

Inside this issue:

Pershing Square Capital Challenge	P. 2
Motorola Solutions	P. 22
Quest Diagnostics	P. 24
2010 Graham & Dodd Breakfast	P. 26

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Issue XII

Spring 2011

“It Is The Judgment That Counts” — Michael Price

Mr. Price began his career in 1973 when he joined Max Heine at Mutual Series. In 2001, he left the firm to begin his own fund, MFP Investors, LLC. He earned a Bachelor in Business Administration from University of Oklahoma.

G&D: You have been involved in distressed and special situation investing for a long time. How has your strategy evolved and what is the mix today?

Michael Price (MP): It has evolved indeed. As a small mutual fund at Mutual Series, we had no say. We

had small amounts of stock. We could not influence proxy fights. We always had value and we always had situations involving corporate control. When the funds got bigger, we realized that we could use our significant influence for the betterment of our position, and that of all the other shareholders. We did that for a while, and then I got out of the fund business. Now I am back to a small, family office kind of fund, where we don't have that clout, but we try and influence directors and officers just because of our point of view that we think is well thought out. That is how it has evolved. We



Michael Price

don't take controlled positions. We don't try and force things to happen anymore.

G&D: Activism is the new buzzword. What do you think about it?

MP: There is nothing new under the sun. We used

(Continued on page 4)

“Big Companies In Small Industries” — Paul Johnson

Paul Johnson manages Nicusa Capital, a long-term concentrated fundamental value hedge fund. He began his career as a sell-side analyst at several Wall Street firms. He has previously taught Security Analysis and Value Investing at Columbia Business School as an adjunct professor.

Mr. Johnson holds a B.A. from UC Berkeley and an M.B.A. from Wharton.

G&D: Tell us a little about your background and how you got into value investing.

Paul Johnson (PJ): In the early part of my career, I was a sell-side technology analyst. I worked for various firms on Wall Street for twenty years. I was one of the senior technology analysts on the Street during the tech bubble of the late '90s and watched that market crash, which had a big impact on my thinking. That experience reinforced how critical the intrinsic value of the underlying company is to the



Paul Johnson

ultimate performance of a stock. One can try to play the game of outguessing where a stock price is going,

(Continued on page 13)

Welcome to *Graham & Doddsville*



Pictured: Bruce Greenwald, named the "Guru to Wall Street's Gurus," at the Columbia Investment Management Conference in February 2011.

We are pleased to present you with Issue XII of *Graham & Doddsville*, Columbia Business School's student-led investment newsletter co-sponsored by the Heilbrunn Center for Graham & Dodd Investing and the Columbia Investment Management Association.

This issue features an interview with Michael Price, portfolio manager of MFP Investors. Mr. Price describes the evolution of his

investing career, shares his perspective on activist investing and gives us insight into a few of his fund's positions.

The issue also features an interview with Paul Johnson, who manages Nicusa Capital. Mr. Johnson describes his value-focused, research intensive approach and gives some examples of recent investments.

We aim to offer specific

investment ideas that are relevant today. The current issue includes two investment ideas by student teams, who were the finalist and the runner up of the Pershing Square Capital Challenge.

Please feel free to contact us if you have comments or ideas about the newsletter as we continue to refine this publication for future editions. Enjoy!

Pershing Square Value Investing and Philanthropy Challenge in Pictures



Professor Andrew Brenner of Morgan Stanley making opening remarks



Pressure is on— Q&A begins



Judges deliberate



Winning Team MSI and Professors Bhatia, Yarsky and Brenner

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Pershing Square Value Investing and Philanthropy Challenge

Students and alumni gathered on April 8, 2011 for the Fourth Annual Pershing Square Value Investing and Philanthropy Challenge, a value oriented stock pitch competition, co-sponsored by the Heilbrunn Center of Value Investing at Columbia Business School and Pershing Square Capital Management. The competition is anchored by their commitment to produce talented, knowledgeable individuals ready to take on leadership roles as value investors.

In a surprise but welcomed move, Pershing Square increased the cash prize for the competition to \$100,000, half of which is directed to the school for philanthropic purposes, and the remainder to the winning team. The prize structure supports the goals for value investors of doing well and doing good.

Bill Ackman, of Pershing Square, kicked off the competition by introducing the team of judges. Each team then gave ten minute pre-

pared presentation of the idea that they had chosen, followed by 20 minutes of Q&A with the finalists.

The five finalists were selected from a pool of 33 teams, which enrolled in the Applied Security Analysis class at Columbia Business School. The course was taught by Professors **Andrew Brenner** (Morgan Stanley), **Daniel Yarsky** (Morgan Stanley) and **Naveen Bhatia** (Keffi Group). Students were taught various search and valuation strategies based on the Graham & Dodd value framework.

First place was awarded to the team of **Cristiano Amoruso** ('12), **Rick Carew** ('12) and **Matt Robinson** ('11) who presented Motorola Solutions (MSI). The judges were impressed by the clarity of their thesis, depth of research, and strong understanding of the underlying business (see write-up on page 22).

Practitioners in the investment management industry generously donated their time and worked closely with the teams to prepare them for the competition. Throughout the semester, each team had multiple chances to present in front



of investment management firms which provided feedback and suggested further areas of research.

Our deepest gratitude to them all for their support of Columbia Business School.

Pershing Square Challenge Finalists

First Place	Cristiano Amoruso '12	<i>Long</i>
	Rick Carew '12	Motorola Solutions (MSI)
	Matthew Robinson '12	
Runner-up	Anuj Aggarwal'12	<i>Long</i>
	Rahul Lulla'12	Quest Diagnostics (DGX)
	Josh Saltman'11	
	Allen Choi'11	<i>Long</i>
	Stanley Fourteau'12	Aéropostale (ARO)
	Kyoo Lee'11	
	Robert Bergan'12	<i>Long</i>
	Joseph Jaspan'12	Lender Processing Services (LPS)
	Adam Kramer'12	
	Peter Lawrence'11	<i>Long</i>
	Melissa O'Connor'12	Marsh & McLennan (MMC)
	Grant Smith'12	

Judges

William Ackman	Pershing Square Capital Management
Paul Hilal '92	Pershing Square Capital Management
Anand Desai	Eton Park
Daniel Schuchman	MSD Capital
Craig Nerenberg	Brenner West Capital Partners LP
David Berkowitz	Ziff Brothers Investments
Mick McGuire	Marcato Capital
Scott Pearl	Seneca Capital

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Michael Price

(Continued from page 1)

activism at Mutual Series to represent our interests and it turned out to be a good marketing mechanism. If we would get active in a situation and the New York Times or Fortune or Forbes would write about it, it would bring money to the fund because we were doing interesting things. People have now realized that activism is good for the money management business, but activism is not a business strategy. You should only get active when you have a position that someone else is trying to take advantage of and then you stick up for your rights. Some of these new hedge fund managers who brag about how they made some computer company sell out are not real activists. The business is really about buying companies cheaply, and letting the management and board run it. If they do something really against your interests, you get active. But you don't buy a position just to get active.

G&D: Can you talk about how you construct your portfolio?

MP: Our portfolio is 60% value, skewed toward small- and mid-cap companies, and 40% cash and special situations. We own some Pfizer, we own some other big cap companies. But analysts can learn much more about small- and mid-cap companies, because Wall Street doesn't follow them well. The other 40% is cash

(which goes up from 5% to 25-30% depending on the opportunities available), and special situations, such as pre or post-bankruptcy investments, spinoffs, mergers, liquidations, etc. Those assets tend to move with the situation, not with the market, and cash will not move with the market. If you have 40% of your portfolio that doesn't move with the market. The other 60% is in very carefully selected value stocks, and if you buy them right, with a big discount to intrinsic value, they

“The business is really about buying companies cheaply, and letting the management and board run it. If they do something really against your interests, you get active. But you don't buy a position just to get active.”

can move less than the market.

That portfolio should

weather a bad market very well. The key in the business is weathering the bear markets, not outperforming the bull markets. That structure that has been in place since the mid 1970's, which I learned from Max Heine, has held up very well, other than 2008, when we went down with everyone else but came right back. Our portfolio went down less than the market, but never in my career had my portfolio ever been down 30%. The most I was down was 5 or 6% - only twice in 35 years. The portfolio with that structure will do well in a bear market and not as well in a bull market, but over a long period of time, it should compound at 15%. It used to compound at almost 20%. That is the goal, to compound at 15%.

G&D: Has it become more difficult to cultivate information sources that are not widely held over the course of your career, with regulation FD or the advent of the internet?

MP: No. You get that sort of information from competitors, customers, former executives who have long since gone and are not privy to inside information, and other people who know the company. The internet is, however, a huge source of information about products, companies, markets and consumer preferences and all sorts of stuff. We do a lot of our original informa-

(Continued on page 5)

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Michael Price



Pictured: Tom Russo and Jean-Marie Eveillard at the Graham and Dodd Breakfast in 2010.

(Continued from page 4)
tion gathering on the phone and a lot on the internet, for free.

G&D: Do you think other investors take advantage of that as well?

