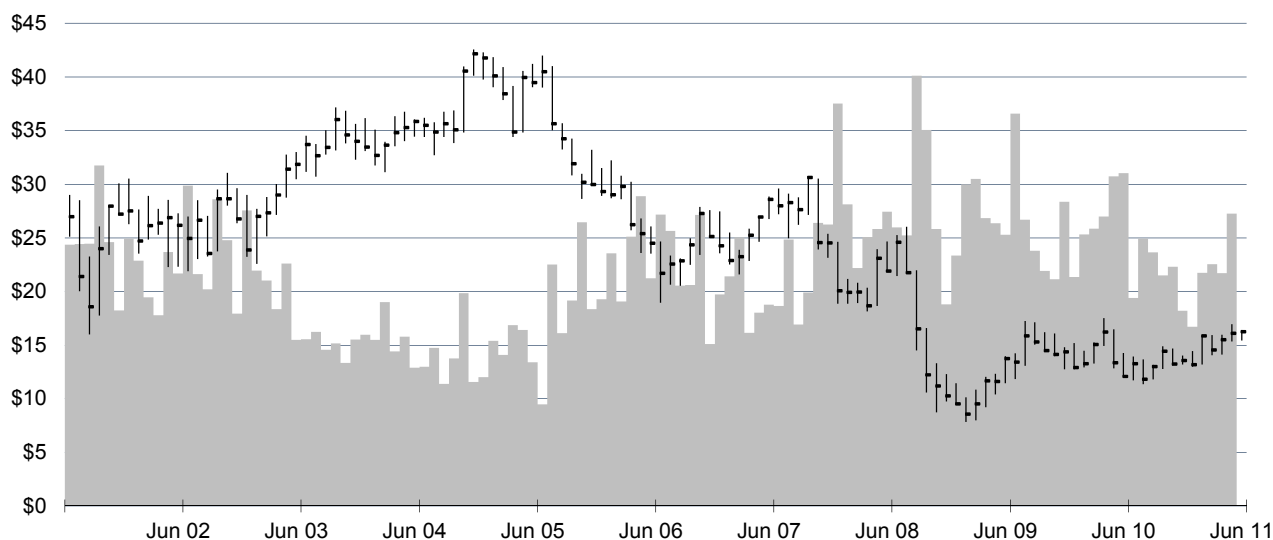
Round Rock, TX, 800-289-3355

www.dell.com

Trading Data	Consensus EPS Estimates				Valuation	
Price: \$16.02 (as of 6/17/11)			Month	# of	P/E FYE 1/28/11	12x
52-week range: \$11.34 - \$16.96		<u>Latest</u>	<u>Ago</u>	<u>Ests</u>	P/E FYE 1/31/12	8x
Market value: \$30 billion	This quarter	\$0.48	\$0.48	31	P/E FYE 1/30/13	8x
Enterprise value: \$23 billion	Next quarter	0.44	0.44	31	P/E FYE 1/30/14	9x
Shares out: 1,885 million	FYE 1/31/12	1.89	1.88	35	EV/ LTM revenue	0.4x
Ownership Data	FYE 1/30/13	1.91	1.90	32	EV/ LTM EBIT	6x
Insider ownership: 13%	FYE 1/30/14	1.87	1.85	7	P / tangible book	29.5x
Insider buys (last six months): 13	LT growth	6.0%	6.0%	7	Greenblatt Criteria	
Insider sales (last six months): 12	<u>EPS Surprise</u>	<u>Actual</u>	<u>Estimate</u>		LTM EBIT yield	18%
Institutional ownership: 73%	5/17/11	\$0.55	\$0.44		LTM pre-tax ROC	n/m

