January 2010 *CGI Growth & Value Focus* Coach: Portfolio Review

Growth Port Round-up

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For those who were able to attend CGI Las Vegas II, some of the following comments will sound familiar, although they've been updated to take into account the remainder of the year's results as well as company updates that have occurred since October. I've summarized the greatest hits from my presentation, while keeping the overall message intact for those who could not attend.

Before I delve into the actual results, it's difficult to recap 12 months and make definitive statements about overall performance. It's just not long enough. As Ori Eyal, portfolio manager of Emerging Value Capital Management, reminded us in Las Vegas, you can't draw conclusions about performance until you have five years to look at, and 10 years is even better. But we can draw conclusions about our investment process, the outcomes we incurred, and determine if we need to make adjustments in our overall strategy.

The CGI Growth Port ended 2009 up 25.6% compared to a 29.1% rise in the S&P 500 over the same period. Thankfully, I'm not running a mutual fund, since my performance would have likely brought a decline in overall funds under management. As an aside, as a 50-percent equity owner in the portfolio, my wife has told me that I have a lot of room for improvement!

Taking into account that the port held 30%+ of its funds in cash for this entire period, I consider this a decent performance overall, but at CGI we run our portfolios for absolute performance and trailing the S&P 500 is not my goal. I am competitive, hate losing, and would much rather be ahead than behind.

On the positive side, the portfolio was invested in the right stocks. Owning two of the hottest performers in the market over the last 12 months—**Google** (GOOG) and **Apple** (AAPL)—gave the portfolio a needed boost. In addition, several of the stocks in the port—**Oracle** (ORCL), **Autodesk** (ADSK), **BMC Software** (BMC) and **AmTrust** (AFSI)—turned in outstanding performances. Though we've trailed the S&P 500 for most of the latter part of 2009, we made good decisions with our put writing and didn't blow ourselves up by doing anything really stupid.

That last point might sound like a joke, but when running a portfolio of companies that are high octane and trading on expectations for revenue and profit growth, not self-immolating is an achievement in itself. I remember telling Tom in February that I thought the stocks we had in the portfolio would be a "good place to hide" in the market turmoil we were experiencing. Fortunately for our results, I was right.

However, for many reasons holding the amount of cash we've had historically is becoming a detriment to our overall performance. One, the size of the portfolio does not allow us to really write a large amount of contracts when we sell puts because our position sizing on existing holdings would be thrown out of proportion.

Sure, we could sell 10 **Activision Blizzard** (ATVI) puts at a $10 strike price and take in $300–$400 of cash immediately, but if assigned, the portfolio would become the *CGI Activision Portfolio* overnight. This means that we need to be writing puts for income on multiple companies at all times to justify holding the cash. It is not only difficult from a presentation and communication standpoint, it is also prohibitive to do this on stocks selling for $30 or more given the size of the portfolio.

Problem Two is that as a put seller, we are in effect selling insurance to the market and depending on our opinion of the relative valuation of the market at any given time, we might not wish to be in the insurance business. I love to write puts as a strategy, but there are times when an overextended market does not offer the opportunity to find option premium combined with a price that will work for us over a two- to three-month period.

In other words, writing puts to own **Autodesk** (ADSK) at $25 might not make sense. Regardless of the income received, a stock trading at $27 might not interest us when we really only want to buy it or add more to an existing position at $22 or below.

When we've written puts, we've been VERY successful with our option record of nine successful trades vs. zero non-profitable trades and no assignments. Admittedly, all of the puts we've written have been in a market that has done nothing but go up and our record should be viewed in that context.

But we should also take solace in the fact that we are using a strategy that is a proven winner, while also layering on minimum requirements for break-even price, time-frame, and premium received. We have a sound strategy for put writing and we continue to implement it even if current conditions make that strategy more difficult.

So will we stop writing puts entirely? No. But along with our put writing strategy, I need to think about the overall cash position in the portfolio in the context of our holdings.

To summarize, we bought the right stocks, our options trading—built on a tested strategy with built-in parameters—was flawless, and we held one-third of the portfolio in cash while underperforming the S&P 500 by four percentage points. All in all, I'll take that performance.

In a market correction, the cash gives us an opportunity to add to our winners, while we can always look to sell existing positions and rotate the funds to stocks we like more, as we did with our **Open Text** (OTEX)/Apple trade in August (see below). And the cash allows us to continue to write puts on companies we'd like to add at prices we determine, as we've done with Activision Blizzard or **Electronic Arts** (ERTS) several times last year.