MP: Yes, they do. We used to have a system in mid to late 1980s called Lexus-Nexus, owned by Mead, a paper company. In the corner of my office, I would have a black box with a red top, and I used to type in a keyword on a little keyboard and they would charge me a nickel for every time the keyword hit in the search. In a minute or two, I would have a ream of paper with some interesting sources from where I would make some calls. Today, instead of paying a nickel, I pay nothing, and we have our computers set up to do automatic searches all the time on our positions, on our company's products, their geographies, all sorts of stuff, for free. It is amazing what is out there, and getting better all the time. We are involved in an arbitration related to a frozen yogurt company, where a company was taken over for a much too low valuation, and we are making the case that the company is worth much more. There is so much information on frozen yogurt consumer trends in the past five years on the internet. It could be a \$3,000 trade group report and you can pull them up for free because they are six

months old.

G&D: Do you find the opposite problem, that there is too much information to absorb?

MP: Yes, then it comes to your judgment as to what to do with the information. Back in 1975 and today in 2011, you still need the judgment. In 1975, you had

“You can get lost in the spreadsheets. You can't rely on the projections that you put in the spreadsheets alone. You have got to step back. Spreadsheets are only one part of the whole equation of whether you want to own a stock.”

to buy a roll of dimes to make a copy of a 10Q at the NYSE's Library, on the fourth or fifth floor of 20 Broad Street. I would walk over there with a roll of dimes to get the 10Q, make a copy and bring it back to the office. Now, it takes a second to pull it up on

Bloomberg, just like every other SEC filing. It is the judgment after you read that 10Q that you need.

G&D: Do you think there is a lot lost in the younger generation that is so reliant to all these modern tools, like Excel?

MP: In the class I taught at Columbia Business School last week, I gave an example of the split up of ITT. I showed the class my back-of-the-envelope calculation on the valuation of the three pieces of the company on the morning of the announcement of the split. I also showed the class our Excel spreadsheets one month after the announcement, where we had refined the numbers. Basically, the two valuations were the same. But it was the back-of-the-envelope judgment that got us started in the position, and made us work harder on the position. You have to do both. It is more than just the spreadsheet. You can get lost in the spreadsheets. You can't rely on the projections that you put in the spreadsheets alone. You have got to step back. Spreadsheets are only one part of the whole equation of whether you want to own a stock.

G&D: What advice do you have for young analysts who find themselves stuck in the weeds?

MP: You have got to re-

(Continued on page 6)

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Michael Price

(Continued from page 5)

duce the analysis to its simplest form and understand what the question in front of you is. Of course, in value investing, the question is, is it a cheap stock? You need to reduce the question to whether the stock is worth \$30, and if it is trading for \$20 or less. You have to know how to ask the question. First, when you are looking at a stock, reduce it to a question, and then, without the noise of Wall Street, answer the question. That means doing segment analysis, sum of the parts analysis, a judgment on the integrity of management, and a judgment on the overall economy, etc., etc.

G&D: Could you illustrate that through an example?

MP: For instance, we own J.C. Penney. If the economy does well, J.C. Penney stock will do well, and if the economy doesn't do well, it will be tough. The economy matters to a mass retailer, so you have to think about what really matters for each company. If you are working really hard on a J.C. Penney spreadsheet and you don't think about GDP, you are missing a big piece. You can't ignore the macro picture. Of course, the macro questions are the hardest ones to figure out. I am not trained to be an economist, and I don't think economists get it anyway. I am left with the bottoms-up, 10Q by 10Q analysis, and hope I have enough sense of where we are in the cycle, and

what the major factors are that could influence the cycle, better than 2007-2008. And these factors are in our face too, but sometimes we don't notice them. I remember being at a friend's Adirondack camp in summer of 2007 or 2008, and I was making a fire in the fireplace with an old Wall Street Journal. I grabbed it and looked at what was on the front page - I think it was roughly nine months

“The key question in investing is, what is it worth, and what am I paying for it? Intrinsic value is what a businessman would pay for total control of the business with full due diligence and a big bank line.”

before the huge mess in mortgages, and there it was, on the front page of the WSJ, that these subprime mortgages were a big problem. These macroeconomic factors are always in our face, we just don't see them.

G&D: How do you think about intrinsic value?

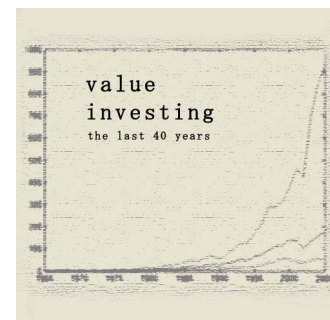
MP: The key question in

investing is, what is it worth, and what am I paying for it? Intrinsic value is what a businessman would pay for total control of the business with full due diligence and a big bank line. The French executives at Schneider who might be bidding for Tyco, haven't done all their due diligence yet, but they are saying the business is worth \$30 billion. We do our sum-of-the-parts at Tyco and we get there as well. The biggest indicator to me is where the fully controlled position trades, not where the market trades it or where the stock trades relative to comparables. Comparables are interesting, but they are only one data point. Discounted free cash flows or replacement value are other such single data points. But when someone writes a check for the control of a business, like it happened with Genzyme (Sanofi is acquiring it for \$20 billion), that tells you what the business is worth. That to me is intrinsic value.

G&D: How do you think about adjusting intrinsic value for the context of Private Equity firms acquiring businesses?

MP: Amongst private equity firms, there are some that add value. For example, at Carlyle, they have real businessmen who really practice it and have other businesses in industries that are related, that gives them insight. There are others who are financial engineers

(Continued on page 7)



Columbia Business School is a leading resource for investment management professionals and the only Ivy League business school in New York City. The School, where value investing originated, is consistently ranked among the top programs for finance in the world.

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Michael Price

(Continued from page 6)
and should not exist, they are just enriching themselves. They are not adding any value to these businesses. When PE firm contracts to buy a company, and they are leveraging up cash flows, and financing with 25% equity and 75% debt (like Del Monte which closed about a month ago), that is an interesting marker for the back-of-the-envelope calculation for the LBO value of a business. But that is a dangerous marker to use in trying to compute intrinsic value, because a lot of these companies can't be taken over by LBO firms, because they don't have enough equity to put up during industry cycles. It is dangerous to use the KKR multiple against any business. I would much rather have a strategic buyer multiple for a comparable business.

G&D: Could you please talk us through an investment that you own?

MP: ITT is dividing into three pieces. The stock is trading at roughly \$59. The shareholders are going to get 75 cents in dividends and three stocks that will probably be worth between \$65 - \$72 by year-end. If you pick \$67, a mid-range, you are going to make 15% in 7-8 months, which annualizes to 20%. Underneath you have a floor on the stock, because they were pushed by Relational Investors, large shareholders to bring out the values. If they

walked away from this deal and the stock went back to the low 50s, they would be under intense pressure to sell the companies. The upside is quite large with any of these three pieces, which will probably trade at \$5-7 billion each. It is much

“ITT is dividing into three pieces. The stock is trading at roughly \$59. The shareholders are going to get 75 cents in dividends and three stocks that will probably be worth between \$65 - \$72 by year-end.”

easier to buy a \$5-7 billion business, than an \$18 billion business. The chance of one or two of the three pieces getting taken over is double the probability of all of ITT getting taken over prior to the split announcement.

ITT has a distinct water business, a distinct defense electronics business, and a distinct industrial business. Wall Street will give it better PEs due to the elimination of the conglomerate discount. These three businesses will all have strong balance sheets. They will all pay dividends. They will all

have a much better definition of their business, so Wall Street analysts will be able to cover and understand each of the businesses better. This is the second time ITT did it in my career. We bought it the day of the announcement and almost every day after that, so it is one of our bigger positions. I think the risk reward is good, down 4% and up 10%, and it is going to happen.

G&D: Was it a similar story last time around?

MP: Yes, different assets of course. ITT back then had hotels, big insurance and telecom holdings, and education and healthcare businesses. Another example is Williams Companies, which is splitting into two pieces. Inside of Williams, there is something called APCO Oil and Gas. We owned APCO Oil and Gas in 1975. Then they spun out their Argentine subsidiary, which Williams owned half of, and we owned and traded it until the late 1980s, and now we are getting it back. As a value guy who works on spinoffs and restructurings, you wind up owning companies numerous times, as they are bought and sold and spun off. I have owned some value stocks five times at different levels, and there are others that have been recapitalized, so you wind up with them again and again. GenCorp that has a defense business and Sacramento, California real estate, came out of RKO Gen-

(Continued on page 8)

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Michael Price

(Continued from page 7)

eral back in the 1970s. We owned it with Mario Gabelli, and we still own it. They have sold off businesses, they have tried to develop real estate, they have run the defense business better, and now they are just defense and real estate. At some point, someone will buy the defense business, and we'll see what happens with the real estate.

G&D: What are some of the differences between running a large mutual fund and the fund you are running now?

MP: Running this fund is much easier. At Mutual Series, we basically wagged slowly from no money to \$15-20 billion. Then we went very quickly to \$33 billion. That is when I sold Mutual Series and retired. Then we started this fund with a few hundred million dollars and now it is almost a billion. It is much easier to move positions around, in and out. You don't have the say in the proxy processes like you did before, but you can still talk to other holders. For rates of return, smaller is better. Returning excess returns at \$20-\$30 billion is not so easy.

G&D: Is there another investment that you currently own and could talk through with our readers?

