

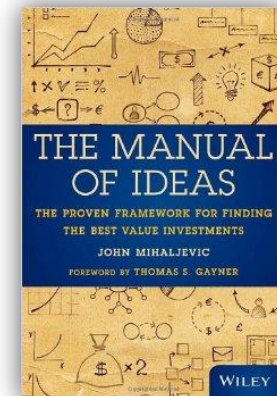
Idea Generation Demystified

The “Secret” to Finding Great Investment Ideas

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The Manual of Ideas
www.manualofideas.com



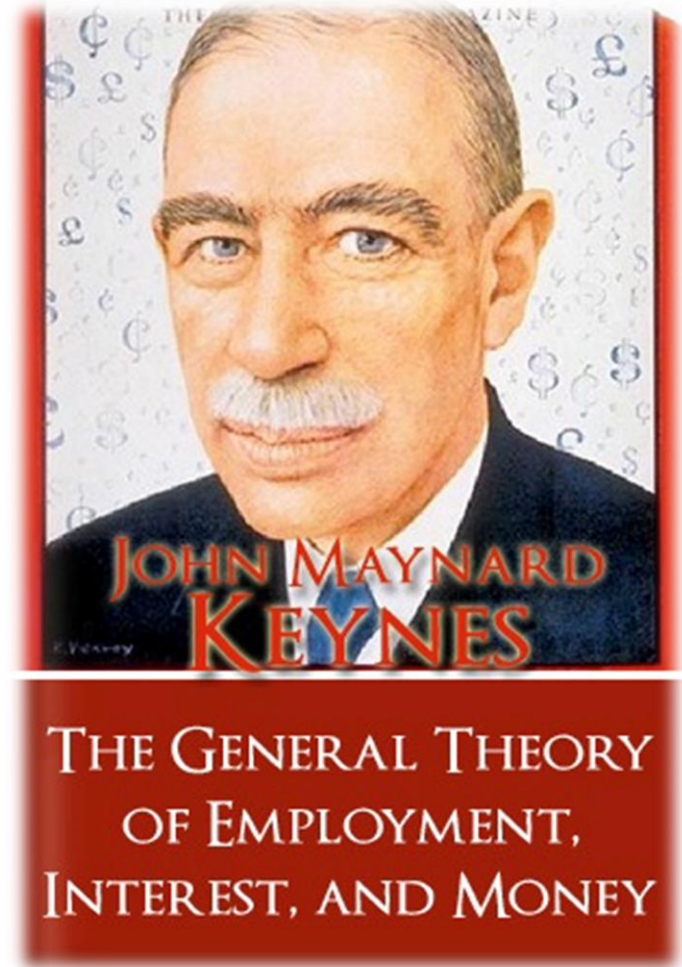
Talks at Google
September 8, 2014



Stock Market: A Beauty Contest

- Concept developed by John Maynard Keynes in 1930s
 - Fictional contest: entrants choose prettiest face in order to win
 - Naïve: Apply own sense of beauty
 - Instead: Consider majority opinion
- Analogy to stock market

“It is not a case of choosing those [faces] that, to the best of one's judgment, are really the prettiest, nor even those that average opinion genuinely thinks the prettiest. We have reached the third degree where we devote our intelligences to anticipating what average opinion expects the average opinion to be. And there are some, I believe, who practice the fourth, fifth and higher degrees.”



