EXPLOITING INVESTMENT ANOMALIES

ALAN T. BEIMFOHR serves as President and a Portfolio Manager at Knightsbridge Asset Management, LLC. Prior to co-founding Knightsbridge in 1998, he co-founded Canterbury Capital Services, Inc. in 1988 serving as President and Chief Executive Officer until 1998 at which time the Knightsbridge Division was spun-off from Canterbury. Prior to that he was Vice President of Kidder, Peabody & Co., Inc. where he worked for seventeen years. He received his B.S. in Operations Research and Industrial Engineering from Cornell University, Ithaca, New York, in 1966. Mr. Beimfohr is a former President of the Cornell Alumni Association of Southern California and currently serves on the board of the Philharmonic Society of Orange County.

(ZBG502) TWST: Would you tell us about Knightsbridge Asset Management, LLC, and your responsibilities there?

Mr. Beimfohr: I’m the Chief Investment Officer and co-Founder along with John Prichard, CFA, as well as the President and CEO. Since I’m in my 60s, one of these years I’ll be turning the reins over to John, with whom I’ve worked for the past 12 years.

We are a registered investment adviser with just one office here in Newport Beach. We’re employee-owned with eight employees averaging 20 years’ experience each, managing $274 million as of the end of September 2005 and $285 million most recently.

TWST: What is the Fund’s investment philosophy?

Mr. Beimfohr: Our investment philosophy is that we believe, to successfully generate alpha, we have to be opportunistic. We choose to pursue what we define as market inefficiencies and we are very contrarian in our thinking. We’re not driven by index characterizations or sector weightings or market capitalization, per se. Our hallmark is that we believe in exploiting certain investment occurrences — we call them “anomalies” — identifiable events we believe enhance the probability we will generate outperformance. So the trick is whether one can actually find enough of these anomalies to assemble a portfolio of 15 to 20 stocks or so. We currently run a 20 stock portfolio.

We are all about studying anomalies from a statistical standpoint. We hypothesize as to what an anomaly might be, and then we go about searching for prior academic work that might shed light. Sometimes we will redo the study with a change in underlying assumptions. And sometimes we find out that there is nothing: that it was a figment of our ever-active imagination that we thought something existed.

Typically, we’re looking for these exploitable anomalies, of which a spinoff would be an example, where the persistence of outperformance is going to last for a two- to three-year time frame. Maybe even more, maybe even four years, but let’s just home in on three years. If a stock gets booted out of the S&P 500, maybe there’s an anomaly there that lasts for a few days or weeks or something. We’re not going to be interested in that anomaly because we’re looking for something that’s going to persist for a longer period of time. So that’s how we go about it.
We look at dividend eliminations and dividend reductions. We look at spinoffs, which I mentioned. We look at currency devaluations and what that might be doing to a local equity market. We look at terminated acquisition targets; we look at bankruptcy emergence; we look at concentrations of insider buying. Sometimes we look at closed-end funds that may be trading at extreme discounts, say 20% or more; sometimes we look at fixed price fungible rights offerings as indicia of depressed equity valuations.

Now most of the things that I just mentioned have negative associations for the majority of investors. We want something that is perceived negatively by the majority of investors because that’s where we believe opportunity will lie. We believe that if we can get the timing down, which in most cases means not being early, that we will have wrung out a great deal of the risk. But, as I am fond of saying, there are infinite opportunities to lose 50% on the way to zero! And we think that we can diversify by aggregating a number of stocks that are exhibiting some of those anomalistic conditions and thus be diversifying away from some of the risk that might come from just one stock or anomaly category.

So we do studies here internally. We look at academic studies, and we do our own which we never publish. We have three CFAs here, we have one PhD in Engineering Physics, and this is what we’re all about. And so let’s say we identify a spinoff. Where do we go from there? Well, the first thing we do is we want to convince ourselves that the debt structure of the company is acceptable to us. Now there have been spinoffs where we had taken a pass on them because we didn’t feel confident that the company was going to be capable of paying down debt principal. As long as economic times are good they may be able to service the debt. However, we actually would like to see an ability to pay debt down. In the case of the Novelis spinoff from Alcan, we passed because we were just not able to convince ourselves that the debt could be meaningfully paid down from cash flows. The idea has to be that if you lever up a company, then with debt pay-down you substitute what had been debt with equity. And added to some earnings growth, that’s a way one can generate superior returns under such a scenario.