MP: Pfizer was a \$16 stock with 8 billion shares. The move to \$20 was very large

in dollar terms. The stock had underperformed in the past few years as Pfizer bought Wyeth two years

“After watching Pfizer underperform for years, to read that headline told you that something else had to give. The board would not throw out the CEO of a major pharmaceutical company without a backup plan ... By throwing the CEO out, the board signaled that they were willing to look out for the shareholders.”

ago, and then the company had to cut the dividend. Then, all of a sudden, the board threw out the CEO. After watching Pfizer underperform for years, to read that headline told you that something else had to give. The board would not throw

out the CEO of a major pharmaceutical company without a backup plan. It signaled that they could bring a great new guy in, they could do asset sales, or they could buy back stock. By throwing the CEO out, the board signaled that they were willing to look out for the shareholders. I bought the stock. I hadn't done a sum-of-the-parts of Pfizer, but I knew what was there because I had followed it over time. I am not a pharmaceutical analyst, but I saw that the Company yielded 5% at \$16.

It had some terrific businesses that could be spun out at very high multiples, and you would be left with the worry over this patent cliff, but you also had the pipeline that you were paying next to nothing for. We bought some stock, and sure enough, the stock went to ~\$19.50, and I started selling the stock. Then, I read an Alliance Bernstein report. I read the sell side reports, but I don't trade based on what they are saying. But they basically put the numbers in black and white as to what the values of the pieces that they could sell or spin off were, and they got to \$24. This report focused me more than I was before. I immediately reversed my sale, bought back what I sold and then tripled my position. Now the stock is \$20.50 and they have already sold one division for almost 3x sales. They have four or five busi-

(Continued on page 9)



Pictured: Glenn Greenberg at the Security Analysis 75th Anniversary Symposium (Fall 2009), with Bruce Berkowitz (left) and Tom Russo (right).

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Michael Price

(Continued from page 8)
 nesses that they could get big realizations of value for. The balance sheet is fine, and they have interesting products. The Street consensus is that there is \$24-25 of value in this company, and they are going to realize that, and maybe they will also get lucky in the pipeline.

G&D: What about the small-cap space?

MP: I prefer the small-caps that no one is working on. Everybody works on Pfizer, but I want to get involved in a retailer like Caché that has \$250 million in sales, 13 million shares and \$30 million in net cash. This company has almost \$3 in cash, and the stock trades at \$4, so I am paying a dollar per share or \$13 million for \$250 million in sales. They haven't made any money for a year or two, but they are starting to make money. They have new management, new merchandisers, hot new products in the stores. What is my risk if I have \$3 in cash and the stock is \$4? I am risking a dollar.

G&D: What if you take a position in a medium-size or small company and then you see the management do something that you think is foolish?

MP: First you have to get a sense of the management. Now, there are managements like that at Charles

River Labs, that did something really stupid a year ago, and the shareholders shot them down. Caché, is a small retailer and is controlled by the Chairman. He's not going to do something stupid. This was his family business for many years. He is not going to take this cash and spend it. He is more likely to run it better. He just spent money hiring some people. The Company is going to earn money this year, not lose it, so the cash is going to build. You have to think about who owns it. Is it their money or is it someone else's money? You have to think through who

"I learned bankruptcy from Hans, I learned value investing from Max, and I had my own interests in the M&A business, so those are the three parts of the portfolio."

is involved. That is the judgment side of it.

G&D: At what point in your life did you realize that investing was what you wanted to do for your career?

MP: While I was in high school, very early on. I was very lucky. I wanted to be a doctor, and then I got into the stock market and thought it was very interesting. My dad had a friend who had worked in Drexel Burnham Lambert's arbitrage department. It was fascinating to me. Basically, from senior year of high school on, I read the WSJ every day. I would clip out articles on mergers and acquisitions. Then I got lucky enough to get a job with my dad's broker who was partners with Max Heine, who had this little mutual fund. I liked the merger and acquisition side of the business, understanding why companies were bought and sold. Max, who was a great value investor, sat next to a guy named Hans Jacobson, who was a railroad bond expert, and all the railroads were in bankruptcy. I learned bankruptcy from Hans, I learned value investing from Max, and I had my own interests in the M&A business, so those are the three parts of the portfolio.

G&D: What were the some of the best pieces of advice you got from Max Heine?

MP: It wasn't so much advice. It was how he was with people, and how he thought about things. He didn't like debt on balance sheets, he didn't like good-

(Continued on page 10)

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Michael Price

(Continued from page 9)

will. He just was a clear thinker. He didn't like the Wall Street machine. He wouldn't play the IPO game, where everyone rushes to flip IPOs. He would never do that. He had a great nose for value. In the 1930s, he was given \$1,000 to buy furniture for their apartment as a wedding gift from an uncle. Instead of buying furniture, he went out and bought ten thousand dollars worth of bankrupt railroad bonds at ten-cents on the dollar, which then went up five times in value. He was a value guy from day one and trying to find cheap stocks through all the nooks and crannies of Wall Street.

Max had his own network of brokers, friends and bankers, who were in the flow of dealing in cheap stocks, like Tweedy Browne, Carr Securities, First Manhattan and other individuals, all descendants of Benjamin Graham. We had our little niche, and you took that niche and combined it with special situations, and it really worked well. We would come up with these little stocks that nobody owned, nobody followed and we had this performance at Mutual Series that was terrific. People would write us up and look at the portfolio and say how strange and different it looked from all the other portfolios out there, filled with bankrupt Penn Central bonds, and little companies

that made wheel barrels and wood products that everyone forgot about. But those are the ones that don't move with the market. Those are the ones that have clean balances sheets and do okay.

G&D: What do you wish someone had told you when you were starting out in the business?

MP: I could not have had a better runway. What happened to me was a once in a lifetime thing - no one is going to have that happen again. Getting to Mutual in the middle of 1970s when stocks were too cheap was perfect. A good time to start in this business is when markets are terrible, like in 2008 when everything was coming apart. It felt similar to when I started in the business - 1974 was a really horrendous year, but I rode it and learned, when we were still small and had influence over the portfolio right away, because Max was a sharing guy. There really wasn't anything that could be better. It was ideal.

G&D: What correctable mistakes do you see young analysts make?

MP: Staying away from debt is the main one. Stocks with A and B shares are another one, because you may not get a say for your shares with that structure. You have to have voting stock. Depending too

much on the Excel spreadsheet and forecast of discounted cash flows is another big mistake. It is not really the approach. We used the discounted cash flows in our frozen yogurt case as one of the several approaches to look at it, but there is no one valuation approach that works for all companies and industries. You have to look at many valuation approaches and pick the one that makes the most sense. Capital intensive business should be very different from ones that do not need a lot of capital.

G&D: How do you think has the investment business changed over time?

MP: It has changed for the worse. The last worst change has been high-speed trading. The ability to execute sizeable orders now is not good. It used to be that brokers would provide much more liquidity to buy and sell stock. If you wanted to buy 200,000 shares, you could have a broker sell you 50,000 and work on buying the remainder later. Today, you can't show any size, or else the high-speed traders run in front of your order. Trading large orders has really become very difficult to execute. On the other hand, the technology has brought big improvements to buy side trading, like Liquidnet, which is an electronic marketplace for buy-side to buy-side trading,

(Continued on page 11)

“... there is no one valuation approach that works for all companies and industries. You have to look at many valuation approaches and pick the one that makes the most sense. Capital intensive business should be very different from ones that do not need a lot of capital.”

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Michael Price



Professor Bruce Greenwald at the 2009 G&D Breakfast

Bruce C. N. Greenwald holds the Robert Heilbrunn Professorship of Finance and Asset Management at Columbia Business School and is the academic Director of the Heilbrunn Center for Graham & Dodd Investing. Described by the New York Times as a "Guru to Wall Street's Gurus," Greenwald is an authority on value investing with additional expertise in productivity and the economics of information.

(Continued from page 10)

where there is no broker involved. That is very efficient and it has been the best innovation in the last 10-15 years. SEC and the regulations have been bad. By and large, the media has not been helpful. There are some shows, like Tom Keene's show on Bloomberg, that are terrific, but there are some total jokes.

G&D: Does it create even more opportunity for you?

MP: Sure. I don't mind competition at all. What you need in order to be in this business is capital. First you have to raise capital or work with someone who has capital. Then it is the brains, but a lot of people have the brains. It is the judgment with the brains that matters, and that comes with experience and from thinking about things in the right way.

G&D: Why is 15% returns the target for the fund now, instead of the 20% before?

MP: I think all this massive information has made it tougher. Lower interest rates have lowered the bar too. It should be some spread above a basic three or five-year treasury rate. In the Mutual Series from 1975 to 1990, we did compound close to 20%. We had a down year in 1990, like 5%, then we did once again compound in the high-teens through the nineties.

Now I have noticed in the 2000s, it has been mid-teens. It has gotten tougher. Whether it is the low rates, the information, or more people in the business, it is tougher.

G&D: In terms of capital allocation for a company, what is your view for dividends versus share buy-backs?

MP: I would rather own a company not paying dividends. Dividends tend to

"I would rather own a company not paying dividends. Dividends tend to raise the stock's price, so if I am a value buyer, I want to buy that stock as cheaply as I can."

raise the stock's price, so if I am a value buyer, I want to buy that stock as cheaply as I can. An extreme case would be a real estate trust that yields seven percent to mostly retail shareholders in this very low interest rate environment. This will make the investment trade at or above its intrinsic value. But real estate is a very illiquid asset. I believe

that real estate should be bought for a third less than the underlying value of the buildings, land, warehouses, whatever that happens to be. I would have no interest in a REIT with that dividend yield. The day that REIT comes out and cuts that dividend or omits that dividend because they have lost tenants, the stock will trade down from \$20 to \$13. That is when I come in because I can then get my intrinsic value. That is precisely what we did in 2008 in the real estate space. We looked at REITs with dividend omissions.