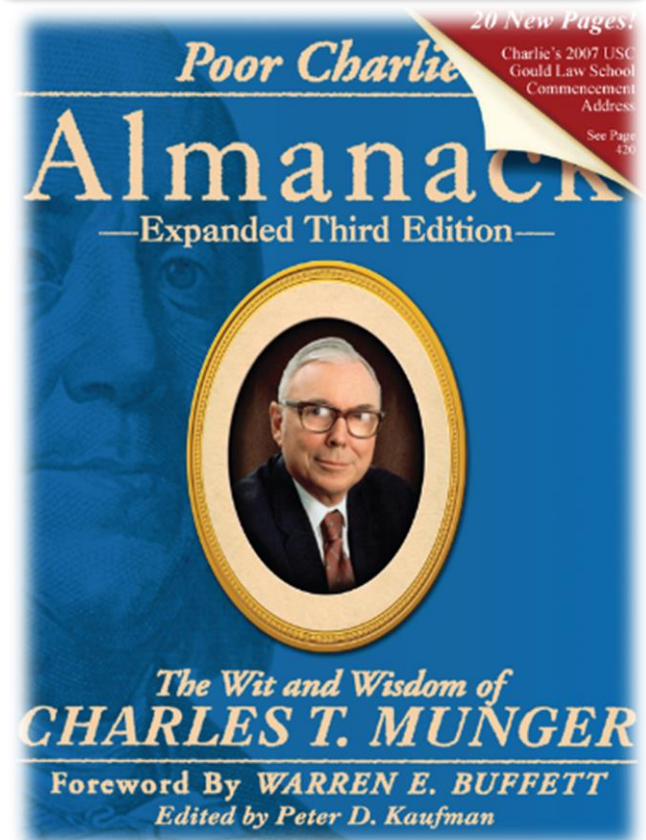
Stock Market: A Parimutuel Betting System

- Created by Catalan impresario Joseph Oller in 1867
 - Used most prominently in horseracing
 - Payoff odds calculated after house vig
 - Horse popularity affects payoff offs

- Analogy to stock market

“Any damn fool can see that a horse carrying a light weight with a wonderful win rate [...] is way more likely to win than a horse with a terrible record... But if you look at the odds, the bad horse pays 100 to 1, whereas the good horse pays 3 to 2. Then it's not clear which is statistically the best bet using the mathematics of Fermat and Pascal. The prices have changed in such a way that it's very hard to beat the system.”

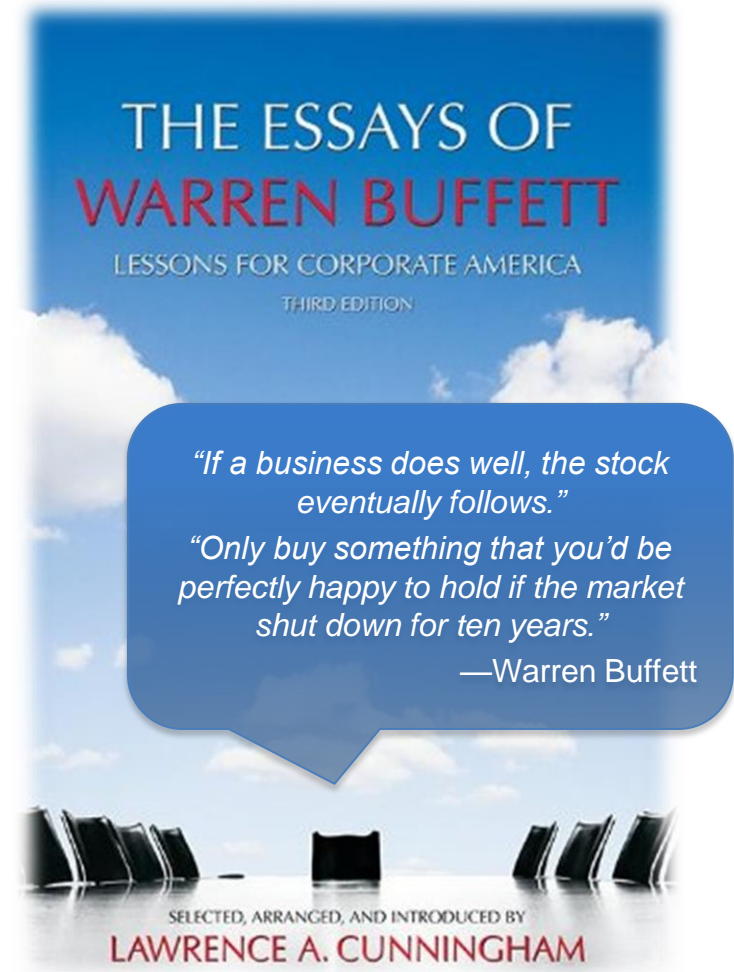
“We simply attempt to be fearful when others are greedy and to be greedy only when others are fearful.” —Warren Buffett



Stock Market: A Conduit to Ownership

- A “place” for buying and selling common stock in companies
- Common stock: participation in the ownership of a corporation
 - Contract between holder and the firm
 - Claim on corporate net worth
- Seth Klarman sums up the essence of the stock market:

“Are stocks pieces of paper to be endlessly traded back and forth, or are they proportional interests in underlying businesses? A liquidation settles this debate, distributing to owners of pieces of paper the actual cash proceeds resulting from the sale of corporate assets...”



