Eidelman Capital Management

Dear Clients & Friends,

2008 was a difficult year to say the least. The S&P 500 Index suffered its 3rd worst year ever, declining 37%. The average U.S. stock mutual fund fell a record 39% in 2008, according to Morningstar Inc. in Chicago. Believe it or not, the U.S. stock indexes outperformed international markets where such countries as China, India, and Russia markets dropped 66%, 51%, and 67% respectively. Such dismal performance was due to a global economic slowdown, rising unemployment, and most importantly, mounting *fear* surrounding the entire financial system. While we are not happy that our clients experienced losses, our performance significantly outperformed that of all the benchmarks listed above. Within this difficult investing climate, our efforts to find value and opportunity paid off.

Our clients' performance benefited greatly from some of our key investment themes. The belief that high quality stocks were relatively undervalued led us to our investments in McDonalds and Wal-Mart, which were the only two stocks in the Dow Jones Industrial Average to report a gain for 2008. American and Continental Airlines also appreciated significantly as they reaped the benefits from plunging oil prices. Finally, our investment in the UltraShort China Index helped us profit when the Chinese stock market bubble popped.

With 87% of all U.S. stocks down in 2008, we also had many losers. While we avoided many of the big disaster financial stocks like AIG, Fannie Mae, Washington Mutual, and Citigroup, investors fled the entire financial sector, driving down the prices of many of our smaller bank stocks. Another big disappointment was recreational vehicle manufacturer Monaco Coach, which we thought would benefit from declining gas prices. When consumers couldn't get cheap financing due to the credit crises, RV sales declined by a much worse than expected 48%.

In addition to the credit crisis, investor confidence was recently rattled by Bernie Madoff's $50 billion Ponzi scheme. Since Madoff acted as his client's investment advisor, broker, and trader, he concocted fictitious trades and demonstrated impossible performance. As a healthy reminder, all of our clients' accounts are held with independent brokers who keep custody of your assets and independently price securities.

(continued on next page)

But enough about last year, what do we see for 2009? We see plenty of opportunities, particularly in beaten down stocks. As I will outline in this newsletter, November offered one of the best buying opportunities we have ever seen and we pounced on it. Where do we find the confidence to be buyers of stocks right in the midst of a recession? I can't wait to show you in my section called "The November Green Light."

In the last section entitled "Year-Ender Strategy," I will outline our strategy of buying down-and-out stocks at the end of the year. We believed that this year, this strategy coincided perfectly with our broader, bullish view and analysis that cyclically depressed stocks were undervalued.

In addition to performance, our goal is to build your confidence both in us and your investment portfolio. We understand that turbulent markets can be unnerving. We think our best course of action is to increase client communication, educate, and make the best investment decisions we can. If you have any questions or concerns, we encourage you to please give us a call. Thank you so much for your support and loyalty.

Sincerely,

Tom Eidelman
Vice President

Update: We're pleased to announce that Tom had an article published in the January 12th, 2009 edition of *Barron's* magazine. The article explains the pitfalls of investing in leveraged exchanged-traded funds (ETFs). A copy of the article is enclosed and available on our website at www.eidelmancapital.com. -David Eidelman

THE NOVEMBER GREEN LIGHT
BY TOM EIDELMAN

History suggests that the best time to invest is when stocks are cheap, investors are scared, and corporate insiders are loading up. Being stock market history buffs and numbers guys, we always dreamed that there would be such a time when all our trusted indicators were flashing a green light. We've studied recessions and bear markets and told ourselves that if we ever got such an opportunity to buy at bargain lows again, we would jump on it. November presented just such an opportunity.

Regardless of what is happening in the economy, the three factors we think are most important for determining future stock market returns are: valuation, investor sentiment, and insider buying.

Valuation

The price we pay for stocks, simply referred to as valuation, is perhaps the most important factor for determining *long-term* investment returns. Numerous studies have shown that when the market trades at cheap levels as measured by the Price-to-Earnings (P/E) multiple, subsequent stock returns have been above average (See Chart A).

