



December 2009 *CGI Growth & Value Focus Coach*: Year-End and Year-Ahead Portfolio Reviews: Defensive Value and Active Value

Dear Member:

Welcome to 2010! After a great year for the Active Value Portfolio—up 69% and 45 points ahead of the S&P 500—2008's debacle is but a faint memory.

But...of course you know we don't believe that. It's *more* than a memory. It's a large piece of a long-term investing mindset, one that we never forget. We remain focused on what could go wrong, not on how great everything could turn out.

The Active Value Port experiences far, far more volatility than, say, the Defensive Value Port, and has experienced more than the Growth Port. Short-term volatility is the price of long-term outperformance, and it can be extreme. In 2008, the AV port lost to the market by 18 percentage points, while this year it beat it by 45. While we

don't expect that volatility every year, we have to accept it if we want the results, the strategy delivers.

We're leaving out reviews of **Chesapeake Energy** (CHK), **ATP Oil & Gas** (ATPG), and **Contango Oil & Gas** (MCF). We had taken extra time with these companies, delayed the *Coach*, thought we knew exactly where we stood, and then came this morning's news for Chesapeake and Contango! Why these companies don't live and die by our *Coach* schedule is beyond us. Be assured that we'll send an update just as soon as we've evaluated all developments.

Here's to a great 2010 for you and yours!

Best wishes,
Jason, Jeff, Ragu, and Tom

Defensive Value Portfolio

[Ragu Chandrasekaran](#), Manager

Fairfax Financial Holdings (FFH)

The most significant business development with Fairfax since we [reviewed their third quarter results](#) was [their announcement](#) about having received regulatory approval to set up insurance operations in Brazil. This has the potential to be a significant area of growth for Fairfax over time. With respect to their equity portfolio, it's worth

noting that the S&P 500 is up about 6% from the levels where the company has hedged 25% of their equity exposure, based on last quarter's report. Reported book value was \$372/share at the end of the last quarter, so today's price of \$393/share is likely not too far off from today's book value given the rise in overall market levels from that time.



At today's valuation, Fairfax is not a screaming buy, unlike when the DV port bought its shares. On the other hand, it is also not yet priced to reflect the future value creation through the capital allocation skills of Hamblin Watsa Investment Counsel. So, **we hold**.

If Fairfax can achieve their stated ambition of growing book value at 15% *over the long term*—a probable outcome given the quality of management and their emphasis on the long term—shareholders will be pleased with both the business results and the consequent share performance.

Burlington Northern Santa Fe (BNI)

The merger process with Berkshire Hathaway rolls on with [approval](#) from the US Federal Trade Commission (FTC). In a special meeting on Feb. 11, 2010, BNI shareholders will vote whether they approve of the merger.

With respect to the merger, an interesting [filing](#) details Warren Buffett's approach to BNI management and earnings estimates from BNI management based on various economic scenarios. *BNI management believes that the most probable outcome is an economic recovery in mid-2011*—a sobering thought for anyone expecting a V-shaped recovery from this recession.

As for what to do with our BNI shares—that is, take the cash or opt for the Berkshire shares—let's take a back-of-the-envelope stab at Berkshire's valuation, based on the 2-column approach that Buffett endorsed in recent shareholder letters:

Cash and investments that reflect the worth of the insurance businesses:	\$143.4 billion*
Berkshire's market capitalization today:	\$152.9 billion
Implied value of the rest of Berkshire's non-insurance businesses:	\$9.5 billion (only!)

*based on the [third quarter 10-Q](#)

While the rest of Berkshire's non-insurance operations have suffered significantly during the downturn, these high-quality businesses with mostly good returns on equity capital earned \$1.45 billion post-tax in the first nine months of 2009, giving us an implied multiple of 4.9 on those earnings on an annualized basis.

Consider that these are extremely depressed earnings in the midst of this severe recession and that while NetJets lost \$531 million for the first nine months of 2009, management expects it to be modestly profitable in 2010. Then that 4.9 multiple on 2010 earnings, *even with no improvements in the other businesses*, shrinks further.