Operating Performance and Financial Position										
(\$ millions, except per share data)	Fiscal Years Ended							LTME 4/29/11	FQE 4/30/10	FQE 4/29/11
	1/28/05	2/3/06	2/2/07	2/1/08	1/30/09	1/29/10	1/28/11			
Revenue	49,121	55,788	57,420	61,133	61,101	52,902	61,494	61,637	14,874	15,017
Gross profit	9,018	9,891	9,516	11,671	10,957	9,261	11,396	12,312	2,516	3,432
Operating income	4,206	4,382	3,070	3,440	3,190	2,172	3,433	4,126	519	1,212
Net income	3,018	3,602	2,583	2,947	2,478	1,433	2,635	3,239	341	945
Diluted EPS	1.18	1.47	1.14	1.31	1.25	0.73	1.35	1.67	0.17	0.49
Shares out (avg)	2,509	2,403	2,255	2,223	1,980	1,954	1,944	1,935	1,961	1,908
Cash from operations	5,821	4,751	3,969	3,949	1,894	3,906	3,969	4,196	238	465
Capex	515	747	896	831	440	367	444	535	46	137
Free cash flow	5,306	4,004	3,073	3,118	1,454	3,539	3,525	3,661	192	328
Cash & investments	9,807	9,070	10,298	7,972	9,092	11,008	14,365	14,479	10,882	14,479
Total current assets	16,897	17,794	19,939	19,880	20,151	24,245	29,021	28,373	24,784	28,373
Intangible assets	0	0	155	2,428	2,461	5,768	5,860	7,347	5,839	7,347
Total assets	23,215	23,252	25,635	27,561	26,500	33,652	38,599	39,788	34,241	39,788
Short-term debt	0	65	188	225	113	663	851	816	1,079	816
Total current liabilities	14,136	16,173	17,791	18,526	14,859	18,960	19,483	18,130	18,980	18,130
Long-term debt	505	625	569	362	1,898	3,417	5,146	6,794	3,582	6,794
Total liabilities	16,730	19,205	21,196	23,732	22,229	28,011	30,833	31,418	28,363	31,418
Preferred stock	0	0	0	0	0	0	0	0	0	0
Common equity	6,485	4,047	4,439	3,829	4,271	5,641	7,766	8,370	5,878	8,370
EBIT/capital employed	n/m	n/m	n/m	n/m	n/m	n/m	n/m	n/m	n/m	n/m

Ten-Year Stock Price Performance and Trading Volume Dynamics



BUSINESS OVERVIEW

Dell, founded in 1984, provides IT products and services.

INVESTMENT HIGHLIGHTS

- **#2 global supplier of desktop PCs** (behind HP); #3 supplier of notebooks. Dell also has strong positions in other IT products (e.g., “cloud” infrastructure, iSCSI storage) and is expanding into IT services.
- **Grew higher-margin services** to 19% of revenue in FY11, up from 12% in FY08. Dell uses products as “anchor tenants” while seeking to win services business. The \$4 billion purchase of Perot Systems in 2009 greatly expanded Dell’s services footprint.
- **Operates with negative working capital.** The cash conversion cycle (days of sales outstanding *plus* days of supply in inventory *minus* days in accounts payable) has generally run at about -30 days.
- **Targeting long-term sales growth of >5-7%**, with GAAP operating income margin of 7+%, and cash from operations in excess of net income.
- **Well-financed**, with \$15 billion of cash, \$4 billion of financing receivables, and \$8 billion of debt.
- **Founder Michael Dell (45) returned as CEO** in 2007 and is the largest owner with 13%. He has allocated capital in a shareholder-friendly way, preferring to focus on “profit share,” not unit share.
- **Repurchased \$450 million of stock in Q1 FY12**, \$800 million in FY11 and \$2.9 billion in FY09.

INVESTMENT RISKS & CONCERNS

- **Turnaround still not complete**, four years after Michael Dell took over as CEO, although FQ1 results showed improvement in gross and operating margin. Revenue growth remains stuck below 10%, despite some contribution from recent acquisitions.
- **Competition in services and enterprise markets**, where IBM, HP and CA possess deeper services capabilities and long-standing client relationships.
- **Direct model evolving** as Dell partners with select retailers. Consumers like to “touch” notebooks and gadgets before buying, more so than they do PCs.
- **Low R&D spending** (1% of sales) hinders Dell’s ability to provide differentiated products and makes the company dependent on acquisitions. While the M&A strategy has worked reasonably well, the lack of internal focus on R&D may make it difficult for Dell to sustain innovation in the fast-paced industry.