With the macro summary out of the way, let's rundown our list of companies. I'll tackle the updates first, then cover our twin 800-pound gorillas—Apple and Google—and summarize one sale, two purchases, and one options trade.

BMC Software (BMC)
BMC was quietly one of the portfolio's top performers over the past year, as management delivered solid results on top of a cost structure that had been winnowed down over the past several quarters. This combination allowed BMC to be in great condition to weather the storm, and while the $1.2 billion of cash on the balance sheet certainly helped, BMC sells software that companies who are looking to cut costs want to buy.

The Blade Logic acquisition has proved to be well-timed as BMC now has a full suite of offerings and as a partner with **Cisco Systems**'s (CSCO) UCS rollout, Cisco's success in taking sales away from heavy hitters like **Hewlett Packard** (HP) and **IBM** (IBM) could be a big call option for BMC with little risk. The lean operating structure will allow for further improvements in operating margin if CSCO gains momentum. BMC remains a buyout candidate as well. We hold happily.

Autodesk (ADSK)
Arguably, there's no other company in the portfolio whose fortunes are so tied to the overall economy than Autodesk. Selling its industry-leading Computer Aided Design (CAD) software to industries including technology and industrial fabrication, Autodesk is a stark example of the market valuing a stock far more on future expectations than on current results.

Candidly, the current numbers for revenue, income, and cash flow stink, but they are slowly recovering. Had the rest of Autodesk's competitors seen a turn in their business and ADSK had not, I'd be more concerned. Right now, it's lousy for everyone and in terms of revenues and technology, Autodesk continues to lead the industry.

This is a situation where the stock price has gotten ahead of the story. With an eye toward income, covered calls in the $28–$30 range is a possible trade—with one caveat: I wouldn't sell calls in a period where you'll have an earnings release. The business model at Autodesk is fantastic and if the market catches a whiff of business picking up for ADSK, it could be off to the races. We hold.

AmTrust Financial (AFSI)
AmTrust is a solid insurance company that understands the niche segments in which they write business. They have had a sterling operating ratio and continue to grow through a combination of acquisitions and internal initiatives. Selling at 1.3x book value, Amtrust is not expensive and as the company continues to integrate their acquisitions, book value should grow, bringing the stock price along as well.

Insurance companies should never be looked to for providing sharp growth, because like a bank building a loan book, disciplined growth at an insurance company takes time and patience. As a shareholder, I'm willing to wait with this management team, collecting our 2% dividend, as the company builds its book.

Interactive Brokers (IBKR)
After the most recent quarterly results, I'm left wondering why Interactive continues as a publicly traded company. Don't get me wrong: the company has a sterling track record, built over 25+ years in the business, along with a fortress-like balance sheet. But the swings the company has endured in its market-making business over the last couple of quarters could probably be better managed as a private company, which IBKR was before 2007.

The market-making segment of the company again took it on the chin, due to extreme levels of lower volatility in the final quarter as well as thinner spreads where IBKR makes its money as a market maker. Wider spreads lead to higher profits for IBKR.

IBKR's brokerage business has been the bright light for the company over the last couple of quarters and has brought needed diversification to its revenue stream. Customer accounts grew 21% from last year as both professional and retail investors are finding the combination of low commissions and IBKR's trading platform a good one.

It's conceivable that the company could spin off the brokerage side of the business, and take the market-making segment private again. Or CEO Thomas Petterffy, who owns 80% of the company's stock, could decide to buy back the remaining shares and say goodbye to being a publicly traded company—something he denied in the last conference call.

Interactive is a good business with an experienced management team selling at a low price. I may be a glutton for punishment, but I'm not selling IBKR down here at the $15 level. We hold.

Oracle (ORCL)
Oracle's last quarter gave us a glimpse into what the optimists are hoping is a full-fledged economic rebound. Oracle has become a closely watched barometer of the willingness of large companies to continue opening their wallets by purchasing large complex software systems like the company's database offerings. Based on the results, that willingness is still there as Oracle delivered yet again.

The current valuation—at 15–16x FCF—isn't the bargain level it was in March, but still gives a decent valuation on one of the world's strongest software companies. Expect the Sun Microsystems acquisition to bring some "noise" to upcoming quarterly releases, but look for news of the company delivering on its promise of another $1.5 billion in operating income from the purchase, as Oracle looks to integrate Sun's hardware with their existing software to create a fierce competitor to IBM and HP.