So, at \$98,550 for a Berkshire A share and \$3,280 for a B share, pre-split, the DV port will opt for 100% Berkshire shares in exchange for its BNI holdings. There's no guarantee that we'll get them. That will depend on what other shareholders ask for, given that the proration will be 60% cash and 40% Berkshire stock. **But our preferred option today is to obtain all the Berkshire stock we can as a result of this transaction.**



Active Value Portfolio

[Jeff Anello](#) and [Tom Jacobs](#), Co-Managers

We close on a great year for the AV Port—up 69% at this writing—but wow, do we see the volatility of any portfolio that is predominantly small cap value: *Outperforming* the S&P 500 by 45 points this year, *underperforming* by 18 points last year. Clearly, the management strategy of this portfolio can only be evaluated through its long-term returns.

Cash

We continue to hold cash from various sales that came from increases in valuation relative to our view of intrinsic value (a 50-cent dollar, say, became an 80-cent dollar), changes in business conditions that impacted the cents per dollar of value, or overall portfolio management where a position was too large for our comfort.

After today's announced trade, cash will be about 23%–24% of the portfolio, and it will act both as a drag on an appreciating market and a hedge against a declining market. We are not making a macro call on the market, but sticking to our knitting. We prefer cash to overpaying.

Steak 'N Shake (SNS) (Jeff)

Lately, you've heard from us ad nauseum regarding SNS. The company is in full turnaround mode and Sardar Biglari has laid out his plans for a Berkshire Hathaway-like structure with his bid for **Fremont Michigan Insuracorp** (FMMH).

As we expected, Fremont has already [rebuffed](#) Biglari's offer as too low. Biglari is awaiting regulatory approval to acquire Fremont in full, which means that if approved, he can begin building a larger stake on the open market before

raising his tender price or making any other moves. This one will be fun to watch.

On the valuation side, SNS has gotten closer to its intrinsic value, which we estimate to be between \$360 and \$420 per share, post-reverse split. However, with the addition of Fremont and any other moves Biglari has up his sleeve, that value may increase rapidly in the coming years.

We view SNS as a truly long-term investment. Thus, unless the price really runs up quickly or we change our mind on Sardar Biglari—the latter highly unlikely—we'll be shareholders indefinitely.

Premier Exhibitions (PRXI) (Jeff)

What can we say about **Premier Exhibitions** (PRXI) that we haven't already? The turnaround is in effect and we're seeing good things anecdotally, such as a successful new *Bodies* exhibition opening in [Dublin](#). An investor conference is scheduled for Jan. 20, 2010, and third fiscal quarter financial results will be released in about a week.

The biggest thing we're waiting on, besides this quarter's results, is the resolution of the court case involving the Titanic artifacts. [Last we've heard](#), the attorneys have until Jan. 4, 2010, to file the final briefs and the judge will hopefully come to a conclusion soon thereafter. Stay tuned.

Aeroquest International (AQSFF/AQL) (Tom)

Airborne geophysical surveys are not within my circle of competence, but Aeroquest executives are both extraordinary cash managers and



strategic thinkers. One prime example is the 2007 purchase of UTS Geophysics.

UTS's fixed-wing survey capability operates outside of Canada and has come in handy. In a recession, more expensive helicopter surveys are the first to go, and they have gone indeed, dropping precipitously to under \$1 million in revenues each of the last quarters, while fixed-wing revenues in the last quarter returned to 2007 levels. That acquisition has kept Aeroquest afloat.

On top of that, management keeps cutting expenses, including their own salaries as reported in the latest MD&A, in ways that do not apparently impact their ability to fly the surveys they have. One of the most wrong statements in investing is "you can't cut your way to profitability." Of course you can—where the revenues are going in the right direction, as they have been for one quarter since what we hope was Aeroquest's and the mining exploration world's bottom.

In a cyclical downturn, the key with a company like Aeroquest is whether it has the cash resources to weather a return to profitability, which in the nearer term almost certainly requires an increase in surveys by junior mining companies—those without production or profits. It's an open question here.

Aeroquest burned \$2 million in cash last quarter and has \$6 million in the bank. That won't last long at the burn rate, so that's a big threat to tangible book value, about 10%–20% under the enterprise value (EV) today. *Without an improvement in cash burn, our cash margin of safety will be zero in three quarters from Sept. 30, or June 30, 2010.*

Yet we think that the uptick in bookings, including those disclosed on the recent conference call for the current quarter, predict an upswing in revenues and cash. This could bring the cyclical upturn that can have a lovely effect on a lean cost structure. Emphasis on "could."