MAJOR HOLDERS

CEO Dell 13% | Other insiders 1% | Southeastern 8%

SELECTED OPERATING DATA¹

FYE January 31	2008	2009	2010	2011	1Q12
Revenue (bn)	\$61	\$61	\$53	\$61	\$15
Change (y-y)	6%	0%	-13%	16%	1%
<i>% of revenue by segment:</i>					
Large enterprise	31%	29%	27%	29%	30%
Public	24%	25%	27%	27%	25%
Small & medium business	26%	24%	23%	24%	25%
Consumer	19%	21%	23%	20%	20%
<i>EBIT margin by segment:</i>					
Large enterprise	7%	6%	6%	8%	11%
Public	9%	8%	9%	9%	10%
Small & medium business	8%	9%	9%	10%	12%
Consumer	1%	2%	1%	1%	5%
Corporate	-1%	-1%	-2%	-2%	-2%
Total EBIT margin	6%	5%	4%	6%	8%
<i>% of revenue by product group:</i>					
Desktop PCs	32%	28%	24%	24%	22%
Mobility	29%	30%	31%	31%	31%
Software and peripherals	16%	17%	18%	17%	17%
Servers and networking	11%	11%	11%	12%	13%
Services	8%	9%	11%	12%	13%
Storage	4%	4%	4%	4%	3%
<i>Revenue growth by product group:</i>					
Desktop PCs	-2%	-10%	-25%	13%	-8%
Mobility	16%	4%	-11%	14%	3%
Software and peripherals	10%	7%	-10%	8%	3%
Servers and networking	12%	0%	-7%	26%	11%
Services	-2%	7%	5%	36%	5%
Storage	8%	10%	-18%	5%	-13%
% of revenue from U.S.	53%	52%	53%	52%	n/a
<i>Selected items as % of revenue:</i>					
Gross profit	19%	18%	18%	19%	23%
R&D	1%	1%	1%	1%	1%
Net income	5%	4%	3%	4%	6%
D&A	1%	1%	2%	2%	1%
Capex	1%	1%	1%	1%	1%
Cash conversion cycle (days)	-36	-25	-36	-33	-31
Δ shares out (avg)	-1%	-11%	-1%	-1%	-3%

¹ Dell changed its segment reporting structure in FY10. Figures reflect acquisition of Perot Systems in November 2009.

COMPARABLE PUBLIC COMPANY ANALYSIS

	MV (\$mn)	EV (\$mn)	EV / Rev.	P / Tang. Book	This FY P/E	Next FY P/E
IBM	199,170	216,180	2.1x	n/m	12x	11x
HPQ	72,600	82,780	.6x	n/m	7x	7x
SNE	24,800	16,300	.2x	1.4x	27x	18x
DELL	30,200	23,330	.4x	29.5x	8x	8x

RATINGS

VALUE Intrinsic value materially higher than market value?	☆☆☆☆
DOWNSIDE PROTECTION Low risk of permanent loss?	☆☆☆☆
MANAGEMENT Capable and properly incentivized?	☆☆☆☆
FINANCIAL STRENGTH Solid balance sheet?	☆☆☆☆
MOAT Able to sustain high returns on invested capital?	☆☆☆
EARNINGS MOMENTUM Fundamentals improving?	☆☆☆
MACRO Poised to benefit from economic and secular trends?	☆☆☆

THE BOTTOM LINE

Dell is a globally recognized technology brand with capable, properly incentivized management. The company has made progress in addressing challenges in the consumer products business amid slowing growth and greater competition. Dell’s direct model continues to produce impressive cash conversion cycles (*minus* ~30 days), though the company has felt a need to partner with retailers to expand distribution. We like Dell’s recent progress on margins, management’s long-term focus, strong FCF generation, share buybacks, cost leadership, and growth prospects in enterprise and services market segments.

DELL – OUR ESTIMATE OF THE EQUITY FAIR VALUE RANGE

	Conservative	Base Case	Aggressive
Valuation methodology	10x FY12 consensus EPS	10% free cash flow yield, based on TTM FCF	7% free cash flow yield, based on forward estimated FCF
Conservative case valuation:			
FY12 consensus EPS estimate	\$1.89		
Assumed fair value multiple	10x		
Base case valuation:			
Free cash flow, TTM April 29, 2011		\$4.1 billion	
Assumed FCF yield		10%	
Aggressive case valuation:			
Free cash flow, TTM April 29, 2011			\$4.1 billion
Guidance for FY12 non-GAAP EBIT growth			12-18%
Est. FCF growth in twelve months ending April 29, 2012			12%
Estimated FCF, twelve months ending April 29, 2012			\$4.6 billion
Assumed FCF yield			7%
Estimated fair value of the equity of Dell¹	\$36 billion \$19 per share	\$41 billion \$22 per share	\$66 billion \$35 per share
<i>Implied valuation multiples:</i>			
Book value to estimated equity value	23%	20%	13%
Tangible book value to estimated equity value	3%	2%	2%
Equity value to FY2012 consensus earnings ²	10x	12x	19x
Equity value to FY2013 consensus earnings ³	10x	11x	18x
Enterprise value to FY2012 sales guidance midpoint ⁴	0.4x	0.4x	0.8x
Enterprise value to FY2012 non-GAAP EBIT midpoint ⁵	5.0x	6.2x	11.4x

¹ Based on 1.9 billion shares outstanding, which represents Dell's share count at May 19, 2011. Our analysis does not account for potential stock repurchases.

² Based on average consensus EPS estimate of \$1.89 for the fiscal year ending January 31, 2012.

³ Based on average consensus EPS estimate of \$1.91 for the fiscal year ending January 31, 2013.