Mindset A: “Small Fish”

Ticker	Company	Stock Price	Market Value	\$100,000 Buys . . .
AET	Aetna	\$30.52	\$4.4 billion	3,277 shares
DAL	Delta Air Lines	29.31	3.6 billion	3,412 shares
F	Ford Motor	17.88	32.4 billion	5,593 shares
GM	General Motors	47.69	26.5 billion	2,097 shares
LMT	Lockheed Martin	45.01	19.8 billion	2,222 shares
NYT	New York Times	45.15	6.8 billion	2,215 shares
TIF	Tiffany & Co.	29.17	4.3 billion	3,428 shares
TM	Toyota Motor	53.71	99.0 billion	1,862 shares

*

“I have \$100,000 to invest, which will buy me a tiny stake in one the above companies. It looks like I can buy a few thousand shares of any of these stocks.”

- Fallacy of focusing on the scale of our portfolio
- Negligible market impact does not imply insignificant *role*
- Instead, focus on the scale of potential investments

* Data in the above table is as of November 2001.

Sources: John Mihaljevic, [The Manual of Ideas](#); publicly available information.

Mindset B: “Chief Capital Allocator”

						*
Ticker	Company	Market Value	Ticker	Company	Market Value	
AET	Aetna	\$4.4 billion	TM	Toyota Motor	\$99.0 billion	
DAL	Delta Air Lines	3.6 billion				
F	Ford Motor	32.4 billion				
GM	General Motors	26.5 billion				
LMT	Lockheed Martin	19.8 billion				
NYT	New York Times	6.8 billion				
TIF	Tiffany & Co.	4.3 billion				
		\$97.8 billion			\$99.0 billion	

“If I could buy one of the above companies, which would I choose?”

- Role: Distribute capital to activities with highest ROC **
- Capital allocator mindset has awareness of relative value
- Owner mentality is congruent with *legal* essence of stocks

* Data in the above table is as of November 2001. Comparison based on enterprise value would be more appropriate than comparison based on market value, as enterprise value takes into account net debt, reflecting non-equity claims on corporate assets.