A dividend tends to keep that stock close to its intrinsic value. I don't own Bristol Myers. Why? It pays a big dividend. But Pfizer had both a 4% dividend and at \$16, it was trading at a third less than its intrinsic value. That was a beautiful thing. A lot of managements want to pay dividends, and the tax on dividends right now is not bad, but still it is double taxation, and it does not make sense. I would tell management not to pay a dividend, and since their stock would be cheaper because of the lack of dividend, buy the stock back, and shrink the capitalization. Dividends are very tax inefficient, because the corporate tax rates are so high, even if the individual tax rates on dividends are low.

G&D: Any parting words of wisdom?

(Continued on page 12)

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Michael Price



Bill Ackman and David Einhorn at the G&D Breakfast, 2010.

Columbia students have the privilege to hear from experienced practitioners in value investing, who frequently give guest lectures at the school.

(Continued from page 11)

MP: I am a big believer in having practitioners teach, and therefore I do that at Columbia Business School. I have hired close to 10 Columbia students in the course of my career. I like practitioners teaching, which is why I do it and I like schools that do that. I think it is important for people who have this experience to pass it on. When I was at University of Oklahoma, I remember hearing economist John Kenneth Galbraith speak. For me, it was a really big thing. I loved it. I hadn't been interested in economics before then. When I support business schools now, I make sure that they bring business people in. I think that is very important.

G&D: What advice do you have for someone who can't find their ideal opportunity upon graduation?

MP: Foot in the door is the most important thing. It doesn't matter what the pay is. Sure, if you are married with two kids, it is tough. But ideally, you don't have those burdens, so you get your foot in the door in a shop, big or small, that does things in the areas you are interested in. You get exposed to it for a couple of years. There is nothing like the real world experience, building the rolodex, and understanding what goes on. Getting your foot in the door is key to figuring out

whether you really have the fire and the ability for the business. You should be honest with yourself and ask the question, do you really like this business? Then, after a couple of years of exposure, that fire will come out in interviews. The fire will come out in the daily work.

G&D: How do you leverage your junior people?

MP: That is exactly what we do. I have people here to leverage my time. This is the time of year when new annual reports come in. We receive nearly 100 reports a day. Every day we have a list of what we get in, and I circle the ones that I want to look at for whatever reason, and I will skim them, read the CEO's letter, maybe look at some of the details that I am interested in. Then the next morning I will tell my analysts to look at the details and lay out for me the segment analysis, evaluate what the real estate is worth, etc. The analyst will do that for two or three days, and will come back to me and present me with a preliminary valuation, and if the stock is twenty dollars and the valuation says it is worth thirty dollars, then we will start to do more analysis on it. That leverages my time.

G&D: For a young analyst, what do you recommend they do with the first four hours of looking at a stock?

MP: The really important thing is to eliminate the Wall Street consensus, the Wall Street research. Start with the quarterly or annual report of a company. Think about the business, think about what you see without any input from Wall Street, and think about how you are going to understand that company, the business values and the management. You need to understand how you are going to benchmark them. You need to understand where the company is in the world and what the competition is for the products, whether the products are any good, and whether or not the company has any pricing power or barriers to entry. How are you going to figure these questions out, without any input from Wall Street research or any road shows? Start calling around to people who use their products, to competitors, to trade associations. Using the press is fine. Regional or local newspapers where the company operates will often have a good sense of the management. If you are going to use a medical products company, talk to the doctors who use their products. I never used any of the consulting sources, because I couldn't control who they were and what they did. Make your own phone calls and do primary research.

G&D: Thank you very much, Mr. Price.

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Paul Johnson

(Continued from page 1)

but in the end, the market is going to gravitate to the intrinsic value of the business. If you do not have a good handle on the economic value of the company in which you are invested, you really are just playing a bit of a carnival game. I had also been an adjunct professor at Columbia Business School teaching Security Analysis and Value Investing for over ten years. The teaching experience forced me to think deeply about what investing is really about, as opposed to just being an analyst on Wall Street. Because of these experiences, I was drawn to the notion of intrinsic value-based investing, which draws one into the value investing world.

G&D: How would you describe the investment strategy at Nicusa?

PJ: By definition, nearly everyone who is a long-term investor trying to buy things at less than intrinsic value is a “value investor.” The phrase that we use most often is that we are “fundamental” investors. We try to find the fundamental value of the operating business. We are much more drawn to income statements than we are to balance sheets; balance sheets are important and can harpoon an investment, but we do not start with the balance sheet. We start with the income statements, the business prospects and

the quality of the business. We then look at the balance sheet to make sure there is consistency. The balance sheet can uncover issues which may preclude an investment, but a balance sheet will not make an investment for us. We focus on the operating results. We're long term investors, so we're looking at the long

“For a company to qualify as great to us, we want it to be growing faster than GDP in a defensible market where that growth is coming from within that franchise. We want the barriers to entry to be large and defensible, and the company should have some sort of scale economics because that's where the excess returns come from.”

-term cash flow of a business, which means that we are looking at the quality of the business. To evaluate that quality, we are looking

at what Professor Greenwald has pioneered: the notion of the business's competitive advantage. We look for barriers to entry, economies of scale, and consumer captivity. Our goal is to buy great businesses that are undervalued. There are two components to our approach: finding a great business and one that is undervalued. For a company to qualify as great to us, we want it to be growing faster than GDP in a defensible market where that growth is coming from within that franchise. We want the barriers to entry to be large and defensible, and the company should have some sort of scale economics because that's where the excess returns come from. On the valuation side, we take the company apart and look at the cash generation of the business as if we owned the whole company and could take the cash home every year and re-deploy it. We look at how much we have to pay for those cash flows versus the quality of the business. In general, we stick to a hurdle rate of about 10%, meaning we want a business that we can buy at a 10% cash yield or an enterprise value multiple of ten times free cash flow.

G&D: How does that compare to the profile of an ideal short candidate?

PJ: Shorts are very much the mirror image of that,

(Continued on page 14)



Pictured: Howard Marks at the Columbia Investment Management Conference in February 2011.

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Paul Johnson

(Continued from page 13)

with one exception. When a short position goes against you, it becomes a bigger part of your portfolio, and therefore we hold smaller short positions. Shorts have what a lot of people refer to as “infinite upside.” They do not really have infinite upside, but they have higher upside than downside. Also, whereas in a long we want a solid balance sheet, on a short we want a company that is losing money and has a minimal amount of cash on their balance sheet relative to the cash drain. We then look at the company and decide if we want to bet against the long-term quality of the business. On a long we look for barriers to entry, and on a short we want no barriers to entry. We want a company where even if they reach their full potential, it will still be an uninteresting business. We want a company with low gross margins, no customer captivity, no natural economies of scale, and low barriers to entry. Ideally, we want a company that is losing money, a balance sheet with some financial pressure on it, and a company with a low probability of developing into a great business. We think those conditions make for an interesting short.

G&D: How do you think about building a portfolio of longs and shorts?

PJ: One needs to ask a couple fundamental ques-

tions when constructing a portfolio. First, is the portfolio going to be concentrated or diversified? Diversified is somewhere between 50 and 200 names. Concentrated can be as few as 4 or 5 names. We have settled in the range of 10-12 names, with each position roughly the same size when we initiate it, although as time progresses that balance tends to move around. The next question is the holding period. Because we are looking at the fundamental economics of the business we tend to be longer-term investors. Because we want to make bets on specific companies, we are concentrated. However, the fewer positions in the portfolio, the more the long-term performance will ride on the success of each investment. As a consequence, the moment the portfolio is concentrated, the better you must know the true intrinsic value of a companies invested. We are research-intensive. Our portfolio is concentrated in 10-12 names, with a holding period of roughly 2-3 years.

G&D: You tend to look at smaller and even micro-cap companies. Why focus your efforts there?

PJ: Market efficiency tends to be correlated with the number of market participants in a stock. The larger the market cap, the greater the number of people looking at a name. We have found that smaller market

cap stocks tend to have fewer participants, which lends itself to a more inefficiently-priced security. Because we are a relatively small fund, we have the ability to go into smaller-cap names. As we get bigger, some of that will go away, and when we got started we could look at even smaller companies than we do today. We can go down to \$50-100 million market cap companies, and that part of the market tends to be less efficiently priced, so we think that there is more opportunity for excess returns.

G&D: You said that you target buying at an enterprise value of around 10 times free cash flow. How do you think about the process of valuation? Some people are very disparaging of DCF. What do you think?

PJ: It's taken me a long time to get my hands around this issue, and I do think that this is the most challenging part of investing: what is something worth? For a fundamental investor, it's either the assets that represent the intrinsic value, which orients the analysis to the balance sheet, or it's the cash flows from the ongoing business that determine the intrinsic value, which sends the analysis to the income statement. We're very much interested in the operating value of these companies, being sensitive to the

(Continued on page 15)

“We can go down to \$50-100 million market cap companies, and that part of the market tends to be less efficiently priced, so we think that there is more opportunity for excess returns.”

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Paul Johnson

(Continued from page 14)
risks associated with the balance sheet.