⁴ Enterprise value is calculated as market value, minus cash, minus short-term investments, minus long-term investments, minus short-term financing receivables, minus long-term financing receivables, plus short-term debt, plus long-term debt. We consider financing receivables in the calculation of enterprise value because Dell can borrow against those assets, suggesting that the receivables are an appropriate conceptual offset to the outstanding debt. We calculate the FY2012 sales guidance midpoint based on management's guidance for 5-9% sales growth, which results in a sales range of \$64.6-67.0 billion for FY2012.

⁵ We calculate the FY2012 non-GAAP EBIT guidance midpoint based on management's guidance for 12-18% operating income growth, which results in a non-GAAP operating income range of \$4.6-4.9 billion for FY2012.

Source: Company filings, The Manual of Ideas analysis, assumptions and estimates.

DELL – MANAGEMENT'S FY2012 GUIDANCE

Key Metrics	Outlook	Key Drivers
Revenue	up +5–9% Y/Y	<ul style="list-style-type: none"> Enterprise solutions and services growth
Operating Income (Non-GAAP)	up +12–18% Y/Y	<ul style="list-style-type: none"> Revenue Strength Commercial Leverage End User Computing
Cash Flow	CFOps > Net Income	<ul style="list-style-type: none"> OpInlc \$ Growth Sustained CCC

- For Q2, we expect mid-single digit sequential revenue growth, which is slightly above normal sequential seasonal growth of 2-3%
- We are confident in the sustainability of our strong margins even as the overall rate of component cost deflation slows
- We anticipate quarterly interest expense of \$70 million, and full-year Non-GAAP tax rate between 21-23%
- We expect improving demand dynamics in the markets that are critical for us, giving us confidence we can deliver on our FY12 outlook of 5-9% Y/Y revenue growth
- Our strong 1Q earnings results are a great start to the year, and we are now raising our total year Non-GAAP operating income outlook to 12-18% Y/Y growth

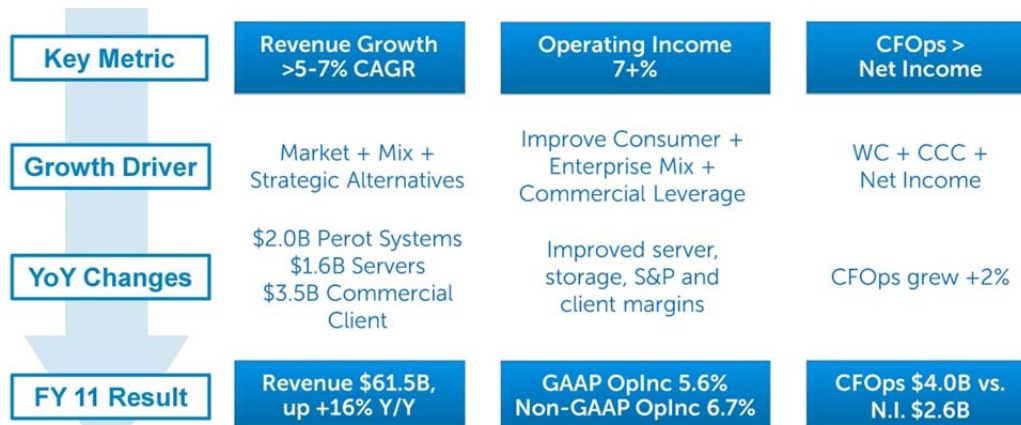
Source: Company presentation dated May 17, 2011.

DELL – CALCULATION OF NON-GAAP PROFITABILITY

	Q1'10	Q2'10	Q3'10	Q4'10	FY10	Q1'11	Q2'11	Q3'11	Q4'11	FY11	Q1'12
GAAP											
Net Income	290	472	337	334	1,433	341	545	822	927	2,635	945
EPS	\$0.15	\$0.24	\$0.17	\$0.17	\$0.73	\$0.17	\$0.28	\$0.42	\$0.48	\$1.35	\$0.49
Adjustments											
Income before Income Taxes											
Amortization of Intangibles	39	40	40	86	205	88	87	89	85	349	92
Severance & Facility Action Costs	185	87	123	86	481	57	24	31	17	129	19
Acquisition Related	-	-	-	116	116	20	16	23	39	98	53
Other ¹⁾	-	-	-	-	-	140	-	(72)	-	68	0
Aggregate Tax-adjustments	(28)	(24)	(51)	(78)	(181)	(62)	(43)	(18)	(50)	(173)	(59)
EPS - Diluted	\$0.10	\$0.05	\$0.06	\$0.11	\$0.32	\$0.13	\$0.04	\$0.03	\$0.05	\$0.24	\$0.06
Non-GAAP											
Net Income	486	575	449	544	2,054	584	629	875	1,018	3,106	1,050
EPS	\$0.25	\$0.29	\$0.23	\$0.28	\$1.05	\$0.30	\$0.32	\$0.45	\$0.53	\$1.59	\$0.55

¹⁾ \$40M Legal Settlement, a \$100M SEC Settlement and a \$72M merger termination fee.