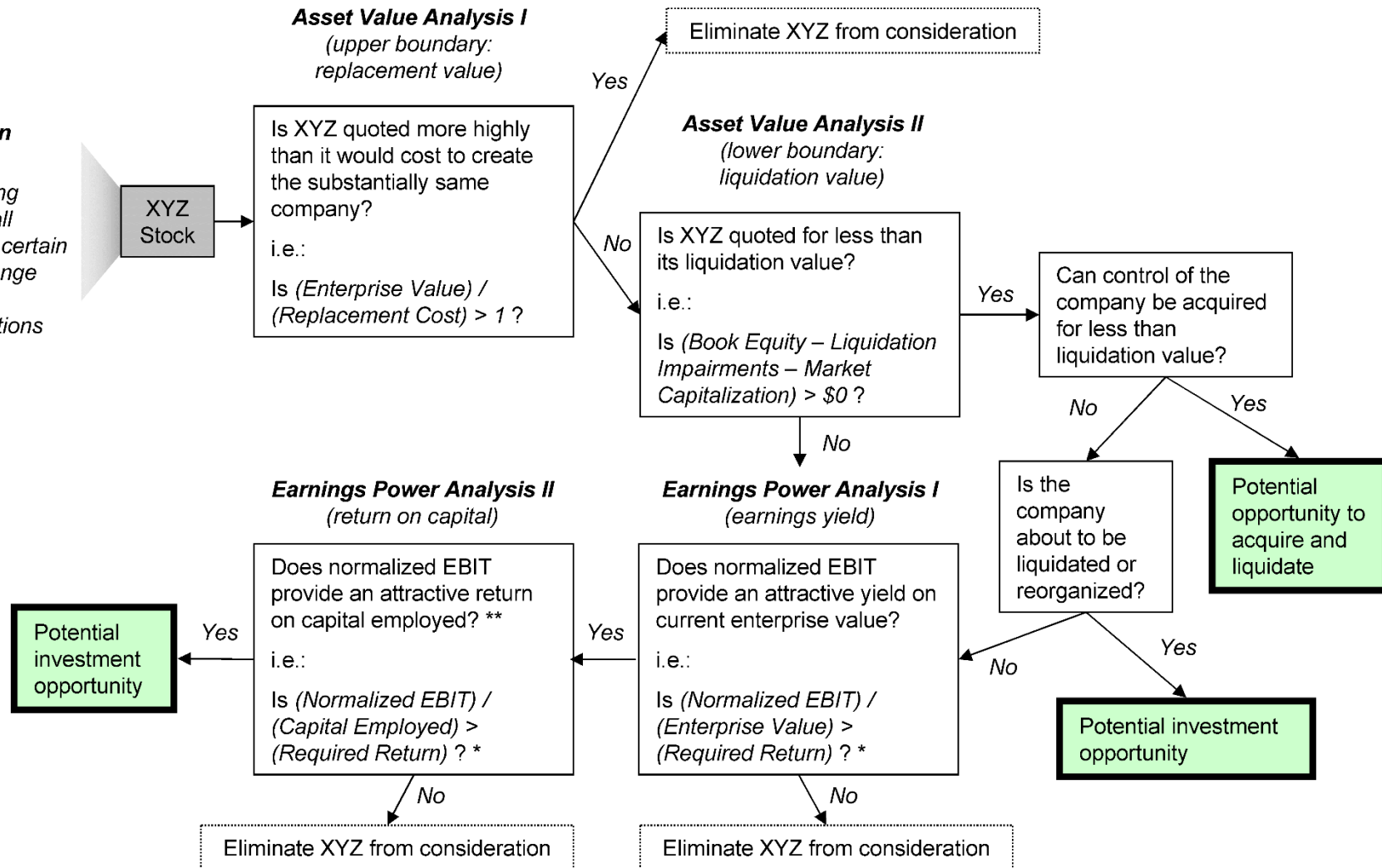
** Subject to modifications based on relative market quotation of different companies. ROC = return on capital.

Sources: John Mihaljevic, [The Manual of Ideas](#); publicly available information.

A Unifying Stock Selection Framework?

Idea Generation

- Quantitative stock screening
- Research of all companies in certain market cap range
- SEC filings
- News publications



* Required return depends on conviction regarding normalized EBIT and other factors.

** Additional considerations: Can capital be reinvested at the normalized return on capital? Are above-average returns on capital sustainable?

Selected Value-oriented Idea Generation Approaches (that we like)

- Joel Greenblatt-style “Magic Formula”
 - Good businesses at good prices
 - High ROCE, high EBIT/EV *
 - Earnings-based approach
- Benjamin Graham-style “Deep Value”
 - “Net nets” and similar strategies
 - (Current assets minus total liabilities) > market value
 - Asset-based approach
- Carl Icahn-style “Sum of the Parts”
 - A staple approach of activists
 - Thesis often based on monetizing non-core and/or excess assets
 - Earnings- and/or asset-based
- Other Approaches
 - “Jockey” stocks
 - Special situations
 - Equity stubs
 - Superinvestor cloning

* ROCE = return on capital employed; EBIT = earnings before interest and taxes; EV = enterprise value.

Sources: Benjamin Graham and David Dodd, [Security Analysis](#); Joel Greenblatt, [The Little Book That Beats the Market](#).

Ben Graham-style “Deep Value”

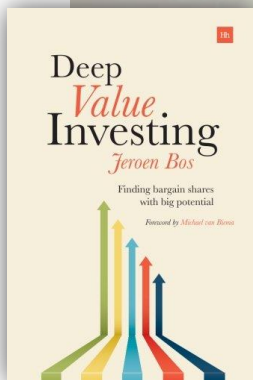
“It seems completely contradictory that you buy companies nobody else wants, and then, given a bit of time, as a group they tend to outperform...”

