Eidelman Virant
CAPITAL

Quarterly Letter — March 2013

4/15/2013

Dear Clients and Friends,

The S&P 500 Index rose 10.6% in the first quarter of 2013, recording its best start since, well, last year's gain of 12%. This year's first quarter gains were due largely to reduced public fiscal political fighting, improving U.S. employment picture, and an accommodative Federal Reserve policy. With the market moving higher and investor confidence restored, what do we expect for the rest of the year? We remain optimistic that the market and our particular investments will continue their ascent throughout the rest of the year.

A key potential headwind is the recent rise in investor optimism. Historically, the market tends to underperform when investors are bullish and does best when investors are pessimistic. Fortunately, market momentum has been an even stronger historical indicator of continued market advances. According to Ned Davis research, stocks have historically increased an average of 12% per annum when market momentum and investor sentiment were at levels similar to those occurring today. Overall, we believe reasonable stock valuations, strong market momentum, and low interest rates still outweigh the concerns over the rise in investor sentiment. While we surely can't predict swings in the market, we remain optimistic.

Individuals and institutions are realizing that current low fixed income rates will not provide adequate income to support their retirement and spending needs. We believe the need for return will continue to entice investors into the equity market and further bolster equity valuations. After five years of a rising market, equity valuations are just now reaching historically "average" valuation levels while fixed income yields are less than half their historical yields. On a relative basis, we still view equities much more favorably than fixed income for the foreseeable future. Given the global search for yield, equity valuations could continue to expand.

With our optimistic view, what is the best way to structure a portfolio to best take advantage of the market? We think a diversified portfolio of 20 to 40 opportunistic "value" oriented investments is the best way to capitalize on the market. In this quarterly letter, I'm going to explain our views on the optimal diversification. While much of the investment industry is recommending buying as many securities in as many asset classes as possible, we believe the sweet spot lies between the benefits of diversification and the power of stock selection.

In exciting firm news, I am pleased to announce a new member to our team here at Eidelman Virant Capital. In our quest to help clients earn superior investment returns, we recently hired Ted Bade as a research analyst. Ted was a portfolio manager for Maclem Investment Company in St. Louis from 2010 to 2012 and a head research analyst for San Francisco-based Cannell Capital from 2004 to 2009. We are confident Ted's skills in equity analysis combined with his intellectual curiosity will produce some great investment ideas.

Thank you so much for your business and confidence, we look forward to building on a great start to the year.

Sincerely,

Tom Eidelman, CFA

OPTIMAL DIVERSIFICATION

Diversification is a wonderful thing. In fact, perhaps no investment tenet is more universally accepted and academically supported. It has even been trumpeted as "the only free lunch in finance." Diversifying is most easily explained by the saying "Don't put all your eggs in one basket." By spreading investment risk among numerous uncorrelated investments, diversifying can both limit losses as well as lower the volatility of a portfolio.

Conversely, Warren Buffet (originally Mark Twain) is famous for saying, "Put all your eggs in one basket and then watch that basket very carefully. Diversification is Protection against Ignorance." In other words, people diversify when they aren't sufficiently confident to bet on which asset will do well and which will do poorly. Mark Cuban, Entrepreneur and owner of the Dallas Mavericks, takes this belief further and has said "Portfolio diversification is for idiots. You can't diversify enough to know what you're doing. You've got to do your homework and play your best bets."

We believe the sweet spot of diversification lies in the middle. Our research has found that owning around thirty diversified securities gets 95% of the benefits of diversification (limiting losses and volatility) while retaining the power of stock selection. In the following paragraphs, I'm going to present lessons from the masters, the academic case, a Dow Jones case study, and lastly our real world experience. All of these contribute to our conclusion that a portfolio of 20 to 40 stocks balances the benefits of diversification with the power of stock selection with the goal to achieve the best risk-adjusted returns possible.

Learning from the Masters

A key part of excelling in any profession is to emulate and improve on traits of masters in their field. If you wanted to learn to golf well, surely you would study the fundamentals of Ben Hogan, Jack Nicklaus, and Tiger Woods. I have had the honor of learning from books and interviews of successful investors such as Ben Graham, Michael Price, and Warren Buffett as well as the privilege of training under our very own David Eidelman and John Virant. So who are the masters and how have they done it?

I examined the Forbes 400 list to find every investor who amassed a personal net worth of over $1 billion from investing. I excluded those funds that were quantitative funds, private equity, or business entrepreneurs to isolate those that truly made their fortunes through excellent investment performance.

I found twenty-nine such people that I will call investment "masters." How did these "masters" construct their portfolios? Of the twenty-nine billionaires, nearly every one of them concentrated their investments into 20 to 40 key investments. In fact, the median billionaire put 10% of their funds into their top idea and 44% of their fund into their top ten ideas. (See Chart A).