So we don’t necessarily buy them indiscriminately, although research shows that even indiscriminate purchase of spinoffs is actually a pretty good idea, and a lot of the academic work shows that you may actually be able to achieve 1,000 basis points above and beyond the S&P in so doing. However, in the current environment, the number of spinoffs has decreased from what it had been in the late 1990s, probably primarily because companies are able to sell unwanted orphan divisions to private equity capital for very generous prices in the current environment. So that gets into the equation. But, of course, there are still powerful reasons that are tax motivated as to why a company might choose the spinoff route as opposed to selling the orphan division outright, mostly having to do with whatever their basis in the business entity is and the necessity of paying taxes versus a spinoff, where the shareholders are getting the equity and there are no taxes paid.

So we have used lots of spinoffs, we’ve used lots of dividend eliminations/reductions in our portfolio construction.

Since inception through December 31 of last year, we have, gross of fees, averaged 17.8% versus 10.7% for the S&P 500; that’s a 13-year period from January 1, 1992, through December 31, 2004.

To give you some recent numbers, again, gross of fees, we were up 9.4% through September 30. We were up 29.1% in 2004.

We use Callan Associates, Inc., to analyze our work, and they have us against their entire Domestic Equity database of managers, which is just a shade under 2,000 managers, in the 18th percentile for the 10-year period through 9/30/05 with a return of 14.9%. So we think that speaks well for us in terms of lending credence to our approach.

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Domestic Equity database, we’re at 1.3 price to sales versus the rest of the world at 1.5. We’re at 1.5 times price to book while the rest of the world is 2.7 times book. We’re 9.4 in terms of the multiple of cash flow versus 11.1 for, again, the Callan Total Domestic Equity database. So we come out looking like a value manager in the aggregate, but some of that is because any company that eliminates a dividend is, in all likelihood, going to end up looking like a deep value stock. Any company that is a spinoff entity that starts out a new life separate from the parent probably was a slower growing division in a non-core business, where the investment bankers came in and told them that the way to boost your earnings growth is to jettison this division over here. Many of them are failed acquisitions. And the evidence suggests that it works because not only does the spinoff end up outperforming the indices, the parent company also ends up outperforming the indices. Not by as much as the spinoff, but still by a measurable amount. So the investment bankers are out there drumming up business for themselves telling managements how they can increase their earnings growth rate and, therefore, make their stock options more valuable.

We own nine spinoffs actually in our 20-stock portfolio. Hospira (HSP) is one that has been very good to us. It was a spinoff from Abbott Labs (ABT) last year. They make injectable medications and hospital delivery systems of largely injectable drugs. Neenah Paper (NP) is a spinoff from Kimberly-Clark (KMB). It has not done particularly well. We’re thinking that if they close down and get out of the pulp business, the losses that are shielding their profitable fine paper business will no longer be there and the bottom line has a pretty good chance of doubling with some time. It’s too soon yet to know whether or not that’s working out.

We own Piper Jaffray (PJC); it was a spinoff from U.S. Bancorp (USB). It went up pretty much immediately when it was spun off, and we said we didn’t want to pay those prices. And then the stock came tumbling down, and we bought it at that point. Then after we bought it, it tumbled down some more. However, it is back up above $40 now, and we paid prices in the $30s. So those are some recent examples.

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Spinoffs also have the advantage of being under liquidation in the first couple of months because, typically, there’s a rotation of investors who own the parent company thinking that they want an exposure in a certain industry or a certain sector, and now this spinoff entity is a different animal, and so it gets sold off for those reasons. It also gets liquidated many times by index funds that are required to liquidate the spinoff piece because the spinoff is not going to be in the S&P 500.

TWST: Would you give us some examples of a spinoff that you have invested in and that’s done well?

