Eidelman Virant
CAPITAL

Quarterly Letter **March 2010**

Dear Clients & Friends,

Our firm's mission is to provide our clients with the best investment management experience in the country. I know that's a bold statement coming from a relatively small, St. Louis-based investment company, but we are laser focused on providing exceptional investment returns, outstanding customer service, and insightful research & education, while maintaining the utmost level of integrity and ethical standards. In keeping with our mission, we have teamed up with John Virant, John Virant Jr, and Karen Jordan to form Eidelman Virant Capital as of April 1st, 2010.

Both John Virant and David Eidelman have been in the business more than 40 years and have accumulated enviable performance records by applying a go-anywhere, value-oriented investment approach. Rob Bertman and I have worked hard to take this approach to the next level with quantitative back testing, more in-depth research and better communication so our clients can better understand our investment ideas. Our core investment team now has more than 100 years of combined investment experience, a broader network of Wall Street contacts, and more resources for research. We think we are in the best position in our history to accomplish our firm's mission.

We write these quarterly letters to our clients to communicate our latest investment ideas and our reasoning behind them. Because our value philosophy often leads us to purchase unfamiliar securities, it's even more important for us to explain our thinking to give our clients peace of mind. I'll now jump into our commentary of the market and where we see value in the market.

The stock market continued to "climb the wall of worry" rising 5.4% for the first quarter. Admittedly, we've been surprised by the magnitude of the snapback in share prices, particularly smaller and more speculative issues. The key reason is that the economy as a whole has improved significantly and numerous industries have seen sharp increases in sales and earnings. For example, auto sales were up 43% year-over-year. Of course, the biggest news of the quarter was healthcare reform, where President Obama signed the $938 billion bill which will expand coverage to 94% of eligible Americans.

As I wrote last September, it was our thesis that when the uncertainty surrounding healthcare reform dissipated, pharmaceutical and health insurance stock prices would revert upward to their higher historical levels. We still believe this to be the case. With 32 million new people covered and no "public option" to compete with, insurers should be able to offset their higher costs with new profitable customers. Pharmaceutical stocks may prove the biggest winners of reform now that more people can afford patented dugs. While S&P 500 healthcare stocks have increased 7.7% since our report, they are still undervalued at 12.8x earnings versus the market of 17.5x, representing a 27% discount to the market despite their favorable growth prospects as the baby boomers retire and require more healthcare services.

(Continued on Next Page)

Another area where we see value is in Japan. We see our favorite combination of pessimistic sentiment, low valuations, and specific investment opportunities. Japan's market is trading at the cheapest Price/Book ratio of any country in the world and we are finding profitable companies trading below their liquidation value. You can read more about this in the next section entitled "Benjamin Graham in Japan." For those who are new to our quarterly letters, this report should give you a flavor of how our value-oriented approach works in action.

We're always happy to hear from our clients, so if you have any questions or topics that you would like to read about in future letters, please contact me at tom@eidelmanvirant.com. Lastly, after working in our current office building for 28 years, we are moving up the street to 8000 Maryland, Suite 380 in Clayton to fulfill our need for more office space. We are scheduled to move on April 30th and look forward to giving you the grand tour as soon as possible.

Thank you for your business and your continued support.

Sincerely,

Tom Eidelman, CFA
Vice President

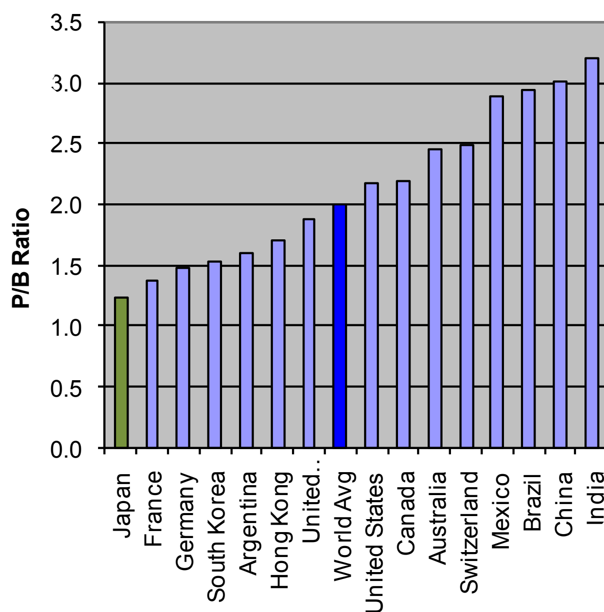
LAND OF THE RISING STOCKS?

BY TOM EIDELMAN

We often say that the best times to buy stocks are when (1) valuations are low, (2) sentiment is pessimistic, and (3) there are good individual investments to buy. Equities in Japan present just such an opportunity.