If Q3 ending June 30 was indeed the low, and Q4 the first leg up, we could pretty easily see GAAP EPS of \$0.05–\$0.10 a share and possibly higher. That makes the upside quite good. If one can see a reasonable case for \$2 a share in a year or so and possibly better beyond, why sell at \$0.65?

Therefore, we will **hold** so long as the Q1 and following numbers confirm the initial trend of lower cash burn, reduced operating expenses, and increased revenues.

Winthrop Realty Trust (FUR) (Tom)

We hold, happily. Nothing has changed: These smart real estate investors still have the cash to take advantage of the still-depressed commercial real estate market to buy cash-producing assets at rock-bottom discounts to NPV of future cash flows.

And...this just in! Crain's Chicago Business [reported](#) at the end of the year that Winthrop has an agreement to purchase an office building in downtown Chicago at a discount to a Dec. 2008 price for a deal that failed. Marquee tenants include Accenture and DoubleClick under long-term leases. This is exactly the kind of deal we expected, though it's not yet consummated.

Management has not been perfect, by any means, but its errors haven't fundamentally affected the reasons for owning. The discipline of the REIT structure and high management ownership has meant focus on the sustainable cash flows from properties.



But we collect our now 6% dividend from this REIT, happily knowing that management is focused on maintaining and increasing our payouts.

Cheung Kong Holdings (CHEUY) (Tom)

CEO Li Ka-shing is doing a lot of buying lately—note all the releases at Google Finance for CHEUY on China Knowledge. The big news is that he is buying both Cheung Kong *and* Hutchison Whampoa, referred to in the Chinese-Hong Kong press as a “telecom-to-ports conglomerate.”

Given Li’s large ownership of each and Cheung Kong’s effective control of Hutchison, Li has tightened his grip—which is fine with us, given his value investing track record. The buying may be a potential catalyst for realizing the value for Cheung Kong, which I put roughly in the \$20s vs today’s \$12.71.

At 3.6% of the portfolio vs its former much larger percentage, Cheung Kong can offer us a somewhat defensive value while we collect the dividend. I suspect that Li Ka-shing’s eventual death will bring disruption as will Buffett’s at Berkshire, but both have talented managers in place at their businesses. Li has a son well-versed in value, as well.

We hold lacking a demonstrably better place for our money, while we collect the dividend, satisfied that whatever the short-term gyrations in Hong Kong real estate, Cheung Kong’s holdings and its large stake in diversified Hutchison Whampoa give us a margin of safety while we wait for Li’s buying or other potential catalysts for realizing intrinsic value in the \$20s.

Sears Holdings (SHLD) (Tom)

We sold half our Sears position on Aug. 4 after it doubled in about five months. Our remaining

position is up over 142% at this writing. At EV/TTM true FCF and EV/TTM EBITDA around 8, we’re not seeing a bargain—and EV/SFCF is a high 17—but the margin of safety case based on the assets is unchanged.

Not only that, but Chairman Edward S. Lampert continues the company’s share buybacks, adding another \$500 million in authority on top of the \$82 million unused from the last. That’s about 5% of today’s enterprise value. The stock price declines, the dollars buy more shares. And so on.

At just under 3% of the AV Port, **we’re holding**, in the absence of another more favorable place for our money.

Hilltop Holdings (HTH) (Tom)

We continue to hold. This is a small speculation on Gerald Ford’s ability to produce profits for investors in distressed bank assets, with significant cash waiting to be deployed. This small position, little portfolio risk, is a nice call option.

Brookfield Asset Management (BAM) (Tom)

To review, Brookfield is an asset manager maximizing cash flows from infrastructure, property, and electrical power operations. Its primary infrastructure assets are held in majority-owned **Brookfield Infrastructure (BIP)**.

Brookfield’s CEO Bruce Flatt told us in his six-month letter that the company would be ready to pounce on opportunities where “[T]hose who have no credible sponsor with the necessary capital represent suitable opportunities for us to assist with their recapitalizations.”

Translation: Owners of highly and overleveraged properties who are desperate—*desperate*—will be great opportunities for BAM to obtain great



cash flows from properties at near-bankruptcy prices.