Source: Company presentation dated May 17, 2011.

DELL – MANAGEMENT’S “LONG-TERM VALUE CREATION FRAMEWORK”


Source: Company presentation dated February 15, 2011.

DELL – PC MARKET SHARE

	Current Rank	Current Year Share					Annual Share										
		Q1 2010	Q2 2010	Q3 2010	Q4 2010	Q1 2011	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
WW Client PCs	2	13%	13%	13%	12%	13%	13%	15%	16%	17%	18%	16%	14%	14%	13%	13%	13%
USA	2	23%	24%	24%	22%	23%	24%	29%	32%	35%	36%	33%	29%	29%	24%	23%	23%
EMEA	3	10%	10%	9%	10%	10%	9%	9%	10%	11%	12%	11%	11%	9%	10%	10%	
Asia Pacific	3	9%	10%	10%	9%	10%	4%	5%	6%	6%	7%	7%	9%	8%	10%	10%	
Japan	4	9%	11%	10%	9%	10%	6%	7%	9%	11%	12%	14%	14%	14%	12%	10%	
Desktop PC	2	13%	14%	14%	13%	13%	12%	15%	17%	18%	17%	16%	15%	15%	13%	14%	
Portable PC	3	12%	12%	12%	11%	12%	14%	15%	16%	17%	18%	17%	14%	14%	12%	12%	
x86**	2	29%	30%	27%	26%	28%	19%	22%	25%	25%	26%	26%	25%	27%	28%	28%	
Consumer	3	9%	8%	8%	9%	9%	6%	10%	12%	13%	12%	11%	8%	9%	9%	9%	
SMB ¹	2	13%	13%	13%	12%	13%	12%	12%	13%	14%	15%	14%	14%	12%	13%	13%	
Public	3	17%	21%	19%	15%	17%	20%	19%	15%	17%	21%	17%	19%	20%	18%	17%	
Large Enterprise ²	2	31%	32%	29%	27%	27%	30%	30%	30%	31%	32%	25%	29%	31%	32%	29%	

*PC's include Desktops, Notebooks, data as of May 2011

**x86 is preliminary Q1 IDC data

¹SMB includes companies with less than 500 employees

²Large Enterprise includes companies more than 500 employees

Source: Company handout, dated May 17, 2011; IDC.

Exclusive Interview with Josh Tarasoff

We recently had the pleasure of interviewing Josh Tarasoff, general partner of Greenlea Lane Capital Partners, LP, a private investment partnership he founded in 2006. Josh graduated from Duke in 2001 with a degree in philosophy. He has worked at Goldman Sachs and holds an MBA from Columbia Business School.¹

The Manual of Ideas: Tell us about the genesis of your firm. What goals did you have at the start, and what operating principles have guided you since then?

Josh Tarasoff: I started Greenlea Lane Capital Partners, LP in 2007 as an extension of an account I had been managing for myself. The partnership structure facilitated participation by friends and family, and its goals are the same ones I had for my own capital: to capture the benefits of long-term compounding. Over the years the investor base has broadened somewhat, but every investor embraces a patient, long-term approach. We contribute money to the partnership intending to leave it there to compound indefinitely, to ignore volatility, and to evaluate results on a minimum three- to five-year basis.

There is an overarching operating principle, which relates to the fact that Greenlea Lane Capital started as my personal account and I expect it always to be the compounding vehicle for my own capital. Charlie Munger stated it best: “The safest way to try to get what you want is to try to deserve what you want. It’s such a simple idea. It’s the golden rule. You want to deliver to the world what you would buy if you were on the other side.” This basic idea is applicable in a wide variety of contexts, but its importance in managing money is something I have come to appreciate more every single year.

MOI: When it comes to stock selection, what are the key criteria you look for in potential investments?

Tarasoff: I have a fairly specific strategy, which is to make concentrated investments in great businesses, at attractive prices. I look for businesses that are resistant to factors that tend to erode the value of most businesses over time, such as competition, inflation, or technological obsolescence. For every business I look at, I ask myself whether I would be comfortable if it were the family business and we would never sell it. If that would not be a comfortable situation, then the business is not a candidate for investment.

One result of this narrow focus on very high quality, understandable businesses is that we pass up opportunities to make money that do not fit with our chosen discipline. On the other hand, I think that by staying focused we reduce mistakes over time. I also like the idea of sticking with a method of investing that fits my temperament very well. This makes it easier to be patient, and hopefully will make it possible to deploy the investment strategy for a very long time.