Chart A

PE Ratio vs. S&P 500

(1950-2008)

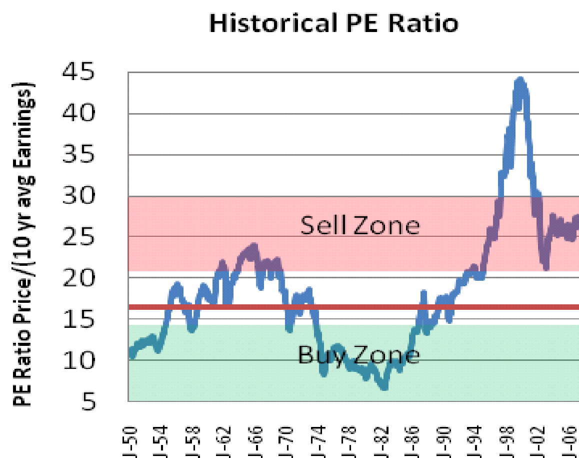
Normalized P/E Ratio*	Gain/ Annum
Above 20.5	6.6%
Between 14.5 & 20.5	6.4%
Below 14.5	14.0%

Period Avg.	9.1%

*Price/10 yr avg earnings

While we tend to be optimistic when the P/E ratio is below its 50-year historical average of 16.5x, we get darn right bullish when the P/E ratio falls below 14.5x earnings. Subsequent returns have averaged 14% since 1950 when stocks traded at such low levels. On November 20th, the market broke into the buy zone where stocks have historically achieved attractive returns (See Chart B).

Chart B



Sentiment

While counterintuitive, another indicator of above average future stock returns is when investors are pessimistic. Such negative sentiment tends to hit its peak when the outlook is: "Things are bad and they are gonna get worse."

When investors are scared, they often dump their stocks at low prices, fearing they will go even lower. In times of extreme fear, panic selling drives down stock prices far below their true value, setting the stage for higher future returns.

One measure of investor attitudes is the Investors Intelligence Survey; which measures investment newsletters to determine whether they are bullish, bearish, or neutral. Since 1969, when the survey indicated that investor sentiment was negative, subsequent returns have exceeded 20% annually (See Chart C).

Chart C

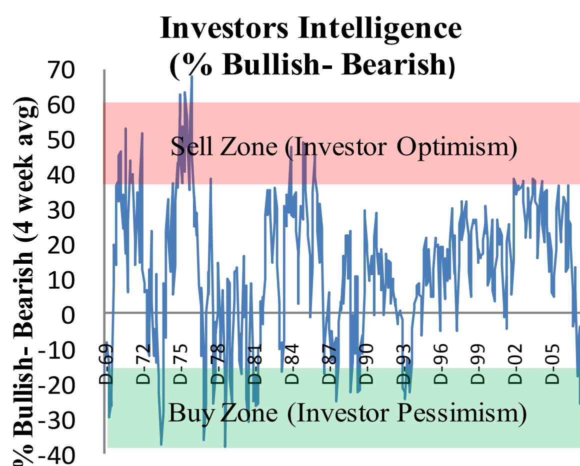
Investor Sentiment vs. S&P 500
(1969-2008)

% Bullish-Bearish*	Gain/ Annum
Above 36	3.0%
-14.5 to 36	8.0%
Below -14.5	21.2%
Period Avg.	8.8%

*Investors Intelligence (4 week avg)

Investor pessimism dove deep into the buy range in November (See Chart D). While investors were selling with fear, we were implementing our Year-End buying strategy in anticipation of a sharp market rebound.

Chart D



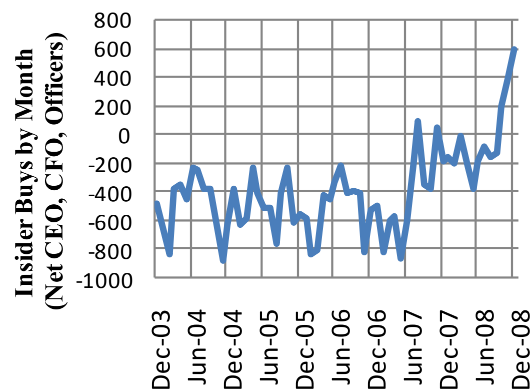
Insider Buying

The final indicator that we analyze is insider buying. Insiders, the people charged with managing and overseeing businesses on behalf of shareholders, have more insight about the health, strategic direction and investment risk/ reward of their respective companies than any other market participant. Insiders are long-term focused investors. Most importantly, insiders have a solid track record of making correct directional market calls.

On 11/25/08, InsiderScore reported that insiders were more bullish than they had been in more than thirty years. They bought stock at record high levels and sold stock at record low levels (See Chart 5). Companies with buying outnumbered those with selling by a 4.5-to-1 ratio, an unheard of figure. Speaking with their pocket books, insiders believed their stocks were undervalued.

Chart E

Insider Buying
(CEO, CFO, Officers)



Conclusion

While most investors were panicking and selling stocks in November, we stuck to the facts. Most people know the problems and fear permeating the economy. What they don't know, is when the market has been this pessimistic, cheap, and insiders were loading up on their own stocks, market performance has been outstanding.