Mr. Beimfohr: There are no shortages really. One that we are in at the moment is Ameriprise (AMP), which was bought relatively recently and is a spinoff from American Express (AXP). Ameriprise is a brokerage firm with an insurance sales emphasis to it. Roots were the old Investors Diversified out of Minneapolis, and Ameriprise is a fairly large entity. We paid prices between $32-$33; it’s now trading somewhere around $43. We just bought that here about two months ago.

When people ask me for a story, I like to tell them about an old one that we are long out of, which was Earthgrains. The reason I like to tell this story is that it’s kind of representative of how management thinking changes through time. There used to be a company on the New York Stock Exchange and if you’ve been in this business as long as I have, you’ll remember this one called Campbell Taggart. And Campbell Taggart was a bread-baking company basically when they were bought by Anheuser-Busch (BUD). Why? Because Anheuser-Busch thought that beer was a slow unit growth business, and their ability to accumulate cash was in excess of the beer business’s ability to grow and cap ex needs. And so they decided, well, we know about yeast, we know about that sort of thing because we use that in beer, so bread baking, that’s kind of the same thing, right? Campbell Taggart disappeared into Anheuser-Busch in 1982. But by 1996 they decided, “You know, this bread business is just a terrible business; it’s extremely competitive; wheat prices are through the roof; best case, we’re probably the number three factor in that business in the United States. Let’s get rid of this thing; it’s a non-main-
stream business. We need to focus on beer. Back to basics.” So they
spun off this bread baking business as Earthgrains. Now, if you’re a
shareholder of Anheuser-Busch, you think you own a beer company,
and you probably bought it because you had some idea that maybe it
was a growth stock, maybe you liked the idea that it was in the beer
business, which maybe is a defensive idea along with newspapers,
cigarettes and drugs or something. But you certainly don’t own it be-
cause you think they’re in the bread business. So it was spun off as
Earthgrains at that time around $17 a share. We bought it in 1996 and
ended up selling part of it in the mid-$30s, and part of it as high as
maybe $51 a share, and then we scaled out of it.

They may also be cheap because the executives are often
getting new stock options pegged at whatever that trading price is in
that early time frame, and they don’t particularly have any incentive
to want to have a high price as opposed to a low price. So there’s
going to be, number one, a paucity of news possibly, and certainly a
dearth of good news.

Another factor is that, typically, they don’t establish a div-
idend-paying policy until a little bit later on, and so people who are
required to own dividend-paying stocks, they don’t know whether to
buy it or not, or consider it for purchase because it hasn’t been es-
tablished that there’s going to be a dividend paid.

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But think about the shareholder constituency of Earth-
grains. This thing was spun off, if I’m remembering right, one share
for every 25 shares of Anheuser-Busch. And Anheuser-Busch was
a $50 stock. So for 100 shares of Anheuser-Busch, $5,000, you got
four shares of Earthgrains worth $17. So you’d get $68 worth of
Earthgrains from this $5,000 position in Anheuser-Busch. What are
you going to do with this thing? Well, you are probably going to call
your broker and say, “Get rid of that thing. I don’t want it cluttering
up my statement, it’s annoying me.” Most people construct portfolios
with certain position sizes, and in the institutional world, it’s cer-
tainly true that if you’re going to take on a position, it’s going to be
a certain size. The idea that you have to add 90% or, in this case,
maybe even 99% to the position to bring it up to parity with An-
heuser-Busch, that’s just ridiculous and you’re not going to do that.
The first thing that has to happen institutionally is that they’ve prob-
ably got to have a new analyst covering Earthgrains as opposed to the
analyst who was covering Anheuser-Busch. So there are all kinds of
things that have to happen. The shareholder constituency has to ro-
tate to people who want to own a bread-baking company and want to
own a lot of it, not just some trivial amount that they got by accident.
And the information available at birth is scarce and risk tolerant in-
vestors are required. So that’s why these things tend to be cheap
when they are spun off. Statistically, they tend to drop about 8% from
the when-issued trading prices over a period of a couple of months.
But they’re cheap for that reason.