Our studies show that low valuations are one of the best predictors of superior future long-term stock returns both for individual companies and for entire stock markets. This is a key reason why we like Japanese stocks, which currently trade at the lowest valuations of any country in world (See Chart A).

Chart A: World Valuations (P/B Ratio)



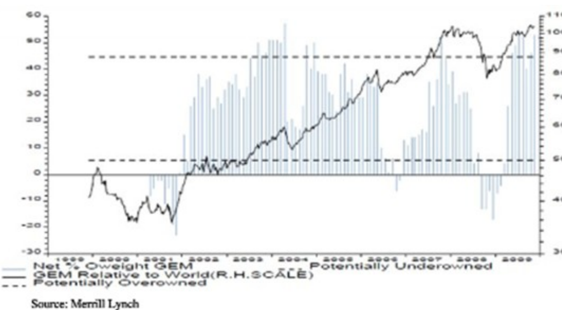
Source: Factset

Investor Sentiment Low in Japan

Investor sentiment in Japan is decidedly pessimistic. Merrill Lynch's Survey of Advisors shows that 40% of advisors recommend *underweighting* Japan (Chart B). In the past when sentiment reached such lows, subsequent stock returns were above average. In contrast, sentiment for emerging markets such as China, India, and Brazil see a record 50% recommending *overweighting* (Chart C). Investors are clearly hot on China and negative on Japan.

Chart B: % Managers Underweight Japan

Chart C: % Managers Overweight Emerging



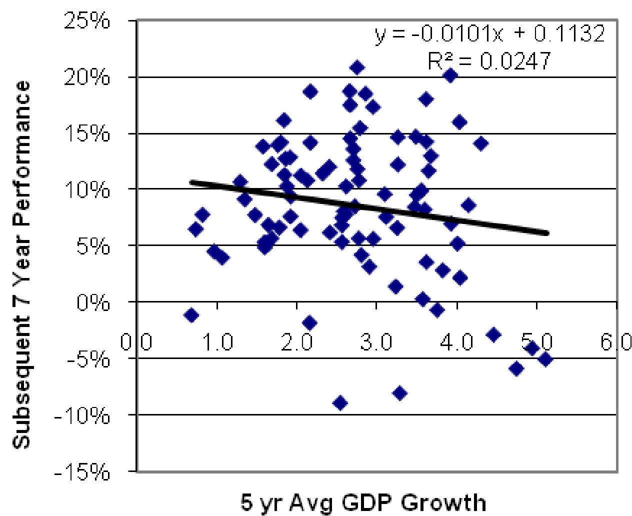
Why so Gloomy? Low Growth, Bad Market

Sentiment is low in Japan because stock market performance has been lousy and economic growth paltry. Japan experienced a stock market boom and bust from 1985-1992, where the Nikkei index rose from roughly 10,000 to 40,000 in just five years only to fall roughly 50% just three years later. It didn't get much better after that. Since 1995, the Nikkei index is down another 43% to 11,000 while the S&P 500 accumulated a return of 155%. After achieving strong 6% GDP growth throughout the 80's, Japan's growth has been negligible for nearly 20 years.

So What's to Like about Japan?

The two reasons investors fear Japan are two reasons we like it the most. First, while high GDP growth may be sexy to many, we found that it has no impact on future stock market returns. In fact, higher GDP growth is more likely to indicate *below* average returns (See Chart D on next page).

Chart D: Historical GDP vs. Stock Returns



Notes: Chart D shows little correlation between 7-year avg. returns vs. 5-year avg. GDP growth for US, Canada, UK, France, and Japan from 1985-2009. Source: Factset

The same inverse correlation is true for historical performance. In the book *Wall Street Revalued*, Andrew Smithers shows that stock returns are not random and periods of good returns are followed by bad ones and vice versa. He says "to some extent it should be possible to predict future returns by comparing returns over, say, the previous 30 years with those over very long periods of 100 years or more." He goes on to say that based on this measure "Japan appears to be outstandingly cheap." In other words, low growth and bad historical market performance are good!

Adding comfort to our thesis, Japan is the second largest economy in the world with a world-class manufacturing base. They have developed capital markets and conservative corporate balance sheets. Japan has a healthy trade surplus and is a top trading partner to the U.S. and China.

Specific Investment Ideas in Japan

There are three ways we are looking to take advantage of the value we see in Japan. These include investing in: (1) a diversified Small Cap Japan ETF, (2) a blue-chip auto and industrial company Toyota Industries, and (3) a basket of individual stocks trading below their liquidation value otherwise known as "net-nets."