—Jeroen Bos



Jeroen Bos

Investment Director, Church House Investments



Observations on Deep Value Approach

“The problem is to distinguish between being contrary to a misguided consensus and merely being stubborn.” —Robert Arnott and Robert Lovell Jr.

1. Unabashedly starts with the price of a stock
2. Studies (e.g., Fama/French) show equities with high book-to-market ratios outperform
3. Holy grail: companies with asset protection and high normalized returns on capital
4. Return of cash to shareholders can make low-return businesses a great investment
5. Investors may overestimate liquidation value (dying businesses hide nasty surprises)
6. Acceptance of discomfort can be rewarding in investing, as fearful equities frequently trade at exceptionally low valuations
7. When we invest in an asset-rich but low-return business, time may be working against us; as a result, catalysts become a relevant consideration
8. Businesses at deep value prices are most likely to be creatively destroyed; unwise to allocate a large portion of investable capital to any one deep value opportunity
9. Suggested screening factors for Graham-style bargains: share repurchases, insider buying, and cash generated through working capital shrinkage
10. Valuation based solely on readily ascertainable balance sheet values runs the risk that values erode over time, negatively impacting future equity value

Example: Nexen Tire Preferreds (Korea) *

(deep value investment)

- Presented by Chan Lee and Albert Yong of Petra Capital Management at Asian Investing Summit 2014
- Investment thesis:
 - Nexen manufactures automobile tires and is one of the fastest growing tire manufacturers in the world – a “hidden champion” from Korea with superior cost competitiveness via state-of-art manufacturing facilities and skilled labor force
 - While the common stock (Korea: 002350) is attractive, the Korean equity market offers two alternative – and superior – ways to invest in Nexen:
 1. HoldCo Nexen Corp. (Korea: 005720): HoldCo owns 41% of Nexen Tire, plus other subsidiaries; stake in Nexen Tire is about 70% of Holdco value; HoldCo shares trade at about a 50% discount to SOTP, including Nexen Tire at market
 2. Nexen Tire Preferreds (Korea: 002355): No voting rights but confers same economic benefits as the common; trades at about a 50% discount to common

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Carl Icahn-style “Sum of the Parts”

*“Vodafone/Verizon is a good example:
Vodafone owned a stake in Verizon
Wireless... it wasn’t getting appropriate
credit sitting inside of Vodafone...”*

—Chris Crawford

BRUCE MCGAW GRAPHICS



Observations on Sum-of-the-Parts Approach

“Vodafone does not consolidate Verizon Wireless and, as a result, sell-side analysts seem to ignore its significant value.” —David Einhorn

1. Some companies best appraised by analyzing each business/asset separately and then adding up those components of value to arrive at an estimate of overall value
2. A reason for occasional mispricing of companies with multiple sources of value may be unwillingness to value assets that differ materially from a company's core assets
3. Companies with distinct components of value often enjoy greater strategic flexibility
4. Sometimes investors slice a company into too many parts, creating an attractive investment thesis in theory but not in reality
5. Sum-of-the-parts ideas are prone to becoming “value traps” absent strategic action
6. It matters whether the offer is “buy one, get one free,” or “buy 10, get one free”
7. Sum-of-the-parts opportunities come in a few different flavors, each of which demands a slightly different approach to screening
8. Usefulness of sum-of-the-parts analysis grows when the various business segments demand distinct approaches to valuation, making corporate-level data less relevant
9. Investors may become patsies by failing to realize that “hidden” value is not hidden
10. Focus on how the value in “hidden” assets will accrue to shareholders—and when

Example: Nesco (India: NSE) *

(sum-of-the-parts investment)

- Presented by Sid Choraria, Managing Partner of Marwar, at Asian Investing Summit 2014
- Investment thesis:
 - Mispriced, with investors getting \$50+ million cash pile and 70-acre land plot – near Mumbai airport and likely worth more than recent market value – for free
 - Land acquired in late 1950s and recorded at acquisition cost of US\$1 million
 - Supporting the valuation is the core exhibition and IT park business, a wide-moat business with 75%+ EBIT margins and multiple growth catalysts
 - Insiders eat their own cooking and are good capital allocators
 - Underfollowed, despite transformation and improvements (exhibition and leasing capacity growth, margin expansion, cash pile and dividends rising every year)
 - Screening databases like Bloomberg show incorrect P/E and P/B multiples

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Joel Greenblatt-style “Magic Formula”



“The baskets that were constructed by people underperformed the automatically generated baskets... We’re just terrible at constructing these baskets.”