Once you start to look at the economic value of the operations, you are really concerned with the economic earnings of the business, not the accounting earnings. It is the cash the business generates that creates its value. However, you have to be careful with this analysis. It is not the operating cash you are after, but the free cash flow that can either be invested back in the business or redeployed in some other opportunity. We are very careful about cash flows. We make adjustments to the true cash expenses of running the business to get to a real operating cash flow. We try to look at it as if we were running the business. We care about the cash coming into the business and the cash expenses going out. Taxes are important, because they have to be paid, so we do not look at EBITDA because that's really only halfway through the process. You also need to think about depreciation and capital spending. Depreciation is an accounting estimate of the economic erosion of a company's assets. If it's a bad estimate, then we need to find a better estimate of the true economic cost of operating the assets. We like businesses that are capital-light, and therefore that part of the analysis is generally not critical. Although

depreciation usually is not a large number in many of our investments, we still need to understand all of the capital needs of operating the busi-

“Growth is a critical component of value creation for shareholders. There are important subtleties to growth of course, but if you are not paying for growth then it is a free option, and if that company delivers growth, that will be part of your excess return. It has to be profitable and defensible growth, which means it has to be within their franchise.”

ness.

Once we have done all of those calculations, we get to what we define as free cash flow. In simple terms, our definition of free cash flow

is the excess cash that the Company has at the end of the day, the month, or the quarter that can be removed from the business because it is not needed to generate future cash flows. To value those free cash flows we use a simplified, no growth DCF model, which essentially is a simple multiple. When we started we used a complicated DCF model, but we quickly found that it is nearly impossible to accurately forecast cash flows far enough into the future to complete the DCF analysis. In our analysis, we use current free cash flows, scrubbed of any accounting anomalies and normalized to make sure they accurately depict the ongoing cash generation of the business. Our cash flow calculation usually contains little or no growth. Throughout the analysis we are concerned with the quality of the business and the duration of those cash flows. A company with low technology risk and high barriers tends to have a longer duration than a technology company with high technology change and low barriers.

G&D: Even though you don't pay for growth, it sounds like one of the criteria you're looking for in an investment.

PJ: Growth is a critical component of value creation for shareholders. There are important subtleties to growth of course,

(Continued on page 16)

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Paul Johnson

(Continued from page 15)

but if you are not paying for growth then it is a free option, and if that company delivers growth, that will be part of your excess return. It has to be profitable and defensible growth, which means it has to be within their franchise. You cannot pay for acquisition growth, because that generally does not generate economic value for the acquiring company. You cannot pay for growth outside of their franchise because that tends not to generate excess profits. In all of these cases, you may get revenue growth, but you are not going to get excess cash flow growth (beyond what was paid for) and you are certainly not going to get an increase in the economic value of the business.

G&D: You are typically a significant shareholder, given the small companies you target and your long-term horizon. How involved do you tend to get with the companies?

PJ: We have become increasingly active in our companies. We believe there are two kinds of activism, the more traditional activism and what we call friendly activism. We start every relationship with friendly activism. We inform the company that we are now a 2% or 7% shareholder, letting them know who we are, how we think, and why we are invested. As long as managements and

boards do what we think is in the best interest of long-term shareholders, then we are going to stay in that

“We tend to have an active dialogue with the company regarding their corporate strategy, investor relations, capital allocation and compensation, although we do not get involved in the daily operations of the business. If the company starts doing things that are not in the interest of long-term shareholders, we get a bit more active in the traditional sense.”

friendly activist role. We tend to have an active dialogue with the company regarding their corporate strategy, investor relations, capital allocation and compensation, although we do not get involved in the daily operations of the business. If the company starts doing

things that are not in the interest of long-term shareholders, we get a bit more active in the traditional sense. We will call or write letters letting them know that their actions are not serving shareholders and we have found that those conversations usually result in a fairly constructive dialogue. If the behavior continues to be a problem or management continues to do things that we do not think are in the interest of shareholders, we will become much more active. In terms of pure activism we have dealt with two specific situations. However, even when we get aggressive, we still try to maintain a friendly approach. We have been forced to become more aggressive with two companies over the last few years. In terms of friendly activism, we do that with all of our companies.

We do not go into any investment with the thought that we will get them to change their operating procedure or their business strategy because of our investment. We are not active on day one. We go in with the intention of investing in a friendly position. Over time we may encourage management to make certain strategic changes, but we always do it in a friendly manner. It's only after they have proven that they need some external pressure that we become more assertive.

(Continued on page 17)



Pictured: Steve Eisman at the Columbia Investment Management Conference in February 2011.

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MANAGEMENT ASSOCIATION

Paul Johnson

(Continued from page 16)

G&D: Could you walk through how that's turned out in a past investment?

PJ: We were a 5-6% shareholder in a company called Metropolitan Health Networks based in Florida. We first got involved with the company when the stock was at 79 cents and then bought some more at 83 cents. Over time the Company performed well. We thought the stock continued to be cheap as the Company's financial performance grew faster than the stock price. The Company then went through a period of stagnation both in business activity and the stock price. There were some internal battles between the management and the board regarding strategy. As we got to understand the dispute more clearly, we were very much on management's side. In December 2009, out of the blue, the Company announced that the CEO was resigning. We found this disturbing because we were very much in his camp and not very fond of the Board. In early January of 2010, we wrote a letter to the Board expressing those concerns and requesting that the CEO be reinstated, which is an unusual position to take. Several large shareholders approached us and it became clear that they also supported the CEO. We believed that we had enough shareholders to force a proxy battle if we wanted

and we presented that information to the Board. In April 2010 the old Board resigned and a new Board was put in place. The new Board rehired the former CEO, the company was unleashed from the constraints of the old Board, and management started to execute on their business plan in a much more aggressive way.

With settlement in Washington over the future of the healthcare bill, many of the issues overhanging the industry were settled and the Company's financial performance improved impressively. The stock was in the \$2 range in early 2010 and ended the year at roughly \$4.50. The new Board is much better qualified and more in sync with management, and we believe it contributed to the stock doubling last year. This was a case where escalating our involvement and doing what was in the best interests of shareholders served us well.

G&D: Why did you decide it was worth it to get involved rather than sell the position and move on?

PJ: Two aspects of the company kept us in it. One, it was a cheap stock all the way through. I do not think at any point it traded at more than six or seven times free cash flow. Perhaps that is what some people think the business is worth. However, if you do the math, six or seven times

free cash flow is a 15% cash yield. We were getting 3-5% growth on a 15% cash yield. Given that return, I would want to own the stock for as long as I knew that the Company's free cash flow would continue, regardless of other investors' opinions about the Company. The quality of the business was important, but the valuation was very attractive, and we never found ourselves at a point where we thought the stock was fully valued.

We were happy with something that some people thought was correctly valued but had such a high cash yield because of our assessment of the quality of the business. The Company provides all the services for Humana in certain parts of Florida. If you are a Humana customer in this area of Florida, you are being served by Metropolitan Health. Some investors do not like the fact that MDF is captive to Humana, since Humana could, in theory, terminate its relationship with MDF with only short notification. On the other hand, Humana has no other place to put these customers. Because each provider must have contracts with doctors, labs, and hospitals, there are natural local economies of scale in the business. Metropolitan dominates several of these markets and Humana has no choice but to work with them.

(Continued on page 18)

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MANAGEMENT ASSOCIATION

Paul Johnson

(Continued from page 17)



Pictured: Tom Russo at the Columbia Investment Management Conference in February 2011.

There had been a lot of controversy in the health-care industry and that had dampened overall valuations. There were concerns that the current administration wanted to eliminate health plans like that of Humana, causing many investors to avoid the area. We thought this was a business that would be difficult to replace and the controversies were fairly easy for us to get our hands around.

G&D: Can you share another example?

PJ: On the activism side, we are involved in a company called BioClinica. The Company's historical business is image management. If a pharmaceutical or biotech company is conducting a drug trial and trying to evaluate tumor shrinkage by using an image to prove efficacy, the company needs to get those images through the FDA process. The drug company needs to provide evidence that there has been a physical reaction to the drug and the images become critical to the process. BioClinica emerged as one of the largest companies in managing the image side of drug trials. They have economies of scale. We like that business. The Company has repeat customers and strong cash flow.

However, a few years ago management decided to

invest in an adjacent business that we did not feel had the same attractive economics. We felt that the core business was valuable enough that we could live with management's new strategy, but in hindsight, that was a mistake. We should have sold the stock, but we stuck it out. It has taken management nearly three years to get the new business up and running. In

“We are interested in companies that are undermanaged and getting new management because new leadership is typically a catalyst, particularly when they begin to cut costs and accelerate growth.”

the last eight months, we have been much more assertive in our communications with the Board, making sure that they hold management accountable for their execution. Any new acquisition should have an

extra-tight filter to get through, and until the new business starts performing, management should be constrained in their ability to make additional large capital deployments. BioClinica also has a poison pill in place, which serves to protect management but not shareholders. We have actively pushed to have it removed and to hold the Board accountable for what we believe to be overly generous management compensation. The proxy vote is in May, so we'll see how other shareholders vote. We were attracted to the core business, but management began doing things that we did not think were in the best interests of shareholders, and we made our views very clear. The stock is trading where we bought the shares three or four years ago and the jury is still out how successful this investment will turn out to be.

G&D: You mentioned that these active situations are rare. Can you share a more typical investment?

