Eidelman Capital Management

Quarterly Letter — September 2009

Dear Clients & Friends,

The S&P 500 stock market index recorded an impressive 15% gain for the 3rd quarter as investors celebrated the economy stepping back from the proverbial edge of the cliff and Fed Chairman Ben Bernanke saying the recession is "very likely" over. Even more noteworthy than just the overall S&P 500 performance was the explosive performance of smaller, more speculative stocks versus larger, competitively stronger companies. Stocks rated B+ and below by S&P earned 22% over the last quarter while A-rated stocks earned just 13% for the quarter.

When I wrote to you last, we described our feelings about the overall market direction as "anything can happen." While we still adhere to this view, we are now a bit more cautious. Extreme optimism, reduced insider buying, and higher valuations suggest that broad market gains will be tougher to come by in the future. This is why it is as important as ever to seek out great individual investments.

A key to our success has been to "go where the value is." Whether it is Benjamin Graham-type value stocks, regional banks, regulated utilities, or high-yield debt, we will invest where the return potential is substantial in comparison to the risk. So where do we see value now? In the next section entitled "The Case for Quality," I will explain why we now see value in blue chip companies. I'll then walk through an individual example of this phenomenon in a case study of Wal-Mart vs. Stein Mart.

In the last section of this letter entitled "Heads you win/Tails you win," I discuss the opportunity we see in healthcare stocks due to the fear surrounding healthcare reform. I'll explain why I believe dramatic reform is off the table and all other healthcare reform outcomes should be beneficial to the under-loved pharmaceutical and health insurance companies.

Finally, as you may have seen in the *St. Louis Business Journal*, we are proud to report that our investment performance for the Eidelman Value Composite was ranked #2 nationally for all US Value Equity Managers for the 12 months ending 6/30/09 by Nelson's, a division of Thomson Reuters. We are honored by this recognition and are committed to keeping it up. We will continue to do our best to find value and seek out superior investment returns.

Sincerely,

Tom Eidelman, CFA
Vice President

THE CASE FOR QUALITY

BY TOM EIDELMAN

Wikipedia describes blue-chip stocks as "well-established companies having stable earnings, no extensive liabilities, and paying regular dividends even when business is faring worse than usual." They also have higher earnings quality (less accounting gimmicks) and provide better protection against down stock markets, inflation, and a weakening dollar. For these reasons, blue-chips stocks, like a luxury car, have historically sold at a premium.

Warren Buffett says "It's far better to buy a wonderful company at a fair price than a fair company at a wonderful price." I say it's best to buy a wonderful company at a wonderful price.

What's a "Wonderful" Company?

A high-quality company has 1) high returns on capital 2) stability of earnings and 3) low leverage. The key to achieving the above criteria is maintaining a competitive advantage. This advantage is often referred to as a "moat" because it keeps intruders from capturing their crown jewels (profits). This advantage could be due to large scale (Wal-Mart), patents (Pfizer), or powerful branding (Coca-Cola).

Finding wonderful companies is not hard. These companies often top the lists of such rankings as Interbrand's world's strongest brands, Fortune's most admired companies, or the best companies to work for. More simply, one could just look at the S&P quality ratings. The crème-de-la-crème of global companies usually rises to the top of all the lists.

Since finance theory teaches that higher returns require higher risk, one might expect quality stocks to earn *lower* returns than those of low quality. However, just the opposite has been true. Since December 1989, an equal-weighted portfolio of high-quality stocks would have outperformed the market handily, earning a total return of 10.6% per year vs. the S&P 500 of 8% (See Table A).