Nasdaq OMX (NDAQ)
As the sole loser on the scorecard, Nasdaq OMX deserves further explanation. The company has been battling eroding market share in its US Cash Equities trading business for the past 18 months. But the company isn't standing still and recent initiatives by the SEC to possibly curb flash orders and dark pool trading—trading volume that is not on the normal exchanges like Nasdaq and NYSE—is positive for the company.

Management is taking the initial steps to broaden into new markets, like interest rate swaps and clearing. However, until these initiatives can deliver income to the bottom line, it's tough to argue the current price isn't in line with the overall intrinsic value of the company.

We may have to admit that our buy price for Nasdaq back in February was rich. With this valuation knowledge, I'm going to continue to write puts at the $17.50 level. Including premium, a break-even price in the $16.50 level would be fine to add new shares.

Research In Motion (RIMM)
Research in Motion beat expectations last quarter in almost every category, including units sold and revenue. Revenue grew 11% sequentially from last quarter and 41% YOY(!).

RIMM shipped 10 million devices, with 4.4 million net new Blackberry subscriber accounts added during the quarter. Net income was $628 million or $1.10 earnings per share (EPS). The total cash balance now stands at $2.41 billion, which is down from second-quarter levels, except that RIMM bought back shares worth $775 million. Cash flow from operations for the quarter was $1.07 billion and the company is using this internally generated cash flow to buy back stock, finance working capital, *and* fund capital expenditures.

The market continues to be very skeptical about RIMM's position in the overall smartphone market, viewing every subsequent release of an Android phone running off of Google's operating system as another nail in RIMM's proverbial coffin. Most interesting to me is that RIMM has pulled off this performance despite a lackluster enterprise market, which RIMM dominates.

Continuing to hold RIMM here is a bet that the company continues to make in-roads in the consumer market while the enterprise market eventually rebounds. I may die by the sword on this position as RIMM is steamrolled by an onslaught of Android phones and continued Apple iPhone dominance, but we'll hold our shares for the time being.

Letting Winners Run

Too often in my investing career, I've sold profitable positions early. Letting my winners run has been one of the hardest things to learn. Often a company needs a catalyst to turnaround or reignite a former source of growth. Once this catalyst comes, the company rebounds and the stock price follows. Historically, my mistake has been selling soon after the market takes heed of this new catalyst.

What I've frequently missed is that it usually takes another negative catalyst to STOP the stock from ascending, meaning I miss a large part of the run-up and subsequent performance. This sums up how I feel about Apple and Google. Based on how fast they've risen from $90 and $300 respectively, it probably should make us pause a second and consider if they still merit holding.

But the reality is that they should have never sold for such cheap prices. The market over-discounted the perceived negative effects on their businesses. In Apple's case, the consumer was the biggest worry. How would a cash-strapped consumer pay for all of Apple's wonderful gizmos and gadgets? Well, the consumer did pay for them because they are wonderful gizmos and gadgets, making people's lives easier and providing real value to the end-user. Google turned out to be a legitimate and growing advertising medium for businesses, as outlets like radio and newspapers continue to lose their effectiveness and face extinction.

I constantly contemplate that we may have stayed at the spiked punchbowl too long with Google and Apple. But what if the punch is still tasty, unspiked, and we have a good two to three hours of fantastic partying left? In this case, it would be a shame for comments like, "The stock is up over $120 since March" stand in our way.

With that lead-in—and with "just what kind of office parties does Jason attend?" rattling around in your head—let's rundown each of the company's results.

Apple (AAPL)

Apple remains the number one choice for new money in the portfolio. The recent quarterly results reported last Monday reinforce my view that the catalysts I've spoken about—iPad release, greater iPhone adoption, and the move to GAAP accounting that more closely approximates the company's cash flow generation—will enable the stock to go higher from these levels.

Apple sold 8.7 million iPhones in the current quarter and that's despite being available only on the least respected carrier in the US. Mac unit sales were up 33% and Apple continues to make money in the higher-end PC market, while no other PC maker can say the same. The company continues to generate gobs of cash flow, with over $5.2 billion in true free cash flow in this quarter alone, adding to a cash hoard that is now over $39 billion.