PJ: We are invested in a company called Accelrys, which we started buying a little bit over a year ago. The Company makes software for computational chemists and biologists, specifically aimed at pharmaceutical and biotech companies. The software assists with data management during the R&D process. The

(Continued on page 19)

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MANAGEMENT ASSOCIATION

Paul Johnson

(Continued from page 18)

Company has a strong set of products, but had been undermanaged for a number of years before new management came in 2009 and 2010. We are interested in companies that are undermanaged and getting new management because new leadership is typically a catalyst, particularly when they begin to cut costs and accelerate growth.

Accelrys's valuation was attractive. We began our research in late 2009 and started buying the stock in early 2010. In mid-2010, Accelrys announced that they were merging with Symyx, a company in the same business but with complementary products. The two companies would have a broader product offering and greater economies of scale. We usually hate betting on operating synergies, but we were comfortable that management would be able to combine the two products and emerge as the dominant vendor in their market. We evaluated the combined company as if it was a new investment. Again, we found the economics attractive and believe that the companies would be stronger together than stand-alone. The valuation of the merged entity looked as attractive as our original investment and we stuck with our position. Our average cost is roughly \$6 per share, and the stock is currently trading near \$8. The

results are starting to come through. The opportunity for the Company over the next two years will be very high. If the company is successful, it will support a high valuation. It has upside both in growth and valuation. It's

“A PM's job is very different. It's all about portfolio construction, position sizing, buy and sell disciplines, and risk management at the individual and portfolio level. The PM's job is to produce performance by building a portfolio correctly.”

one of my favorite names in the portfolio because we can get multiple expansion as well as cash flow growth.

G&D: So you've been doing this for around...

PJ: I have been running the fund for a little over eight years and I have been on

Wall Street in various roles since the early 80's.

G&D: What do you think are the advantages of one role over the other?

PJ: I have worked in two specific roles in my career. I was a sell-side analyst for 20 years and have run my hedge fund for the past eight. The two jobs are very different. A sell-side analyst's job is to follow a specific industry and to be perceived as one of the experts in that industry. Stock-picking ability is not nearly as important as knowing your industry and companies well. Sell-side analysts need to have industry expertise, access to management, detailed financial models, a sense of the history of businesses and where the industry is in its business and growth cycle, and an understanding of the competitive pressures between companies. There is a lot of marketing and investment banking involved in that role as well. In comparison, a buy-side analyst's job is to understand the companies they follow and to be able to find opportunities where there is a mismatch in value and price. Buy-side analysts have to be able to find companies that are mispriced, do the work to gain confidence in their analysis, and then convince the PM to put the stock in the portfolio.

(Continued on page 20)

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MANAGEMENT ASSOCIATION

Paul Johnson

(Continued from page 19)

A PM's job is very different. It's all about portfolio construction, position sizing, buy and sell disciplines, and risk management at the individual and portfolio level. The PM's job is to produce performance by building a portfolio correctly. In addition to being a PM, I also am charged with running the business side of the hedge fund. In that role, I have to deal with investors, and administrative issues and payroll. To be successful in running a hedge fund, one needs to do many things well.

G&D: What do you wish someone had told you when you first opened the door?

PJ: There are lots of things that someone should have told me, although it is probably a good thing they did not because I may not have opened the door. The hardest parts of the new role for me to learn have been portfolio construction and risk management. I was an analyst for a long time; analyzing companies was a fairly straightforward process. I did a lot of rigorous analysis when I was a sell-side analyst, and that helped when I moved to the buy side. However, being a portfolio manager is tricky. Portfolio construction has a lot of subtlety, and risk management has even more. The tricky part is putting it all together.

G&D: Many students find time management to be one of the most difficult aspects of working on the buy side. How do you go about allocating your time day-to-day?

PJ: Time management is the biggest challenge we all face, not just professionally,

to do it all again. By the third week, you start to filter what you need to do and what you don't. You try a few things and the ones that work you do again, those that don't work, you eliminate. In any job, the most important activity you want to accomplish is what your boss wants you to do. Very often people think, "I'm smarter than my boss, he wants me to do all these things that I don't need to do!" I encourage people to do what their boss asks them.

"... high quality research is going to be crucial to surviving in the business going forward. The markets are very competitive and crowded."

Second, you want to learn to think outside the norm. You want to look at situations differently in a way that creates opportunity. You look for investment ideas that make money; the individuals who are most successful in the business are the ones who quickly gravitate to this notion of finding investment opportunities. Sometimes ugly stocks make money, sometimes beautiful stocks make money. Peter Lynch used to say that he thought one of his great advantages in the business was that he came to work with no preconceived notions and no natural biases. He might make money in airlines one day and autos the next. He did not say "I hate autos" or "I hate airlines"; it all came down to opportunity. There might be times where you want to hate the autos because they're overpriced, or hate the airlines for the

but in our personal lives as well. In the job, the hard part is to learn the things you do not have to do. I suspect most business school students were like me: the first week in the program, you try to do it all, and the next week you try

(Continued on page 21)

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MANAGEMENT ASSOCIATION

Paul Johnson

(Continued from page 20)
 same reason. But you do not want to have any pre-conceived convictions; open-mindedness helps. You always want to be looking for opportunities. Third, high quality research is going to be crucial to surviving in the business going forward. The markets are very competitive and crowded. Everyone has access to Bloomberg and the Wall Street Journal, so you have access to those sources just to stay even. You have to be creative in finding ways to make money where nobody is looking. Clarity matters because there is a finite amount of time and you will need to allocate your time efficiently to find those opportunities. Think of it as a riddle and a puzzle, and you're trying to figure out the pieces.

G&D: You've also taught at Columbia as an adjunct professor. What do you think is the most interesting gap between academics and practitioners?

PJ: I think that there's a huge gap between the two, and I think that's unfortunate because we can learn from each other. The academics think in an evidence-based, bigger-picture way and are criticized that they've lost the forest for the trees. Practitioners say their theorems do not describe the real world and that what they say has little practical value. Practitioners, on the other hand, are

pragmatic, realistic, and entrepreneurial. However, while their theories may work well in practice, they do not have the robustness

“When you find inefficiency, move to exploit it and possibly try to understand why the opportunity exists. For instance, when markets get chaotic, the academics try to figure out why, while the practitioners are exploiting the anomalies.”

needed to impress the academics. When I teach, I try to balance the two. There is a lot to learn from theoretical finance. Is it perfect? Absolutely not. There are big flaws in it, but I think there's a lot to learn from the historical evidence. Combine that with a practi-

cal nature and there are opportunities to exploit the two disciplines.

There's an old joke about two economics professors walking on the street. One sees a ten dollar bill laying on the ground, but does not pick it up because if it were real someone would have picked it up already. The practitioners would pick it up and have a laugh as they enjoyed a few pints of beer. That's the idea: the market is efficient except when it's not. When it's not, you should exploit the opportunity. When it is, you should remain patient. Understanding the academic side of what makes a market efficient gives you a leg up in this business. When you find inefficiency, move to exploit it and possibly try to understand why the opportunity exists. For instance, when markets get chaotic, the academics try to figure out why, while the practitioners are exploiting the anomalies. I have felt for a long time that there is a gray area between the two. When I teach, we spend time on theory not because I love it but because it gives a structure to think about finance problems. At the end of the day, though, you need to go out into the market and produce results.

G&D: Thank you for speaking with us.

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Cristiano is a first year MBA student. Prior to enrolling at Columbia Business School, he worked in macro investing and Private Equity.



Rick is a first year MBA student. Prior to enrolling at Columbia Business School, he was a WSJ reporter and columnist. He is the forthcoming author of *All The Emperor's Money*.



Matt is a second year MBA student. He was a summer associate at Goldman Sachs. Prior to school, he spent several years in consulting.

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Motorola Solutions (NYSE: MSI)

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Total Enterprise Value Calculation		Trading Multiples			
Shares Outstanding (m)	335.65		2010	2011e	2012e
Fully Diluted Shares outstanding	338.10	EBITDA	1,105	1,389	1,691
Stock Price (April 6 Close)	\$44.26	Adj. TEV/EBITDA	10.9x	8.6x	7.1x
Equity Market Value (\$m)	14,966	Adj. TEV/(EBITDA-Capex) (3)	12.4x	9.7x	7.8x
Plus: Total Debt	2,729	Adj. TEV/Sales	1.5x	1.4x	1.4x
Plus: Pension Liabilities (Post Tax)	1,170	P/Cash Earnings	16.3x	11.6x	9.0x
Less: Cash & Equivalents (1)	(5,733)	TEV/FCF yield	5.5%	8.1%	10.3%
Less: Cash from Sale of Networks	(975)	P/LFCF yield	5.7%	10.1%	13.6%
Less: Accounts Receivable Run Off (2)	(150)	P/B	2.6x		
TEV	12,007	Short interest	1.7%		

Notes:
 (1) Including Sigma Fund and \$1.35bn of post tax proceeds from sale of Network Business to Nokia Siemens.
 (2) Motorola Solutions is keeping \$150m of receivables from the network business.
 (3) Maintenance capex assumed average of 2007-2010 capex (post Symbol acquisition)

Motorola Solutions Background

MSI is what remains of Motorola, Inc. after it spun off Motorola Mobility (the mobile phone business) on January 4th 2011. This spin-off was advocated by Carl Icahn, a long-term Motorola shareholder. Motorola Solutions has been the cash cow funding the Motorola Mobility sinkhole, which has disappointed over the years. Today Motorola Solutions is the largest US franchise in communications hardware (mostly radios) for public safety and data collection/management. It operates in two segments:

- Government (65% of total revenues) selling to governments, state agencies, and municipalities (i.e. fire and police) radio and video surveillance systems. \$3.1bn of total revenue is generated in the US, for an estimated US market share of 70-80%.
- Enterprise (35% of total revenues) selling to enterprises around the globe barcode scanners, inventory tracking devices and systems for an estimated Global market share of 30-35%.