Table A: A+ Quality vs. S&P 500 Performance

Year	A+	S&P	Year	A+	S&P
YTD '09	13.1%	21.0%	1999	-1.5%	21.0%
2008	-21.1%	-37.0%	1998	20.5%	28.6%
2007	-10.4%	5.5%	1997	40.6%	33.4%
2006	11.2%	15.8%	1996	21.6%	23.0%
2005	1.4%	4.9%	1995	37.1%	37.6%
2004	12.0%	10.9%	1994	3.4%	1.3%
2003	28.3%	28.7%	1993	-0.2%	10.1%
2002	-6.4%	-22.1%	1992	13.0%	7.6%
2001	4.7%	-11.9%	1991	49.5%	30.5%
2000	19.7%	-9.1%	1990	-0.5%	-3.1%
Avg. Annual Return				**10.5%**	**8.0%**

So is successful investing just as easy as buying the highest quality companies? Not so fast! Let me tell you about a time when high quality stocks got creamed.

The Nifty Fifty

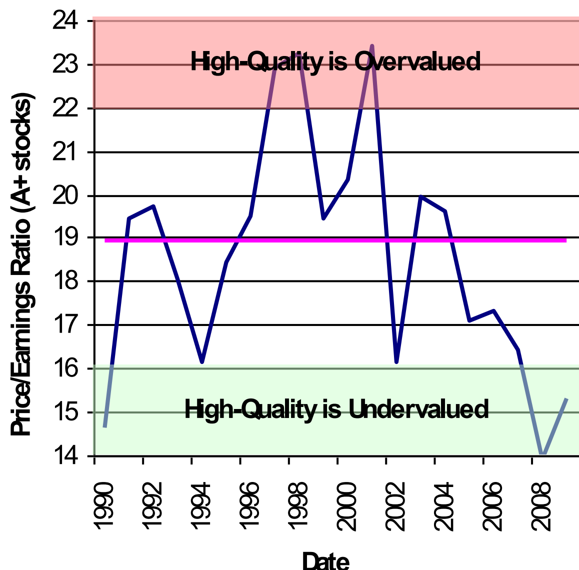
The "nifty fifty" was a group of premier growth stocks such as Xerox, IBM, Polaroid, and Coca-Cola that became institutional darlings in the early 1970s. Lured by their high and stable growth rates, investors bid these stocks all the way up to 42x earnings by 1972, more than double that of the S&P 500 Index.

Because of their overvaluation, these stocks went on to decline by an average of 66% from the peak. Investors who believed outstanding performance could be obtained with just "one decision" to buy blue-chip stocks and hold them forever suffered severe losses.

Wonderful Prices

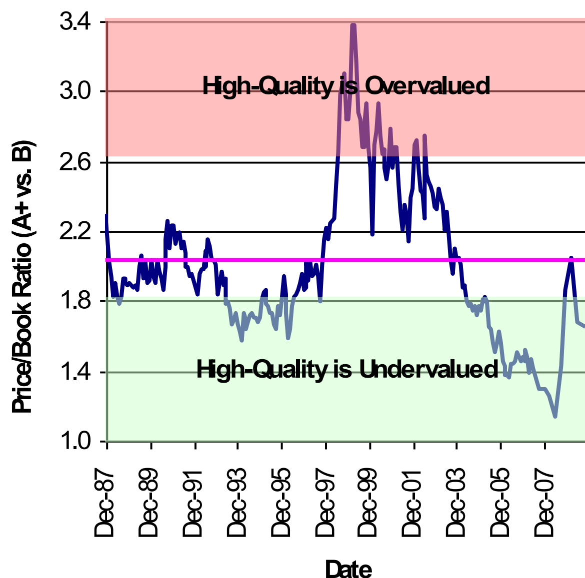
So when do you want to buy high-quality companies? When they are undervalued! Right now, high quality companies (as measured by the PE ratio on S&P A+ rated stocks) are selling for their cheapest values in 20 years. More importantly, they are undervalued relative to all other stocks (See Charts A & B on next page).

Chart A: A+ Stocks PE Ratios (1990-2009)



Notes: Chart A shows the historical valuation of high-quality stocks as defined as S&P A+ rated stocks.

Chart B: Valuation of A+ vs. B rated Stocks



Notes: Chart B shows that A+ stocks have historically sold at 2 times the price of B-rated stocks. When A+ stocks sell for 2.5x, they are overvalued and when they only sell for 1.5x, they are undervalued.