WisdomTree Japan SmallCap Dividend ETF (Ticker: DFJ) $42.16

The easiest way to invest in small-cap Japanese stocks, particularly for smaller U.S. based investors, is through the Wisdom Tree Small Cap Dividend Fund ETF (Ticker: DFJ). While the larger Japanese Nikkei index trades at 1x book value, the DFJ owns a diversified group of 300 dividend paying stocks with an average P/B ratio of .80 and a dividend yield of 2.3%.

Toyota Industries (6201) Price $29.64.

Toyota Industries (6.4% owner and former parent to Toyota Motor (TM)) is a world class manufacturer of automobiles, auto parts, and forklifts. Its shares present an opportunity to buy into Toyota Motor company at a discount. TM recalled 8.1 million vehicles for sudden acceleration problems and has begun a recall program to fix brake problems on some Prius models. While these developments are certainly a concern, a fix has been established at an estimated cost of $2B. While damage to their reputation may result in costs that exceed this amount, we believe the sell-off that resulted in a destruction of $14B in market value is overdone.

Shares of Toyota Industries can now be bought at a discount to liquidation value. In fact, Toyota Industries current quote is equal to its share of TM stock alone. In other words, buying a share of Toyota Industries gets you Toyota motors plus the rest of its business for free. When you add it up, we believe it is conservatively worth $43/share in value, 45% higher than its current price.

Benjamin Graham's Net-Nets

My personal favorite way to capitalize on opportunities in Japan is to buy a basket of the cheapest stocks in the cheapest country. I will discuss this strategy in more depth in the next section called "Ben Graham in Japan."

BEN GRAHAM IN JAPAN

BY TOM EIDELMAN

Benjamin Graham (1894-1976) is considered the father of "value investing" and one of the greatest investors of all time. He accumulated a compounded annual investment return in excess of 21% from 1936-1956 and mentored numerous other successful investors including Warren Buffett. In our March 2009 quarterly letter, "The Return of Benjamin Graham," I discussed Graham's favorite investment strategy, which was buying stocks he called "Net-Nets." These are stocks selling for two-thirds of net working capital. In other words, stocks that trade below their liquidation value.

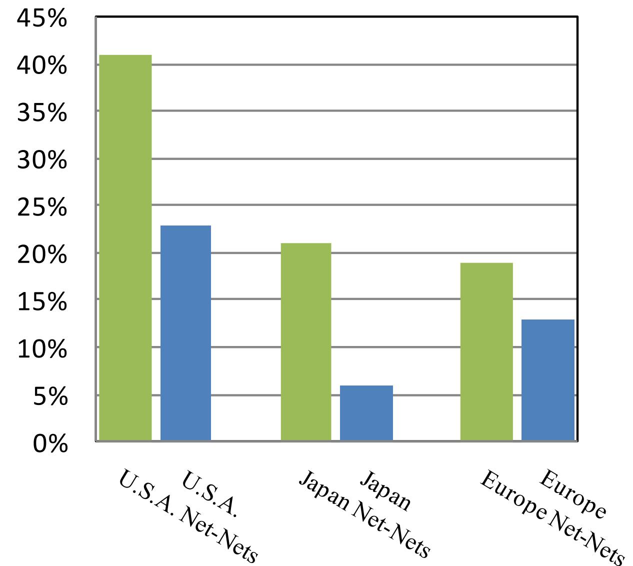
We outlined two Graham-like stocks in our Q1 2009 letter, both of which worked out tremendously well. So why don't we buy more of these kinds of stocks? Because they just don't exist. In the U.S. there are no stocks with a market capitalization above $60m that trade at Graham's recommended 66% of net liquidation value. Fortunately; however, there are such opportunities outside the U.S.

Global Net-Nets

In the book "Value Investing," James Montier published a study of Benjamin Graham's formula for ALL countries. Testing the strategy from 1985-2007, buying a global basket of net-nets would have generated a return of over 35% per year versus an equally weighted universe return of 17%. While there are currently no U.S. companies with a market capitalization above $60m that trade at such bargain levels, there are 29 such companies in Japan. Historically, Graham's strategy has worked in the U.S., Europe, and Japan (See Chart E).

Despite a lackluster return for the Japanese market overall, net-nets in Japan returned over 20% annually, beating the market by 15% per year. For this reason, we thought it was worth taking a close look at the Japanese companies passing Graham's stringent value test.

Chart E: Performance of Net-Nets vs Market by Region (1985-2007)



Source: Value Investing, James Montier

Our Secret Weapons: Yohei & Dandan

We hired two interns, fluent in Japanese, to help us dig into each individual company that passed Graham's deep value test. Yohei is a Japanese international student at Webster and Dandan is an MBA student at Washington University who worked for numerous companies in Beijing including Mercedes-Benz, Sureauto, and Toyota. We were impressed both with the quality of our interns and at the quality of companies they helped us research.