Rationale for Investment

Boring, difficult to understand, and disappointing: this is Motorola Solutions (MSI):

- Trading below intrinsic value and comparables on both Cash P/E and TEV multiples: forward 11.6x P/cash E vs. Comps of 15x and forward 8.6x TEV EBITDA vs. Comps of 10x EV. Additional cash earnings come from large tax loss carry forwards from the legacy mobility business, giving MSI a 7-year 20% effective cash tax rate
- Yields 8-10% unlevered free cash yield
- Low leverage (Gross 1.5x EBITDA)
- Catalysts for realizing return:
 1. Normalization of earnings to 16% Operating Earnings margin (management target by 2011 end) as removal of legacy costs from Motorola Mobility takes place over the next three quarters (30% upside)
 2. Dividend Initiation and/or Buyback (40+% upside) by using the excess cash balance
- All of the above on the backdrop of huge margin of safety given by over \$6bn (\$17 per share) of gross cash on balance sheet, unmatched barriers to entry and strong resiliency to economic cycle.

Return Scenarios

Base Case (p>=30%)

- 30% upside
- P/normalised cash earnings at comps multiple of 15x
- OE Margin improvement to 16%
- 2011 sales growth of 6% (3% government; 12% enterprise)

Upside (p>=60%)

- 50+% upside
- \$4.2bn buyback at current leverage, repo at \$48ps
- \$30m outperformance in margin improvement and 2011 sales growth of 7%
- TEV/EBITDA to 9x

Downside (p>=10%)

- Loss of ~15%
- Government sales down 15% yoy
- OE Margin down 100bps to 12.5%

- Scenario Price: \$55

- Scenario Price: \$68

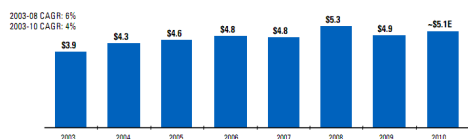
- Scenario Price: \$37

Barriers to Entry/Franchise:

MSI has high barriers to entry driven by customer captivity and resiliency to economic cycle. This is underpinned by the a) long term nature of contracts (generally 5-10 years if not longer), and contract size/timing diversification - the biggest cluster of customers is the US Federal Government (8% of total revenue.), which includes government agencies. Diversification of customer base also benefits revenue recognition - there is no cluster of renewals/upgrades that make the company particularly vulnerable in the near future, as the chart below shows for the last 8 years.

MSI (Continued from previous page)

Government Segment Revenue



Source: MSI Management

Buyback and Dividend Initiation

MSI has almost a third of its \$15bn market cap (\$17 per share) in cash and has negative net debt of ~4bn. We think the company has the potential to distribute this cash and to initiate a dividend using the FCF it produces every year (~\$900m - \$1bn). This could lead to a one time buyback/dividend of approximately \$4.3bn (\$3.5bn of cash on BS+800m of cash generated over the year) and an ongoing dividend/buyback in the vicinity of \$400m annually. By keeping the leverage at current levels (gross 1.5x EBITDA), and assuming no change in adjusted trading multiple (8.5x TEV/EBITDA) implied share price is \$62 per share:

(US\$ in millions unless otherwise stated)

Share Buyback Analysis

2011 Adj. EBITDA	1,389.1	2012e EBITDA	1,691.0
Leverage Turns (of EBITDA) (1)	1.5x	2012 EBITDA Multiple	8.5x
Total Target Leverage	2,083.6	TEV	14,373.8
Less: 2011e Debt	(2,129.0)	Plus: Cash Available Pre Buyback	7,480.7
Plus: 2011 Cash Generated (LFCF)	818.1	Less: Cash used for Buyback	(4,272.7)
Additional Leverage	772.7	Less: Debt	(2,083.6)
Plus: Available Cash Used (2)	3,500.0	Equity Value Post Buyback	15,498.2
Bought Back	4,272.7	Shares Outstanding Post Buyback	249.1
Net Debt After Cash use	(1,124)	Earnings Per Share	\$4.48
Blended Buyback Price	\$48.00	Share Price	\$62.22
Buyback Shares (m)	89	Implied P/Cash Earnings ratio multiple	12.3x
New Outstanding (m)	249.1		

Notes:

(1) Excluding cash generated in the year.
(2) Cash on balance sheet includes \$1.3bn expected from closing of Network Business sale.**Valuation**

On an Earning power basis – current share price assumes there will be no growth in the franchise:

(US\$ in millions unless otherwise stated)

Earnings Power Calculation

Adj. normalised EBIT	1,280
Less: Tax at 35%	(448)
Less: Maintenance Capex (1)	(160)
Plus: D&A	155
Distributable Cash Flow	827
WACC	8.5%
TEV	9,729
Plus: NPV of Tax Assets Utilisation	2,092
EPV	11,820
Less: Total Debt	(2,729)
Less: Pension Liabilities (Post Tax)	(1,170)
Plus: Cash & Equivalents	5,733
Plus: Cash from Sale of Networks	975
Plus: Accounts Receivable Run Off	150
Equity Value	14,779
Shares Outstanding (m)	336
Per share	\$44.03

Implied Equity Value

	WACC		
	8.0%	8.5%	9.0%
Cash	727	14,138	13,604
Flow	827	15,387	14,779
	877	16,012	15,368
	927	16,637	15,956
	977	17,262	16,544

Share price

	WACC		
	8.0%	8.5%	9.0%
	727	\$41.82	\$40.24
	827	\$45.51	\$43.71
	877	\$47.36	\$45.45
	927	\$49.21	\$47.19
	977	\$51.06	\$48.93

Notes:

(1) Maintenance capex assumed average of 2007-2010 capex (post Symbol acquisition)

Risks

Government spending cuts: Radios for public safety are the quintessential definition of non-discretionary spending. Moreover, there are a myriad of funding sources underpinning each contract (ad-hoc taxes and grants, most of which are already funded as part of the P25 standard roll-out initiative). MSI has a large diversified account base (US federal Government account for 8% of total revenue). The rest of the government spend within the US are individual states, municipalities, and cities, without any coordinated procurement. Finally the increase in government revenue and \$2.6bn backlog in Q4 2010 is a testament to Motorola Solution's resilient government business.

Bad acquisitions with cash: Motorola Solution's management has been fairly disciplined in acquisitions with the major one being Symbol, in 2007 (\$3.7bn) to complement its Enterprise business. We also believe the presence of likeminded value-focused shareholders (Carl Icahn, Dodge & Cox and Highfields hold 25% of share capital in total) will ensure that cash is returned to shareholders. Management has publicly laid out a roadmap: 1) get the spin-off done (completed) 2) become Investment Grade (two out of three agencies have already given this status) 3) Sell Network Business (awaiting final approval) and 4) return cash to shareholders. We expect a dividend initiation or buyback program within 12 months.

“MSI has almost a third of its \$15bn market cap (\$17 per share) in cash and has negative net debt of ~4bn. We think the company has the potential to distribute this cash and to initiate a dividend using the free cash flow it produces every year.”

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Anuj is a first year MBA student. Prior to school, he was a private equity associate at Crestview Partners and an investment banking analyst at JP Morgan. He holds a BS from MIT.



Rahul is a first year MBA student. Prior to school, he was a private equity associate at Monitor Clipper Partners and an investment banking analyst at Credit Suisse. He holds a BA from Vassar College.



Josh is a second year MBA student and a participant in Columbia's Applied Value Investing Program. Prior to school, he was a private equity associate at TA Associates and an investment banking analyst at Morgan Stanley. He holds a BSE from Princeton University.

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Quest Diagnostics Inc. (DGX)

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Current Price (\$M)		Valuation/Financials				FYE on Dec 31				Quest Diagnostics Incorporated	
		2010	2011E	2012E	2013E						
Share price (4/24/11)	\$56.55	EV/EBITDA	7.6x	7.2x	6.7x	6.3x					
Shares outstanding	156.4	EV/EBIT	9.1x	8.5x	7.9x	7.4x					
Market cap	\$8,846	P/E	13.9x	11.6x	10.4x	8.8x					
Debt	4,224	FCF Yield	10.3%	10.4%	10.5%	11.2%					
Cash and investments	994	P/BV	2.2x	2.4x	2.4x	2.4x					
Minority interest	23	5-Year Revenue CAGR					6.2%				
EV	\$12,099	5-Year EBITDA CAGR					6.0%				
Trading Statistics		5-Year EPS CAGR					7.9%				
Avg. volume (M)	1.9	'03-'10 Avg. ROIC					14.4%				
Avg. volume (\$M)	\$110	'03-'10 Avg. ROE					19.9%				
Short interest	1.3%										



Recommendation:

We recommend buying the equity of Quest Diagnostics (DGX or "the Company") because it is a great business with a sustainable competitive advantage trading at an attractive valuation. DGX is the low-cost provider of lab-testing services due to significant economies of scale. This positions DGX to capitalize not only from inevitable growth in the market, but also from healthcare reform, which represents a free option in our investment thesis. So you're able to buy a stable, compounding business at 10x 2012E P/E and an 11% FCF yield. We believe this opportunity exists due to temporary volume headwinds and investor misperceptions about the impact of healthcare reform. Our target price of \$90 per share represents a 60% total return in the next 12-18 months.