I'll further demonstrate the current quality disparity in the next section "Wal-Mart vs. Stein Mart," but first want to emphasize two more qualities of high-quality companies that may prove crucial in the coming years.

The Best Inflation Hedge

When a company's costs rise due to inflation, it is critical that a company can pass on these costs in the form of higher prices to its customers to maintain their profit margins. Due to their dominant market positions, high-quality companies have pricing power. This means that consumers are unlikely to decrease their spending or switch to another brand if the company raises its prices. Conversely, when commoditized businesses like airlines try to maintain margins by increasing fares, customers switch airlines, delay travel, or even drive instead. Dominant companies are better able to maintain profits in inflationary environments.

Benefits from a Decline in the Dollar

Because high-quality companies have a larger percentage of their sales internationally, they benefit from a weakening dollar as their goods become cheaper to the world and international sales are translated into higher values here in the U.S.

Bottom Line: Right Strategy at the Right Time

Our investment strategy is to take a fundamentally sound investment approach like buying high quality stocks and implement it at the right time (when that strategy is undervalued). We believe high-quality stocks present one of the greatest opportunities in the current market. Here is a list of some high-quality companies showing their strong fundamentals and valuations. In other words, wonderful companies at a wonderful price (Table B).

Table B: Low-Priced, Wonderful Companies

Company Name	Market Cap ($B)	S&P Stock Rank	% Int'l Sales	10 Yr EPS Gr. Rate	Div Yield	P/09E Ratio
Coca Cola	$ 125	A	75%	6.0%	3.4%	17.2
Proctor & Gamble	$ 166	A+	61%	10.5%	3.1%	14.0
Exxon	$ 320	A+	70%	18.0%	2.5%	16.5
Johnson & Johnson	$ 165	A+	49%	13.0%	3.3%	13.5
IBM	$ 156	A	65%	9.5%	2.1%	12.4
McDonalds	$ 62	A-	66%	9.5%	3.8%	14.3
Wal-Mart	$ 189	A	24%	14.5%	2.3%	14.0
Average	**$ 169**	**A**	**59%**	**12%**	**3%**	**14.6**

CASE STUDY: WAL-MART VS STEIN MART

Two companies that exemplify the current value disparity between high and low quality stocks are Walmart (WMT, $49.09) and Stein Mart (SMRT, $12.71).

Walmart is the world's largest retailer, using its large format stores and bulk purchasing power to offer customers "everyday low prices." WMT's low-cost competitive advantage has allowed them to grow earnings at 15% compounded over the past 10 years and earn a 20% return on equity (ROE) every year.

Stein Mart is a smaller retailer offering off-price high-quality goods such as clothes, home decor, linens and gifts. While I personally like shopping at SMRT, their financial performance has been less than stellar. They have grown sales at 7%, but neither their book value nor earnings have grown at all. They have no competitive advantage as manifested in their below average ROE of just 9%.

Here is a side-by-side comparison using the most important financial metrics:

Historical Performance (10-year Avg)

	SMRT	WMT
Sales Growth	7.0%	13.5%
EPS Growth	0.0%	14.5%
Book Value Growth	0.0%	14.5%
Avg Profit Margin	1.5%	3.4%
Avg Return on Equity	9.3%	21.0%

The Punch line

Despite its financial superiority, Wal-Mart bafflingly now trades at a *discount* to Stein Mart. WMT trades at a 25% discount to SMRT based on PE ratio and virtually the same price based on Price/Book (See Table C). This is like being able to buy a house in the best neighborhood cheaper than an equivalent house in a bad neighborhood. How is this possible?

Table C: Valuation Comparison

	Current		Historical**	
	P/E*	P/B	P/E	P/B
Wal-Mart	12.5	2.8	23.0	4.6
Stein Mart	16.5	2.6	14.6	1.0

*'09 Consensus Analyst Estiamtes

**10 year historical average

Excitement & Apathy

Investors often chase excitement and performance. Enthralled by Stein Mart's recent earnings turnaround, as they swung from a big loss to a solid gain this year, investors are hoping SMRT will be a large beneficiary of an economic recovery. Such enthusiasm has bid the stock up from below $1 per share in March all the way to $12.71. Caught up in the excitement, SMRT investors fail to realize they are paying three times historical values and a higher earnings multiple than shares of Wal-Mart.