—Alon Bochman

Observations on Magic Formula Approach

“The key to investing is not assessing how much an industry is going to affect society, or how much it will grow, but rather determining the competitive advantage of any given company and, above all, the durability of that advantage. The products or services that have wide, sustainable moats around them are the ones that deliver rewards to investors.” —Warren Buffett

1. Advice to buy good companies only when they're cheap seems glib at first glance
2. According to MF, the higher the return on capital employed, the better the business
3. Use of EBIT/EV and EBIT/CE eliminates the effects of leverage and taxes
4. In theory, outperformance of MF methodology should prompt investors to flock to it, eliminating its attractiveness; in practice, MF is likely to keep outperforming
5. Highly concentrated long-only MF portfolios could suffer debilitating volatility
6. Mr. Market overvalues businesses whose returns on capital derive from explosive but transitory trends or fads; Mr. Market often undervalues un-hyped quality businesses
7. A key adjustment is to use forward-looking earnings data in the MF calculation
8. If we run the MF screen on a database that includes both U.S. and non-U.S.-listed companies, the greater number of candidates should enhance performance
9. It might make sense to introduce a hurdle above which all companies are tied from the perspective of ROCE — the cheapness factor then carries more weight
10. High ROCE is almost meaningless without an ability to reinvest at high returns

Example: St Shine Optical (Taiwan: 1565) *

(“magic formula”, based on normalized earnings)

- Featured by Koon Boon Kee, Managing Editor of *The Moat Report Asia*, in the June 2014 Issue
- Investment thesis:
 - #5 contact lens manufacturer globally, #1 original design manufacturer (ODM)
 - Unique cast-molding technology gives St Shine unmatched flexibility in product design, increased quality, and better-than-competitive cost structure
 - Underappreciated moat, despite high and growing ROE (41% in FY2013)
 - Downside protection due to 3% dividend yield and net-cash balance sheet
 - Takeover target: St Shine has been regarded as a “thorn in the flesh” by the Big Four players for its role in feeding the hundreds of mid-tier competitors

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Full presentation: <http://www.moatreport.com/st-shine-optical-taiwan/>

Warren Buffett-style “Jockey Stocks”



“Management is very important. That’s where we start our process... We look at the proxy. We read the shareholder letter. We get the 2008-’09 conference call archive—it’s very revealing.”
—Michael Shearn

Michael Shearn
Founder, Time Value of Money, LP

THE INVESTMENT CHECKLIST
The Art of In-Depth Research
MICHAEL SHEARN

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Observations on Jockey Stocks Approach

“Commoditization is correlated with management impact. If you’re the manager of a retailer, an insurance company, a commodity company, a miner, or a bank, you can have a huge impact on whether your business is great or good. If you’re managing a business that already has a wide moat, you’re more of a caretaker. Your job is to not screw up.” —Pat Dorsey

1. CEOs can deliver in two ways: business value creation and smart capital allocation
2. Whether better business management also results in market-beating stock performance depends on the market’s equity quotation at the time of investment
3. Munger’s advice to invert serves us well — not in identifying the greatest jockeys but rather in eliminating the bad actors; an acid test is compensation
4. Reflections of CEO attitude toward owners: Are the CEO’s communications open and honest? What is the composition of the board? What does financial leverage tell us?
5. We can use screens to move a closer to identifying firms with good management
6. In the context of screening, two simple factors are ownership and insider buying
7. Between the extremes of excellent and poor capital allocators is a world of mediocrity, in which managements often view reinvestment of capital as the default option
8. Building a list of great capital allocators is a continuous process of curation
9. Subjective assessment of management in a one-on-one meeting likely adds value to the investment process, assuming the investor is aware of the biases involved
10. Investors should prioritize meetings likely to yield incremental, differentiated insights