Good Companies at Low Prices

U.S. companies trading below book value are often laden with debt and losing lots of money. We were surprised to see that the below list of Japanese net-nets didn't just trade at low valuations, but also had long, profitable histories, clean balance sheets, and were still making money in a tough economy.

The average Japanese net-net has an average size of $99 million, dividend yield of 3%, and is selling for an average price below the cash on the balance sheet. Many of these companies have enjoyed ten or more profitable years in a row and carry no long term debt. The average net-net below would need to appreciate 79% to trade at their liquidation value (See Chart).

Chart F: Japanese Net-Nets (Market Cap>60m)

Company Name	Market Cap	Dividend Yield	Price/ cash	Price/ Liquidation	Appreciation Potential
Ryoyo Electro	307.2	3.4	0.9	0.51	98%
Macnica	296.5	2.0	1.3	0.64	55%
Noritsu Koki	258.0	2.3	0.6	0.48	107%
Sanshin Electronics	256.0	2.5	2.6	0.47	114%
Ryoden Trading	239.9	3.7	2.0	0.57	74%
Shinko Shoji	214.7	5.0	1.2	0.50	101%
Tomen Electronics	196.5	2.6	9.1	0.62	62%
Nippon Game Card	131.9	4.6	0.4	0.58	73%
Eidai	126.2	4.0	1.1	0.54	84%
Excel	121.9	2.4	1.2	0.62	60%
Satori Electric	117.4	2.5	0.9	0.59	70%
Daiko Clearing Svcs	109.3	3.8	0.6	0.48	110%
Ohmoto Gumi	107.6	3.6	0.7	0.29	248%
Nippon Antenna	105.6	3.0	1.0	0.61	65%
Takano	92.5	0.9	1.2	0.51	96%
Unidux	92.1	3.1	1.3	0.58	72%
Uehara Sei Shoji	90.1	2.4	0.6	0.41	143%
Koito Industries	88.1	0.0	0.9	0.40	151%
Sanyo Engineering	81.5	3.1	0.6	0.43	134%
Seikoh Giken	76.6	2.0	0.5	0.49	104%
I-O Data Device	74.6	1.1	0.8	0.56	79%
Charle	71.8	6.3	0.6	0.58	72%
Japan Found E&C	69.0	1.4	0.6	0.51	98%
Marufuji Sheet Piling	66.8	5.1	2.1	0.40	148%
Kaneshita Construction	66.2	5.2	0.6	0.57	77%
King	64.7	3.3	0.7	0.62	62%
Fuji Oozx	61.2	2.9	1.4	0.66	51%
Nireco	60.7	1.9	1.8	0.66	50%
Kaneso	60.1	3.8	0.7	0.57	77%
Median	**99.1**	**3.0**	**0.90**	**0.56**	**79%**

Source: Factset

We believe the most prudent way to capitalize on these companies is to buy a diversified basket. Here are some details of two specific companies to give a flavor of what we find attractive.

Ryoden Trading (Ticker: 8084) $5.21

Ryoden distributes and manufactures electrical equipment such as computers, LCD monitors, and integrated circuits. It also distributes industrial systems such as air conditioners. In 2009, Sales were down 21% in their electrical division due to the slower economy's effects on industrial product demand. Ryoden does about $2B in sales and has been profitable every year for the past 10 years with an average return on equity (ROE) of 6.5%. Ryoden has a large tangible book value of $11.66, including $8.78 in liquidation value and no long-term debt. The stock currently trades at 7x normalized earnings and a 41% discount to Graham's liquidation value calculation.

Nippon Game Card (Ticker: 6261) $1,136

Nippon Game Card operates prepaid card services for pachinko halls and amusement parks. Similar to a slot machine, pachinko is a gambling machine played for entertainment. Nippon Game Card makes money by selling and servicing the card machines as well as through a fee each time the cards are used. During the recession of 2009, demand for Nippon's card services fell as gaming demand dropped due to the slowing economy. In a normal environment, Nippon should do $330m in sales and has earned an average ROE around 5.5% for the past 5 years. Nippon Game Card's shares trades at 5.4x normalized earnings and a substantial 42% discount to liquidation value.

Conclusion

Historically, buying a diversified group of stocks trading below their liquidation value has yielded great investment returns. There are currently a significant number of such stocks in Japan and we have been able to apply our analysis and research to pick our favorites. We think this strategy is a great way to take advantage of the currently undervalued Japanese stock market.