“I look for businesses that are resistant to factors that tend to erode the value of most businesses over time, such as competition, inflation, or technological obsolescence.”

¹ For more information, see Josh’s presentation at the Nexus 2011 conference in April 2011, available at <http://bit.ly/jdRu2t>

Exclusive Interview with Sahn Adrangi

We recently had the pleasure of interviewing up-and-coming value investor Sahn Adrangi, founder of Kerrisdale Capital Management. Previously, Sahn was an investment analyst at Longacre, an investment partnership focused on distressed debt and equities. Prior to Longacre, Sahn worked in the bankruptcy restructuring group at Chanin Capital, where he helped advise creditors in out-of-court and Chapter 11 restructurings. Prior to Chanin, Sahn worked in the leveraged finance group of Deutsche Bank, where he helped structure and syndicate non-investment grade debt. He holds a BA in Economics from Yale.

The Manual of Ideas: Your fund was up 66% net in 2010 and another 73% net in the first quarter of this year, driven by your ability to uncover and profit from equity declines in U.S.-listed Chinese companies that appear to be committing fraud. What led you to focus on this area of the market and how have you gone about separating the frauds from the legitimate companies?

Sahn Adrangi: In early 2010, when I was looking at this space, there were dozens of companies showing abnormally high margins and growth rates that were trading at unusually low valuations. This struck me as unsustainable. Either these companies were reporting accurate figures and their stock prices deserved to trade several times higher than their current market prices, or the companies were fabricating their financial statements and the managements needed to be investigated by the SEC. We decided to immerse ourselves in the sector to figure out what was going on and share our detailed granular research on whether these companies were severely undervalued (i.e., reporting real numbers) or severely overvalued (i.e., reporting fake numbers).

In terms of how we've separated the frauds from legitimate companies, we've relied on investigators, financial filings in China, and common sense. Some of these businesses are reporting irrationally high margins, growth rates and returns on capital despite operating commodity businesses. These too-good-to-be-true situations have led us to dig deeper on whether these companies are misrepresenting themselves in their filings.

MOI: How have you typically structured your bearish positions? Could you walk us through a typical timeline and mechanics, perhaps using an example that has already played out?

Adrangi: We short stock, sell calls and buy puts. In the early part of this year, we took an aggressive bearish directional exposure to U.S.-listed Chinese frauds because we saw the rapid acceleration of fraud reports on these companies, as well as increased regulatory scrutiny. In terms of a specific example, we did granular research on **China Education Alliance (CEU)** late last year, and took an unusually large bearish position when we recognized that the company was one of the most obvious stock scams we would ever come across. Our 30-page report showed that its classroom facility was vacant, its Chinese financial filings showed negligible revenue, and that its customers could not actually purchase products on the company's website, despite the company's claim to be an online education provider. We took a large bearish position via shorting the stock, buying puts and selling calls and waited for our thesis to play out.

MOI: As we surveyed potential U.S.-listed Chinese frauds recently, it became clear that taking a short position in those securities was no longer an easy proposition. The short interest on many of the stocks is already so high that

“Either these companies [U.S.-listed Chinese stocks] were reporting accurate figures and their stock prices deserved to trade several times higher than their current market prices, or the companies were fabricating their financial statements and the managements needed to be investigated by the SEC.”

Extra: Dissecting Fannie and Freddie Preferreds

BY ORI EYAL, founder & portfolio manager of Emerging Value Capital Mgmt

EVCM is a long-short global value fund. The firm's in-depth research explores the merits of each investment in the context of a global market. Ori worked at Deutsche Bank Asset Management, Deephaven Capital and Aquamarine Fund. He holds an MBA from the University of Chicago Booth School of Business.

Background

At the recent Value Investing Congress in Pasadena, CA, Michael Kao, the founder and portfolio manager of Akanthos Capital Management, gave a compelling presentation on the investment case for the preferred shares of the GSEs, Fannie Mae (OTC: FNMA) and Freddie Mac (OTC: FMCC). He argued that such an investment provides a favorable, asymmetric risk/reward. The Fannie and Freddie preferred shares are a “perpetual option” on the possibility that the payment of the preferred share dividends is resumed.

We will briefly summarize the argument for owning a basket of Fannie Mae and Freddie Mac preferred shares. Interested investors are further referred to Michael Koa's presentation³ and the discussion on the online blog of Gator Capital Management.⁴

Assuming an investor carefully weighs this investment thesis and decides to invest, he or she is still left with the open question as to which Fannie Mae and Freddie Mac preferred shares offer the best value. By our count, there are 36 different types of Fannie Mae and Freddie Mac preferred shares outstanding, and each has somewhat different characteristics.