Example: Sears Hometown (Nasdaq: SHOS) *

(“jockey” stock; capital allocator: Eddie Lampert)

- Presented by Todd Sullivan, General Partner of Rand Strategic Partners, at Small-Cap Investing Summit 2014
- Investment thesis:
 - Can boring, slow-growth business equal large returns? Todd thinks so — SHOS may be analogous to AutoZone (AZO), a successful Lampert investment
 - Opening of new locations should provide additional unencumbered cash flow (due to franchising) that will enable steady share repurchases
 - SHOS spun from Sears Holdings (SHLD) in October 2012 (Lampert’s ESL owns 48% of SHOS) and retains operational links with SHLD, a positive for SHOS
 - SHOS is #4 U.S. appliance retailer (Sears #1, Lowe’s #2, Home Depot #3) and is a play on the dominant brands in their categories: Craftsman, Kenmore, Diehard
 - Trades at ~6x EBITDA versus ~11x for Home Depot and ~9x for Lowe’s; asset-lite franchise model eliminates largest complaint about “Sears” (retail execution)

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Session recording and slides: <http://www.valueconferences.com/2014/02/smallcap14-todd-sullivan/>

Seth Klarman-style “Special Situations”



“You have to start with a clean sheet of paper mentally and be willing to learn. I don’t think there is any particular magic to it in terms of skill.”

—Phil Ordway

Philip C. Ordway
Portfolio Manager, Anabatic Fund

Observations on Special Situations Investing

“Simplicity is the ultimate sophistication.” —Leonardo da Vinci

1. Special situations encompass equities whose near- to medium-term stock price performance is largely independent of the performance of equity markets
2. Special situations, liquidations in particular, crystallize the meaning of value
3. Flood of talent has taken some areas from obscurity to popularity, reducing returns
4. The more obscure a niche, the more likely that diligent investors will outperform
5. In markets that exhibit informational inefficiency, rewards may accrue to those who make the effort to obtain timely, accurate, and relevant information
6. Analytical inefficiencies play an even greater role in outperformance; while data is available to investors willing to dig for it, many struggle to overcome analytical hurdles
7. Investing rules, as distinct from laws, need to be broken occasionally in the pursuit of excellence; in this context, rules include the financial formulas we have memorized
8. Some insights can be gained only if we launch the process of inquiry at the relevant point in time; if we do so, we may enrich the process with new insights at a later date
9. Special situations are an investment area in which it makes sense to pay at least as much attention to the time component of annualized return as to the absolute return
10. If we can identify a non-fundamental factor that explains the low valuation of a security, we gain confidence in an estimate of value that differs from the market price

Example: Can-One (Malaysia: CAN) *

(special situation investment)

- Presented by Roshan Padamadan, Fund Manager of Luminance Global Fund, at Asian Investing Summit 2014
- Investment thesis:
 - Special situation with catalyst for value recognition
 - In addition to operating business, Can-One owns stake in competitor Kian Joo Can (Malaysia: KJC), worth ~US\$150 million – approaching Can-One's MV
 - As KJC is selling itself, Can-One and other KJC shareholders should get cash
 - Can-One shareholders get the valuable Can-One operating business for free
 - Can-One manufactures tin cans (~25% of profits), produces condensed milk (~45 of profits) and has property-related activities (~30% of profits)
 - Can-One's controlling family, led by Yeoh Jin Hoe (66), has proven shrewd capital allocators and may return some cash from KJC stake to shareholders

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APPENDIX

MISTAKES AND LESSONS LEARNED (HOPEFULLY)

Lessons Learned: Nokia (NYSE: NOK)

(failed Graham-style investment)