Conversely, Wal-Mart shareholders are bored and impatient that the stock has gone nowhere in ten years. However, such performance is due to P/E contraction from an overvalued 39x to 14x. Under the hood, earnings grew a phenomenal 15% annually. Going forward, we think the earnings multiple has bottomed and the stock price will reflect its strong earnings growth. In addition, WMT may get a pop as the P/E multiple reverts upward. Lackluster stock performance has lulled investors into a state of apathy, unable to see that it's the same great company that has grown into its price and is ready to climb.

Go Where the Value Is

The Stein Mart vs. Wal-Mart comparison is a microcosm of the larger phenomenon of undervaluation of high-quality stocks. Wal-Mart currently presents an opportunity to buy a great company at a great price.

HEALTHCARE STOCKS: HEADS YOU WIN/TAILS YOU WIN

BY TOM EIDELMAN

"If we do nothing to slow these skyrocketing costs, we will eventually be spending more on Medicare and Medicaid than every other government program combined. Put simply, our health care problem is our deficit problem. Nothing else even comes close." – Barack Obama - Healthcare Speech 9/9/09

Soaring Healthcare Cost

Healthcare costs have grown an eye-popping 10% annually since 1970. This growth has transformed a small industry representing 5% of our economy to roughly 18%, accounting for $7,500 per person. Most of this growth is due to technological advancements and an aging population, both of which are estimated to continue into the future. The Centers for Medicare and Medicaid Research (CMS) estimates healthcare costs to continue to grow at 6% annually until 2018. Combined with the millions of uninsured, these growing costs are now commonly referred to as our "healthcare crisis."

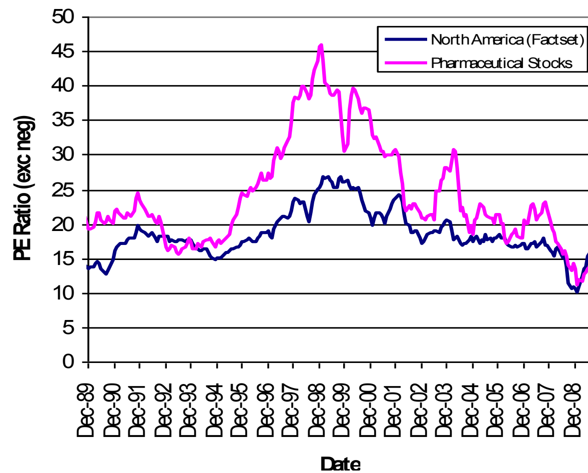
Healthcare Reform – The Elephant in Room

To combat this crisis, many on the political left believe that a "single-payer" system where the U.S. government pays for all costs for everyone is the best way to combat cost increases through price controls, administrative economies of scale, and standardizing care. Whether or not one believes that a public solution is the right one, it certainly would not be good for drug and health insurance company's profits as the government would dictate what pharmaceutical companies can charge and health insurers would be at least partially replaced by a public system.

Fear Creates Opportunity

Because of reform fears, pharmaceutical stocks are trading cheaper than the S&P 500 for the first time since 1993 (See Chart C). Not coincidentally, 1993 was the last time healthcare reform was being championed by Hillary Clinton. Since we see parallels between 2009 and 1993, lets look at what happened to pharmaceutical stocks in 1993-1995.