We present a table summarizing the characteristics of the different preferred shares as an aid to investors trying to decide which offer the best value.

Summary Thesis

The ultimate fate of Fannie and Freddie is a political issue. While the final outcome is uncertain, there are multiple compelling reasons for the U.S. government to eventually allow the GSEs to exit conservatorship and resume operating as in the past (but under much stricter limits and supervision). In such a scenario, it is likely that payment of the preferred share dividends would resume and that the various Fannie and Freddie preferred shares, currently trading for about 10 cents on the dollar, would appreciate close to their face values, providing up to a 10x return to current investors.

This is inherently a speculative investment, since certain future scenarios would leave the preferred shares worthless. However, given a potential 10x return, buying the preferred shares could be a good bet even if we assign only a 20% probability to a positive outcome.

³ Available at <http://bit.ly/iuyKWc>

⁴ Available at <http://bit.ly/jtPJJu>

Favorite Screens for Value Investors

Contrarian: Biggest YTD Losers (deleveraged & profitable)

Non-financial companies with no net debt, positive analyst estimates for next year's EPS, and large YTD price drop

	Company	Ticker	Price (\$)	MV (\$mn)	EV (\$mn)	Price Change Since December 31,			Price to Tangible Book	Next FY P/E	Insiders	
						2004	2009	2010			% Own.	Buys/Sells
1	SemiLEDs	LEDS	7.49	204	112	n/m	n/m	-74%	1.2x	19x	0%	1 / -
2	Smith Micro Software	SMSI	4.06	146	81	-55%	-56%	-74%	1.4x	12x	4%	10 / 8
3	Am. Superconductor	AMSC	7.55	383	140	-49%	-82%	-74%	.9x	18x	1%	2 / 7
4	Trident Microsystems	TRID	0.71	127	57	-92%	-62%	-60%	1.1x	9x	1%	9 / 1
5	MIPS Technologies	MIPS	6.31	332	223	-36%	44%	-58%	3.4x	14x	0%	6 / 5
6	Motricity	MOTR	7.80	362	300	n/m	n/m	-58%	3.8x	8x	3%	7 / 7
7	Voyager Oil & Gas	VOG	2.30	133	101	-86%	121%	-57%	1.7x	12x	7%	- / 1
8	Axcelis Technologies	ACLS	1.51	160	115	-81%	7%	-56%	.8x	6x	1%	7 / 1
9	* Oclaro	OCLR	6.36	321	246	-74%	-13%	-52%	1.5x	22x	1%	5 / 5
10	* Finisar Corp.	FNSR	14.87	1,333	1,081	-18%	67%	-50%	2.2x	11x	1%	5 / 7
11	Uranium Energy	UEC	3.05	221	188	n/m	-19%	-50%	3.7x	18x	2%	1 / -
12	Cree	CREE	34.27	3,752	2,679	-14%	-39%	-48%	2.1x	21x	0%	2 / 1
13	Longtop Fin. Tech	LFT	18.93	1,080	668	n/m	-49%	-48%	2.6x	9x	0%	- / -
14	* Sigma Designs	SIGM	7.78	248	133	-22%	-27%	-45%	1.0x	17x	2%	2 / -
15	* Xyratex	XRTX	9.06	274	176	-45%	-32%	-44%	.8x	6x	0%	- / -
16	* Winnebago	WGO	8.55	249	184	-78%	-30%	-44%	2.4x	13x	1%	17 / 2
17	Nephros	NEP	3.28	116	44	720%	-65%	-43%	1.0x	3x	0%	- / -
18	Monster Worldwide	MWW	13.48	1,743	1,672	-60%	-23%	-43%	n/m	17x	3%	10 / 5
19	Rentrak	RENT	17.43	196	170	40%	-1%	-42%	5.3x	11x	5%	4 / 4
20	* Infinera	INFN	6.02	629	354	n/m	-32%	-42%	1.5x	151x	0%	10 / 6
21	* Nokia	NOK	6.02	22,521	12,669	-62%	-53%	-42%	2.2x	14x	0%	- / -
22	Gaiam	GAIA	4.60	107	76	-25%	-40%	-40%	1.0x	16x	1%	3 / -
23	Tellabs	TLAB	4.07	1,479	421	-53%	-28%	-40%	.9x	204x	5%	18 / 12
24	Novatel Wireless	NVTL	5.75	184	145	-70%	-28%	-40%	1.9x	72x	2%	10 / 6
25	* QuinStreet	QNST	11.60	544	505	n/m	n/m	-40%	9.4x	12x	0%	6 / 6
26	Citi Trends	CTRN	14.87	223	146	n/m	-46%	-39%	1.0x	10x	2%	11 / 6
27	NutriSystem	NTRI	12.76	344	326	348%	-59%	-39%	4.9x	12x	4%	7 / 3
28	* Broadwind Energy	BWEN	1.41	151	143	1663%	-83%	-39%	1.4x	35x	13%	9 / 4
29	* Resources Connection	RECN	11.39	528	377	-58%	-46%	-39%	2.7x	20x	0%	8 / 2
30	Daktronics	DAKT	9.85	410	336	-21%	7%	-38%	2.1x	17x	5%	4 / 3
31	* Exceed Company	EDS	5.12	130	(9)	n/m	-40%	-38%	.5x	3x	0%	- / -
32	* Hecla Mining	HL	6.99	1,952	1,637	20%	13%	-38%	1.9x	10x	0%	7 / 3
33	* PharmAthene	PIP	2.63	127	117	n/m	34%	-38%	14.9x	8x	4%	2 / 5
34	* Entropic Comms	ENTR	7.57	649	506	n/m	147%	-37%	2.5x	9x	0%	9 / 9
35	* Akamai Technologies	AKAM	29.49	5,506	4,943	126%	16%	-37%	3.2x	16x	0%	10 / 5
36	* Dolby Laboratories	DLB	42.70	4,774	3,987	n/m	-11%	-36%	3.7x	15x	0%	13 / 11
37	Rosetta Stone	RST	13.75	289	168	n/m	-23%	-35%	2.3x	37x	0%	- / 1
38	* Capella Education	CPLA	43.19	679	494	n/m	-43%	-35%	3.4x	13x	6%	9 / 1
39	* U.S. Energy Corp.	USEG	3.95	107	95	33%	-33%	-35%	.8x	66x	5%	5 / 2
40	USANA Health	USNA	28.28	445	411	-17%	-11%	-35%	4.7x	9x	52%	1 / 5
41	* TEKELEC	TKLC	7.79	537	297	-62%	-49%	-35%	1.4x	18x	1%	14 / 6
42	Grand Canyon	LOPE	12.85	577	574	n/m	-32%	-34%	4.4x	10x	9%	6 / 6
43	* EnerNOC	ENOC	15.73	415	313	n/m	-48%	-34%	3.0x	37x	11%	10 / 2
44	* WMS Industries	WMS	29.86	1,710	1,609	34%	-25%	-34%	2.4x	15x	1%	- / 3
45	* Northern Oil & Gas	NOG	18.07	1,141	1,016	n/m	53%	-34%	2.6x	10x	7%	4 / 7