Chart A: Master Investors Asset Allocation

Investor Name	Net Worth	Company	% in Top Holding	% in Top 10 Holdings
Warren Buffett	$46B	Berkshire	20%	86%
George Soros	$19B	Soros	10%	41%
Carl Icahn	$15B	Icahn LLC	27%	96%
Abigail & Ed Johnson	$12B	Fidelity	6%	32%
John Paulson	$11B	Pualson & Co	22%	57%
David Tepper	$5.5B	Appaloosa	10%	49%
Bruce Kovner	$4.3B	Caxton	15%	40%
Eddie Lampert	$3.2B	ESL Inv.	39%	100%
Ken Griffin	$3.1B	Citadel	1%	8%
John Arnold	$3B	Centaurus	29%	95%
Stanley Druckenmiller	$2.7B	Duquesne	8%	50%
Julian Robertson	$2.6B	Tiger	4%	38%
Wilbur Ross, Jr	$2.3B	Invesco	30%	96%
Leon Cooperman	$2.2B	Omega	6%	37%
Ken Fisher	$1.8B	Fisher	2%	18%
Glenn Dubin	$1.7B	Highbridge	15%	44%
Ron Baron	$1.5B	Baron Funds	3%	21%
Chase Coleman	$1.5B	Tiger Global	10%	62%
James Dinan	$1.4B	York Capital	8%	46%
Michael Price	$1.4B	MFP	6%	38%
Louis Bacon	$1.3B	Moore	6%	27%
Dan Loeb	$1.3B	Third Point	27%	70%
Thomas Steyer	$1.3B	Farallon	6%	39%
Richard Chilton Jr	$1.2B	Chilton	4%	28%
David Einhorn	$1.2B	Greenlight	11%	62%
Steve Mandel Jr	$1.2B	Lone Pine	7%	42%
Nelson Peltz	$1.2B	Trian Funds	25%	100%
Mario Gabelli	$1.1B	GAMCO	2%	14%
Paul Singer	$1.1B	Elliot Capital	30%	81%
		Median	**10%**	**44%**

Source: Forbes.com & SEC Edgar Website

The Academic Case

Numerous academic studies conclude that almost all of the benefits of diversification can be achieved with approximately thirty stocks in a portfolio and that the majority of the benefits of diversification occur within the first twenty stocks. In 1972, Nobel Prize winner William F. Sharpe published an article on the effect of diversification on non-market risk which showed that increasing the number of stocks in a portfolio does reduce risk but once the portfolio reaches 25-30 stocks, the risk reduction is almost negligible (See Chart B on next page).

Chart B: Diversification Benefits Diminish

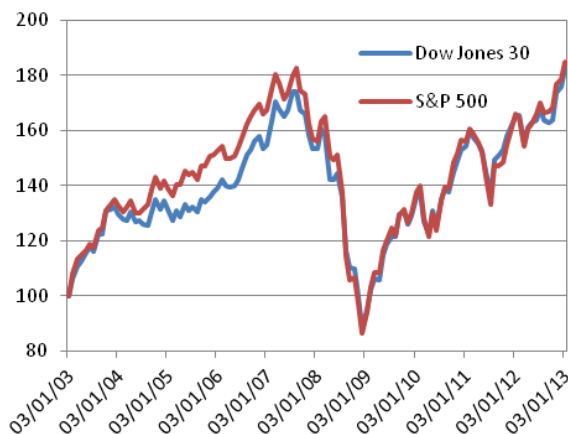
Source: "Risk, Market Sensitivity and Diversification," Financial Analysts Journal, January/February 1972, pp. 74-79

The same conclusion has been drawn from other academic studies. In the book "Investment Analysis and Portfolio Management," Frank Reilly and Keith Brown reported that "about 90% of the maximum benefit of diversification was derived from portfolios of 12 to 18 stocks." In "Modern Portfolio Theory and Investment Analysis," authors Edwin J. Elton and Martin J. Gruber showed the average standard deviation (risk) of a portfolio with only 1 stock was 49.2% and 1,000 stocks was 19.2%, but a portfolio of 20 stocks reduced volatility to approximately 20%. In other words, adding 980 more stocks to the 20-stock portfolio only reduced the portfolio's risk by a miniscule amount.

Dow Jones vs. S&P 500

Perhaps the simplest example of showing the diversification benefits of 30 stocks is to compare the Dow Jones Industrial Average (containing 30 stocks) to the S&P 500 index (representing 500 stocks). Whether you look at a 10-year or 50-year performance record, the two indices have performed nearly identically with the same level of risk as measured by annual standard deviation.

Chart D: Dow Jones 30 vs. S&P 500 Performance



De "worse" ification

The whole concept of investing in a portfolio of 20 to 40 investments may not sound revolutionary. After all, that's what successful investors have been doing for decades. What is surprising is how many individuals and advisors have migrated towards passive "asset allocation" strategies. While intelligent asset allocation using ETFs can be a prudent investment strategy, many seek to own as many securities in as many asset classes as possible with the goal to reduce risk by owning a little of everything.

As I outlined in the "Pitfalls of the Asset Allocation Model," we think it's important to know what you own and pay attention to value. For example, international bond ETFs are becoming more and more prevalent. In 2011, Van Eck came out with a Market Vectors® LatAm Aggregate Bond ETF (BONO), which invests passively in all Latin American debt. It may sound reasonable to own debt in every Latin American country, including a 4% allocation to Argentina. After all, the fund offers a 5% yield.

After visiting Argentina, I can tell you that nearly nobody in their right mind would invest in Argentina bonds. In fact, citizens actually pay a 40% premium above their fixed peso/dollar exchange rate just to convert their pesos in dollars. Because of a 25% inflation rate, their dollars can earn 25% relative to their depreciating peso virtually risk free. Although interest rates are around 15%; their high inflation rate nearly guarantees bond investors lose significant purchasing power. Rather than blindly investing in every security in every country, we think its imperative to know what you own.

What has Worked for Us

Both John Virant and David Eidelman have been managing money for over 30 years and independently came to the same conclusion as many of the investment greats listed above: a portfolio of roughly 20 to 40 securities maximizes the benefit of diversification with the power of stock selection. Since 2000, the Eidelman value composite has significantly outperformed the S&P 500 and Russell 2000 while also experiencing less risk using such a strategy. With a similar diversification strategy, John Virant's individually managed accounts and partnership have also performed spectacularly, with the partnership outperforming the S&P 500 eleven years in a row from 1999-2010. At Eidelman Virant, we believe selecting a portfolio of 20 to 40 uncorrelated securities gives us the best probability of achieving superior risk-adjusted returns in the future.

Disclosures

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