And indeed it has. Through its majority-owned Brookfield Infrastructure, Brookfield invested \$1.1 billion in Babcock Infrastructure, and owns, now that the transaction is approved:

...100% of the third-largest freehold port in the UK; 50% of the world's largest export coal terminal, located in northeast Australia; and approximately 40% of the newly named, Prime Infrastructure. Prime will continue its listing on the Australian Stock Exchange and own approximately \$5 billion of infrastructure assets, including approximately 5,000 kilometres of rail lines, the other 50% of the aforementioned coal terminal, a 26% interest in the 15,000 kilometre [Natural Gas Pipeline Company of America] NGPL pipeline in the U.S., interests in a portfolio of ports across Europe, and various gas and electricity distribution systems in New Zealand, Australia and the UK. Upon completion, the recapitalized assets will have a favourable loan-to-value ratio of less than 70%, strong cash flow coverage, and attractive growth prospects. We will also have the benefit of integrating BBI's capable management and operating teams with our own, which will significantly expand our management team to enhance the value of existing operations and create further growth opportunities.

What's not to like?

For commercial property, get a load of this: Brookfield's global occupancy rate is 96%, and net operating cash flows *increased* about 62% year over year. New North American leases of 3.2 million square feet came with rent increases

of 20%. Flatt reported "virtually no tenant issues in 2009" and low single-digit lease expirations annually for the next three years.

And they aren't sitting around, having shown interest in some General Growth Properties assets, too.

Brookfield calculated underlying value in Dec. 2008 at \$20.62, *before* the positive six-month results here identified, and at \$29.81, using valuations in the public markets for their assets. With its next report, the company will update these numbers to Dec. 31, 2009. Brookfield has profited in the last nine months from being a capital provider in markets where capital has been, shall we say, constrained.

We're still looking at a company selling for roughly 10 times operating cash flow, if you assume a certain level of profitable sale of assets, and about 14 times if you don't. Here, the dependability of the cash flow is rock solid, armor-plated, underground-bunker defended, and that's worth a much higher valuation. I don't think we'd look seriously at selling a share here unless the stock approached the \$40s quickly or we had screaming better uses for the cash.

Brookfield is a large 7.3% of the port and could be much more with a rise to \$30 and beyond. Absent a rapid rise in price to and beyond intrinsic value of \$40-\$50 or another screaming value elsewhere, we're happy to hold indefinitely.

PNI Digital Media (aka PhotoChannel)
(PNDMF/PNI) (Tom)

There is a lively debate on the GVF Members Forum among shareholders—and former shareholders—whether PNI is worth holding.



On the one hand are those that point to the growth—42% vs 2008 and 30% year-over-year each of the last two quarters—and the potential for more; on the other, to the risks to their business of in-store photo printing. Some see the photobook and other memorabilia printing business to be promising, while others say that the company’s data on declining at-home photo printing is wrong or not indicative of the trend.

A few point to the network, an interconnected network from consumer computers to a huge installed base of stores, as a stealth creator of future wealth, while others say that the world will move entirely to digital photo frames, so who cares about a network?

Each contradicting argument could be right. For us and for now, we look at five—soon to be six given that the current quarter just ended is seasonal PNI’s best—continuous quarters of positive and growing EBITDA, true FCF, operating cash flow, and four (to be five) of owner earnings, as well as CAN\$0.14/share in net cash. We see operating expenses staying flat while revenues continue to increase both sequentially and year over year.

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Then we see that shares today sell for about nine times EV/TTM owner earnings, 9.5 times EV/OCF, and 11.5 times EV/EBITDA. Growth in high margin transaction revenues is slowing to 30% year over year, but it would have be a more serious decline for us to sell. With even flat operations, we’d just watch the cash pile up. It’s growth at such a reasonable price that you could argue “value” were it not for the future business uncertainty.

At 4.3% of the portfolio, PNI is just about right **to hold** absent a dramatic change in the business.

India Globalization Capital Warrants

We continue **to hold** them. Given their March 2011 expiration, we may decide to sell some time this year.

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If you have any questions, please join us on the Member [Forum](#) and thank you so much for being a *Growth & Value Focus* member.

Best wishes for the New Year,
Tom, Ragu, Jeff, and Jason

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