- Highlighted in The Manual of Ideas, October 2010
 - Price down from \$10 per share to \$7.50 per share recently
- Original investment thesis:
 - Leading maker of mobile devices, with 1.2+ billion people using a Nokia handset
 - Remains synonymous with mobile telephony in most of the world
 - Recent CEO change and increasing shipments of smartphones
 - Globally-recognized brand, strong technology/patents, wide distribution platform
 - Trades at an enterprise value to revenue multiple of 0.6x; net-cash balance sheet
- Key lessons:
 - Focus on “deep” in deep value, i.e. the share price should be low enough relative to measurable asset protection (how do you value brands/patents/distribution platform?) and/or profit (lots of revenue may not mean much); at \$10 per share, Nokia lacked a margin of safety on either an asset or earnings basis
 - Pay more attention to catalysts other than price itself (e.g. management actions), especially if time is working against the investor (net asset value eroding)

Lessons Learned: Sony (NYSE: SNE)

(failed sum-of-the-parts investment)

- Highlighted in The Manual of Ideas, October 2011
 - Price down from \$20 per share to \$16 per share recently
- Original investment thesis:
 - Synonymous with challenged consumer electronics franchise, but investors are ignoring the profitable financial services, film and music businesses (which account for much of enterprise value, providing downside protection)
 - Solid balance sheet and IP assets to launch innovations in the future
 - Upside if Sony can stabilize/improve consumer electronics business
- Key lessons:
 - Need to assess likelihood (and potential success) of any strategic action; otherwise, an attractive investment thesis may only be attractive in theory
 - Sony's profitable businesses paradoxically allow electronics losses to continue, with no strategic action required to survive (little or no need for external funding)
 - Governance fallacy: Sony has relatively good governance in the Japanese context; but competitive/industry dynamics matter much more for valuation

Lessons Learned: Corinthian (Nasdaq: COCO)

(failed “magic formula” investment)

- Highlighted in The Manual of Ideas, February 2013
 - Price down from \$2.60 per share to \$0.25 per share recently
- Original investment thesis:
 - Price down 50+% in past year on renewed regulatory fears, including potential requirement to raise new capital to continue to participate in Title IV programs
 - Even if Corinthian is required to raise new capital, the risk reward tradeoff is tempting at the recent price as the latter already implies quite onerous terms
 - Market may be ignoring improved balance sheet, operational progress, and some success in reducing other regulatory risks over the last year
 - Large upside potential at quotation of 1.1x tangible book and 6x forward EPS
- Key lessons:
 - OK to look for trouble, but avoid weakest players; Corinthian had weak balance sheet, management, and standing with regulator (contrast with DeVry or Strayer)
 - Consider a basket approach if an industry is out of favor; properly sized, an investment in Corinthian may still have made sense as part of a basket approach

Lessons Learned: Dell (acquired)

(failed “jockey” investment)

- Highlighted in The Manual of Ideas, July 2011
 - Price down from \$16 per share to \$14 per share at MBO in October 2013
- Original investment thesis:
 - Global technology brand with capable, properly incentivized management
 - Addressing challenges in consumer amid slowing growth and greater competition
 - Direct model produces impressive cash conversion cycles (minus ~30 days), though Dell has felt a need to partner with retailers to expand distribution
 - Progress on margins, management’s long-term focus, strong FCF generation, share buybacks, cost leadership, growth prospects in enterprise and services
- Key lessons:
 - Choose your jockeys wisely: Michael Dell is clearly capable and incentivized, but his interests were also different from those of other shareholders (try to assess such differences and stay away if you can’t get comfortable with them)
 - Be aware of “passive investor risk,” especially in situations involving change; position sizing can be crucial (to be able to add if circumstances warrant)

Lessons Learned: GigaMedia (Nasdaq: GIGM)

(failed special situation investment)

- Highlighted in The Manual of Ideas, July 2010
 - Price down from \$2.20 per share to \$1.05 per share recently
- Original investment thesis:
 - Balance sheet does not reflect receipt of \$100 million in May 2010 from sale of stake in online poker software business
 - Pro forma net cash balance exceeds recent market value
 - While GigaMedia is redeploying cash into strategic investments in Asia, raising the risk of bad capital allocation, the potential rewards outweigh the risks
- Key lessons:
 - Difficult to draw general lessons here, but if there is one lesson... be clear about the investment thesis: what's "special" about your special situation? With GigaMedia, the receipt of \$100 million was special; however, when management made it clear that it would not return the cash to shareholders, an investment in GigaMedia became bet on capital allocation and the fortunes of the business

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