Company Description:

DGX is the largest provider of lab-testing services in the U.S. The market is evenly divided between hospital labs and commercial labs like DGX. Within the commercial segment, DGX and LabCorp (LH) represent an effective duopoly, while the remaining competitors are highly fragmented. The Company provides "routine" tests (60% of sales), genomic and other "esoteric" tests (24%), and "anatomic pathology" or cancer biopsy tests (16% of sales). DGX operates a network of 31 regional labs that test samples gathered from physician offices and over 2,000 patient service centers across the country. Payers include health insurers (51% of sales), physicians/hospitals/employers (24%), Medicare/Medicaid (18%), and patients (7%).

Investment Thesis:

Secular market growth: The U.S. lab-testing industry is around \$60B in size, and we project market growth of 4-6% per year. Volumes should grow 3-4% due to population growth, an aging population (people who are 65+ get 5x more lab tests than people under 65), the introduction of new esoteric tests, and increasing focus on preventative care and personalized medicine. DGX's average pricing should grow 1-2% due to a mix shift toward higher-priced esoteric tests.

Favorable competitive dynamics: The commercial lab-testing market is an effective duopoly between DGX and LH, and both companies appear to be rational competitors. DGX and LH compete nationally, but our proprietary analysis of market shares by state indicates that there is relatively little geographic overlap at the local level. We believe this minimizes direct competition and facilitates local economies of scale. Pricing for both companies has been steadily rising since 2003.

Sustainable competitive advantage: DGX's massive size provides significant economies of scale, economies of scope, and a privileged relationship with health insurers. DGX's hub-and-spoke business model allows it to enjoy high utilization of its fixed-cost testing centers, translating into lower unit costs. Our primary research indicates that most hospital labs are unprofitable due to insufficient scale. DGX provides over 3,000 tests, which allows it to leverage its massive distribution network and offer a wider menu of tests to payers. Health insurers prefer to deal with large, low-cost providers like DGX and LH and charge higher co-pays to patients who use other labs.

Market share growth: DGX is gaining market share due to growth in esoteric testing. Most hospitals don't provide esoteric tests because the volumes are low and esoteric tests require costly equipment and significant technical expertise. A growing focus on reducing healthcare costs could allow DGX to gain share from the dominant hospital segment since hospital labs charge 2x-4x higher prices than DGX.

Quest Diagnostics (continued from previous page)

Margin expansion: Margins should expand 40-50 bps per year due to operating leverage and a mix shift toward higher-margin esoteric tests. EBITDA margins are 35-40% for esoteric tests compared to 15%-20% for routine tests.

Good capital allocation: Management has opportunistically repurchased \$4.4 billion of shares since 2003. Dividends have been paid every year since 2004 and the stock has a 0.7% dividend yield.

Attractive valuation: DGX trades at a 10x '12E P/E and an 11% '12E FCF yield based on our forecast.

Variant Perception:

Physician visits should stabilize: The number of patient visits to a physician dropped 5% in 2010, contributing to a 1% drop in DGX test orders. Our discussions with physicians indicate that visits are down because unemployed people lost their insurance and are deferring checkups to save on co-pays.

We believe this trend is unsustainable and should reverse as employment trends improve.

Insourcing trends should cease: Some sell-side analysts are concerned about a recent trend toward physicians performing more of their own lab tests ("insourcing"). We believe that insourcing should reverse due to Federal regulations called Stark Laws that ban most physician-owned labs (to reduce over-utilization of healthcare). Our discussions with physicians indicate that most won't take the legal risk to generate small incremental revenues from insourcing. In addition, our ROI analysis indicates that insourcing is unprofitable for most physicians due to high fixed costs and low testing volumes.

DGX should benefit from healthcare reform: Some investors are worried about the impact of healthcare reform. Our research indicates that DGX will actually benefit from reform due to expanded health insurance coverage, the elimination of co-pays on lab tests, and greater cost-consciousness driving volumes to low-cost providers. We estimate that the addition of 32 million uninsured people to managed care in 2014 represents 4-9% of upside to the stock, which is a free option in our thesis.

Valuation:

Our 12-18 month price target for DGX is \$90 per share, representing a 60% total return from today's price of \$56.55. This target price represents 8.8x EV/'13E EBITDA, 10.4x EV/'13E EBIT, 14.0x '13E P/E and a 7.4% '13E FCF yield, which are below DGX's 8-year average multiples. Our forecast assumes that by 2013, DGX maintains share with industry growth of 5% and EBIT margins are 19.7% (vs. 18.1% in 2010). We see limited downside from today's price and the upside/downside ratio is compelling at 8:1.

	Downside	Base Case	Upside
'13E Rev. Growth	(1.0%)	4.9%	6.6%
'13E EBIT Margin	17.1%	19.7%	20.1%
'13E EV/EBITDA	7.3x	8.8x	9.4x
'13E P/E	10.9x	14.0x	15.0x
'13E FCF Yield	10.3%	7.4%	6.8%
Target Price	\$50	\$90	\$105
Upside/(downside)	(11%)	60%	86%

Catalysts:

Physician visits stabilize: Physician visits drive testing volumes and are impacted by unemployment rates. Improving employment trends should lead to more physician visits and higher volume growth.

Earnings outperformance: Our projected EPS is 13% and 21% above consensus in '12 and '13.

Smart M&A: Acquisitions in this industry are usually very accretive due to significant cost savings on overhead as well as visible revenue synergies from expanded distribution for new esoteric tests.

Risks and Mitigants:

Drop in reimbursement rates: Declining reimbursements is a risk for all healthcare companies.

However, lab test reimbursements from Medicare and other payers have been stable/growing over time. Lab testing represents only 2% of total healthcare costs, and our discussions with payers indicate that they are most focused on cutting reimbursements for high-cost procedures. Lab testing allows for early diagnoses, which saves payers money by avoiding costly, late-stage treatments. DGX has contracted pricing with its insurance clients through 2013, and Medicare/Medicaid only account for 18% of sales.

Anatomic pathology ("AP") insourcing: DGX has been losing share in AP testing (16% of sales) to physician-owned labs due to a loophole in Stark Laws that ban most self-referrals. Our base-case projections assume continued declines in AP revenues. However, the AP exemption from Stark Laws could be eliminated and the long-term trend toward outsourcing is likely to continue.

Point-of-care ("POC") testing: DGX could lose share due to greater use of portable testing equipment by physicians. However, only the lowest-priced, most-routine tests are performed at the point-of-care. These POC tests are less accurate than lab tests and the cost per test is higher. In addition, there are technological challenges with developing portable, easy-to-use POC testing equipment.

"Our 12-18 month price target for DGX is \$90 per share, representing a 60% total return from today's price of \$56.55. This target price represents 8.8x EV/'13E EBITDA, 10.4x EV/'13E EBIT, 14.0x '13E P/E and a 7.4% '13E FCF yield, which are below DGX's 8-year average multiples."

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20th Annual Graham & Dodd Breakfast Seminar

On October 21st, 2010 Columbia hosted the 20th annual Graham & Dodd breakfast at the Pierre Hotel in midtown. Each year, the breakfast brings together students, alumni, faculty, and investment practitioners to discuss current investment markets and celebrate Columbia's ongoing contribution to the value investing discipline.

At the event, Mr. Cheah Cheng Hye, Chairman & Co-CIO of Value Partners Limited gave his views on making value investing work in China and Asia. Under the leadership of Mr. Cheah Cheng Hye, Value Partners Limited has established one of the most successful investment management teams in the Greater China region.

Mr. Cheah spoke about first and foremost being a value investor and only secondly being a China investor. "The only thing new I can say about research is that in the China context, we have been moving increasingly away from quantitative analysis to



Mr. Cheah Cheng Hye, Value Partners Limited

qualitative analysis. When I first started in the 1990s, there were very few companies with superior business characteristics in China. What you were really buying were pretty lousy companies trading at very cheap prices. But in more recent years, the trend has been much more encouraging. You are finding more companies that may fit the description of a good franchise. I.e. a sustainable, competitive advantage, durable advantage we call it, and to do that it is very difficult to quantify in numbers."

The investing process at Value Partners is broken down into a set of skills that "can be mastered by fairly ordinary people...and the process is teachable, repeatable, sustainable, and scalable."

To implement this strategy Mr. Cheah emphasized the importance of creating an appropriate culture where everyone helps each other and a focus on hiring the right people.

For a full copy of the transcript, please visit www.grahamanddodd.com

"Each human being has different strengths and weaknesses, but together we make a formidable team."

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Please also share with us any suggestions for future issues of *Graham and Doddsville*:

Graham & Doddsville 2010 / 2011 Editors



Garrett Jones is a second year MBA student. This summer he interned at Nicusa Capital, a concentrated long-short value fund. Prior to Columbia, he was a Senior Consultant with Booz & Company in Dallas and the Middle East. He received a BA in Music and Computer Science from Dartmouth College.



Daniel Kaskawits, CFA is a second year MBA student and participant in the Applied Value Investing Program and Advanced Investment Research seminar. This summer he interned at Steinberg Asset Management, a long-only value fund. Following school, Daniel will work at Elm Ridge, a long-short value-focused equity fund. Prior to Columbia, Daniel worked for six years in research at Citi, where he was a member of the U.S. equity strategy team. Daniel received a BSM in Finance and Marketing, with a minor in Sociology from Tulane University in 2003.

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