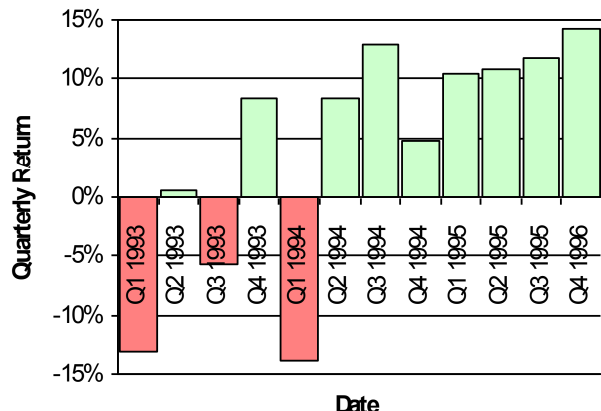
Chart C: Pharma vs Market PE (1990-2009)



Pharmaceutical stocks performed very poorly throughout 1993 and early 1994 as Hillary Clinton testified before congressional committees on health care. Soon after, drug stocks started climbing as fear of dramatic reform abated and Senate Majority Leader Mitchell introduced a compromise proposal in August 1994. Healthcare stocks continued rising as the Mitchell plan died a few week later due to lackluster support.

As you can see, pharmaceutical stocks performed poorly as investors feared healthcare reform, but rose dramatically when the fear dissipated in late 1994 (See Chart D). We foresee a similar positive outcome for healthcare stocks in late 2009 and 2010.

Chart D: Pharma Performance (1993-1995)



Similar to 1993, Healthcare stocks have recently underperformed due to fear surrounding reform. However, it is our opinion that such fear is unwarranted. Here are the three potential outcomes for Healthcare Reform and their effect on healthcare companies:

1. Single-Payer/Govt Healthcare – Negative
2. Incremental Reform – Neutral
3. No Reform – Positive

Option #1: Government-Run Healthcare

Most believe that a single-payer system is completely off the table due to political impossibility. Our key thesis is that <u>neither of the other two options will be negative for healthcare stocks and thus healthcare stocks will appreciate under either scenario</u>.

Option #2: The Baucus Bill

The most likely healthcare reform outcome is a bill with provisions similar to those in the current Baucus Bill. This bill essentially expands coverage to 90% of Americans by mandating coverage and eliminating discriminatory pricing to those with pre-existing conditions or high-risk factors. Funding for such coverage is achieved through raising taxes on the rich, taxing Cadillac healthcare plans, and cutting some Medicare spending.

Many don't realize that such reform would *not* be bad for most healthcare companies, including pharmaceutical companies and health insurers. While private insurers would have to cover sicker individuals, they also would increase their customers an additional 15% as more than half of the current uninsured population will get coverage. Drug companies would also give some price concessions, but make it up on volume, as more people have insurance to pay for their drugs.

Option #3: It All Falls Apart

Given emotional spirits, large political lobbies on both sides, and tumultuous history, it is still quite possible healthcare reform doesn't get passed at all. Greg Valliere, Chief Political Strategist of the Washington Research Group, believes the chances of nothing getting done are as high as 50%. While such an outcome would be demoralizing to many Americans and the current administration, it would be extremely bullish for healthcare stocks. With reform clouds passing, we believe investors will focus on the favorable dynamics of the healthcare industry.

Innovation

The healthcare industry has grown at a very healthy clip for the past 30 years due to dramatic improvements in technology such as new blockbuster drugs to treat cholesterol, heart disease, heartburn, asthma, high blood pressure, schizophrenia, depression in addition to new devices such as drug coated stents, medical imaging machines, and more.

While we may complain about the high costs, I was sure happy to be back quickly on the playing field after rotator cuff surgery, and my uncle is happy to be alive after having a stent inserted to unclog an artery to his heart. Healthcare companies provide an invaluable service, make solid profits, and have a tail wind of growth due to the number of Americans over 65 doubling over the next 25 years.

International Opportunity

In addition to growing healthcare expenditures in the US, emerging economies like China and India may present even greater opportunity. They currently spend an infinitesimal $10 vs. $7,500 per capita in the U.S. annually on healthcare. With the aging of the population and increase in standards of living, emerging economies will spend *much* more on healthcare to the benefit of global healthcare companies like Pfizer (PFE) and Johnson & Johnson (JNJ) who generate 60% and 49% of their sales internationally respectively.

Conclusion

Due to the fear surrounding reform, healthcare stocks are depressed. Under either reform outcome, these companies should appreciate when the fear dissipates and investors attach value to the favorable prospects of the healthcare industry.