Company website

SEC

Y!

Stock Price Charts

Proxy

Y!

* New additions are highlighted. Criteria: ▶ Positive net cash ▶ Positive next FY EPS ▶ MV > \$100 million ▶ China RTOs excluded

This Month's Top 10 Web Links

A Selection of Our Favorite Freely Accessible Internet Resources

Click on the link next to each title, or type the Web address into your Web browser:

- 1 Muddy Waters on Sino-Forest (Toronto: TRE)**
Plus: Follow-up article by The Globe & Mail, <http://bit.ly/m6ZYqs> <http://bit.ly/aMuTGw>
- 2 Nexus 2011 Value Investing Conference Presentations**
Includes Zeke Ashton's excellent discussion of Japanese sovereign credit risk [http://\[REDACTED\]](http://[REDACTED])
- 3 Howard Marks Memo: "How Quickly They Forget"**
Plus: Bloomberg background piece on Marks, <http://bloom.bg/jDKJLz> <http://bit.ly/lmCWp6>
- 4 Barron's Midyear Roundtable Discussion**
Participants: Felix Zulauf, Scott Black, Bill Gross, Fred Hickey, Meryl Witmer [http://\[REDACTED\]](http://[REDACTED])
- 5 Interview with Bob Doll, BlackRock's Chief Equity Strategist** [http://\[REDACTED\]](http://[REDACTED])
- 6 Interview with Small-Cap Value Investor Chuck Royce** [http://\[REDACTED\]](http://[REDACTED])
- 7 Bill Ackman's Presentation on Family Dollar (NYSE: FDO)** [http://\[REDACTED\]](http://[REDACTED])
- 8 Fortune: Bob Rodriguez, "The Man Who Sees Another Crash"** <http://bit.ly/lqLilk>
- 9 Interview with Jean-Marie Eveillard** <http://bit.ly/l70lvQ>
- 10 Interview with Jim Grant on Biography of Tom Reed** <http://cs.pn/lx9aVr>

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