As far as future catalysts, I'm not even touching on increasing Mac sales, international expansion, enterprise uptake of the iPhone, or even greater adoption of apps from the App Store, which could all be additional levers in the future. I originally thought that a $260–$270 stock price might be the upper end for AAPL but it doesn't have to be. Selling for 14x FCF, and with the other catalysts I've mentioned, we could have a long profitable run with Apple. I'd buy more if it wasn't already the largest position.

Google (GOOG)
Google released quarterly results on January 21, 2010, and delivered yet another quarter of strong performance. Annual free cash flow was up 68% compared to fiscal 2008, as Google enjoyed the duo of better gross margins and lower capex spending. Cash continues to pile up on the balance sheet, as the costs cuts combined with an improving ad and search environment literally rain cash down into the company's coffers. Want to know what a great business Google is? Free cash flow was 31% (!) of total revenues for 2009 after adjusting for options tax benefits.

We talk a lot about buying the right business model at CGI and GOOG is a paragon for that investment philosophy. There's no reason that Google can't have a $700 price tag. That'll be the price level where we'll reassess our holding.

This brings us to our soon-to-depart friend Assurant.

Assurant (AIZ)
Selling at less than book value, we know the company's specialty property segment is likely to face declines in overall revenues. AIZ has primarily written property insurance policies for subprime mortgages and foreclosure properties owned by banks. This segment is currently the largest profit contributor by far to the overall company's results.

However, management has done a credible job of keeping recent losses in business from Bank of America from affecting overall performance by aggressively courting and finding new business. Problems in their healthcare insurance segment have been negatively affected by the economy, creating an additional drag on profitability. Does all this make AIZ a possible sale candidate? I think it does.

Those who follow me in selling face the risk that at any time AIZ might finally decide to use some of their excess capital to buy back stock, which at a discount to book value, would be a good use of company funds. This is a conservative management team who felt that having extra capital over the last 12 months was prudent. It's hard to argue with that logic, since the industry was in such turmoil only a year ago.

Since I haven't needed the cash, I have probably been too lax with this company's place in the portfolio. At this time, the promise of a share buyback is not enough of an enticement to keep holding the shares. In keeping with moving capital from lesser ideas to our best ideas, we'll sell our Assurant shares and move the funds to an existing portfolio holding.

Actions

I touched on Google's latest quarter and the recent news of cyber attacks from China, Google's subsequent threat to remove their business from the country, as well as missing the "whisper number" for earnings (Did you hear something?) in the latest quarter have caused the stock to fall to the $540 level.

Selling at 20x TFCF and 22x SFCF, this is a great opportunity to add to our shares at a discount to its current cash flow growth, while also gaining a call option on a market recovery over the next 12–24 months. As we did with the Open Text sale, we'll take our AIZ proceeds, add some cash, and buy five more shares of Google in the $540–$550 range after this *Coach* is released.

Finally, I'm not giving up on Activision Blizzard (ATVI). While all the puts we've written to date have turned into income, not shares, for the portfolio, the recent weakness in the share price has seen the shares dip to the $10 level and given us another opportunity. With this slide, we'll buy 100 shares, as well as write two May 2010 $10 puts that are currently bid $0.55. I've discussed the company here in past trade emails as well as in my Growth Port Blog. The investment thesis is the same as it was back in the summer when we wrote the last batch of puts.

Coming off the success of its gargantuan blockbuster *Call of Duty: Modern Warfare 2*, ATVI is the clear leader in the video games industry. The overall industry results have been weaker than I thought, but the long-term demographics bode well for the industry as a whole. ATVI is a class above its competitors. It's deserving of a place in the portfolio.

We'll have a starter position in place if our puts expire as income yet again in May. If the market corrects in the next five months, we'll have 200 more shares with a cost basis around $9.50. Either is an acceptable outcome as I'm expecting our buy price to be in the 20x free cash flow range once the last quarter's results are out.

To summarize, soon after this *Coach* is released we'll do the following:

SELL 50 shares of AIZ
BUY 5 shares of GOOG
BUY 100 shares of ATVI
Sell to Open 2 May 2010 $10 puts on ATVI
(AQV100522P00010000)

Please bring your questions and thoughts on any of the CGI GVF Growth Portfolio stocks, philosophies, and strategies to the Member Forum. Members have been instrumental in shaping my thoughts on all of our portfolio holdings over the last 12 months. We are all better investors as a result of the informed discourse on the boards.

Best wishes,
Jason Fitnich
Growth Portfolio
CGI Growth & Value Focus:
The patient search for bargains

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