YEAR-ENDER STRATEGY

In 1971, my father was working as Director of Research at I.M. Simon & Co. On a December afternoon, he received a call from a client who wanted to dump a stock for tax purposes because it had declined significantly. The client's reasoning made sense. Since he had to pay taxes on his realized stock gains, he wanted to sell his losers to offset the gains and minimize taxes.

Before executing the order, my father researched the stock and came to the conclusion that the stock was a buy, not a sell. The company had a good business and was selling at a deep discount to tangible book value.

After informing the client of his research, the client's response was enlightening. The client knew the company was trading at a rock bottom price and had the potential to snap back, but he wanted to sell it anyway. Since the loss on the stock was so severe, the tax benefit outweighed that of a potential rebound.

It was during this encounter that my dad discovered the year-end tax loss selling effect. <u>Thousands of investors sell companies at bargain basement prices at year end to harvest the tax loss, further depressing the prices of beaten down stocks.</u>

Since my father's original discovery, this effect has been widely written about and dubbed the "January Effect." It is now well documented that smaller companies which experienced significant price declines rebounded in January to earn abnormally high returns.

The Stock Traders Almanac published an analysis showing that Year-Ender's have recorded an outstanding average return of 13% compared to just 3.4% for the New York Stock Exchange (NYSE) in just two months (See Chart).

Year Enders* vs. The Market
Dec 15-Feb 15 (1974-2008)

34-Yr Avg 2-Month Return		
YearEnders*	**NYSE**	**Difference**
13.0%	3.4%	9.6%

*Stocks at 52-wk low on Fri before Christmas

Source: Stock Traders Almanac 2009

We have worked hard over many years to improve further on this year-end buying strategy, including developing screens to put stocks with the highest probably of outperforming on our radar screen. These include stocks that are not only down significantly, but have strong balance sheets, trade at low valuations, and have fallen even further in December. Since 1987, such companies have earned more than 7% on average in January alone vs. 2.5% for the overall market.

This year, we were particularly excited about our year-end buying because it coincided with our bullish view of the market in November and December.

Our next step is the hardest aspect of our year-end strategy: knowing when to sell. While we typically hold investments for more than a year, our year-ender buys are often held for a much shorter period of time. Late December and January are by far our most active months in terms of trading as we take advantage of the year-end strategy and position portfolios for the new year. We are excited for 2009 and so far, our year-enders are off to a great start.

Here are some examples of Year-Ender stocks we bought with a brief summary and analysis. Prices as of 12/31/08.

Huntsman (Ticker: HUN) $3.44

Huntsman makes chemicals used in thousands of products. Huntsman went public in 2005 at $23 per share. In June 2007, HUN accepted a buyout offer for $28 from Apollo private equity group. Amidst the financial turmoil and lower earnings estimates for HUN, Apollo wanted out of the deal. On 12/15/08, HUN agreed to let Apollo out of the deal in exchange for a $1 billion cash settlement. HUN shares plunged to $3.00 a share on the news. I believe investors are overreacting and probably taking a tax loss. The $1 billion settlement equates to $4 a share in cash for HUN. Now HUN is back on its own with its previous $6 tangible book value plus a fresh $4 a share in cash. I believe that Huntsman is worth a premium to its new tangible book value of $10. Insiders, including Peter Huntsman, apparently agree and have acquired more than $5 million of stock for their personal accounts in the last two weeks.

Abercrombie & Fitch (Ticker: ANF) $23.07

Abercrombie is a leading teen retailer of casual clothing including jeans, polos, and sweaters. Abercrombie is a high-end, reputable brand and has achieved a Return on Equity (ROE) in excess of 20% for more than 10 years. Despite its successful earnings record and having no debt, economic fears have driven ANF shares down from a recent high of $84 to under $15. ANF has a tangible book value around $21 and is projected to earn $2.13 in 2009. Abercrombie deserves to trade at a significant premium to book value given its brand and earning power.

USG (Ticker: USG) $8.04

USG Corporation makes building materials and is a market share leader selling gypsum wallboard. Gypsum products are used to finish interior walls, ceilings, and floors in residential, commercial, and institutional construction. USG stock has experienced a dramatic decline from a high of $121 a share to just $11 due to the housing slowdown. With its dominant market position, successful track record, an estimated $4 a share in earning power, we think USG shares are worth a significant premium to its $17 tangible book value. Warren Buffet, a major shareholder of USG, recently loaned them $300m in the form of convertible 10% bonds, a sign that USG has access to capital if they need it and that the oracle of Omaha still has confidence in USG Corp.