So there are just a whole host of reasons why, as a universe,
those things tend to start out cheap. It doesn’t say that they all go up,
but a great number of them go up. The positive alpha is pretty dra-
natic in the first couple of years, and it’s still strong in the third year,
but starting to taper off. And by the fourth year, it’s gone away; by
the fourth year you’re statistically into market performance.

So we look at the world in statistical terms, probabilistic
terms, if you will, and some of that comes from my formal education.
But it’s also how we feel we can add value, how we can bring something to the party. Because, what are we going to do? Sit here and pretend that we are going to be analysts who are going to figure out that a company’s earnings are going to be $0.03 more than all the rest of the analysts think, or a nickel less? Or that we’re going to be the cowboys that get their gun out of the holster faster than others? We view that as a loser’s game. And those are not the games that we play; we’re not really so much concerned about earnings in the first year that we own a company, actually. What we do is we prognosticate cash flow four years out, and then we work back down to a probable earnings number, actually a distribution, from what we think a normalized cash flow would be extrapolated out four years. And from that earnings number, we come up with what we think would be a rational price for the stock in the third year, assuming the trading price that year is predicated on the earnings one year out. And if we can’t convince ourselves that there’s the possibility of a 100% return in a three-year period of time, we are probably not going to buy the stock.

And of course, we’re not always right among the ones that we buy. It’s not written in stone, of course, that they all have to go up 100% in three years.

TWST: What are some examples of your stocks that are not spinoffs?

Mr. Beimfohr: We bought PG&E Corp. (PCG). Now, let me first say, of course, that they went into bankruptcy. However, we waited until we could see the form of the bankruptcy emergence before we bought it. Now that was a dividend elimination. And I’ve been in companies that have eliminated dividends way back in history: General Public Utilities (I bought it in 1984, five years after Three Mile Island at $7 and it went eventually to $70 split adjusted), and Consolidated Edison (ED), going back to 1974. Pinnacle West (PNW), the old Arizona Public Service, was a great one when they got into trouble with the Palo Verde nuclear facility. If you have a utility stock that is largely owned by widows and orphans for purposes of garnering the dividend, and that company says, “Guess what, folks? We’re not going to pay the dividend anymore,” what do you think those people are going to do? They are going to sell. And the question is, how long is that selling going to persist, and at what point is the selling saturated at its trough? Typically, that occurs at the end of the year. You get immediate selling upon the announcement of the dividend elimination, and then you get further selling depending on when that announcement was made during the calendar year, in November and December for tax loss purposes.

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where they’ve got some other large gains that they’ve harvested, and they go looking for things that they can sell off that represent losses to offset it. So you get a second round of tax loss selling, but not as pronounced as in that first year. But as long as you are willing to wait past that tax loss selling period, you will then be in a position statistically where good things are going to happen.

Now, in the case of PG&E, we thought all along that the assets were going to be worth $30-$40 a share. We bought the stock at $13. We bought that early in 2003; it might have been something like February 2003. We are very close to selling it; we haven’t sold it yet, but we’re very close to selling it. And we just recently started not buying it for new accounts. The stock was trading at $37.14 at yesterday’s close.

The stock went down to, again — going from memory here — $6 a share. So we were not brave enough to buy it at $6 a share because we wanted to wait and see what form the bankruptcy emergence would take. You may remember that they thought they had meritorious legal defenses ring-fencing a particular part of PG&E, and that was really one of the key issues. So once we felt that we could see the outline of the emergence, we bought it in the belief that they would trade like a normal utility eventually.

Corning (GLW) was another one that we bought that was an example of a dividend elimination. And Corning’s revenue dropped a tremendous amount between 2000 and 2003 as demand for fiber-optic cable dried up... But when we started to see heavy insider buying in Corning, we thought we have to be in on this one. We bought it around $6 a share, and we still own it.

One that came out of the South Korean won currency devaluation was SK Telecom (SKM), which is a cell phone company, probably the second-most advanced cell phone company behind NTT DoCoMo (DCM) in Japan. And SK Telecom we bought for the twin reasons that there had been a currency devaluation in South Korea, and then there was a rights offering. So we bought this stock

Mattel at $9.75 and we thought it was worth $20, and when it went to $19.50, we sold half our position. We waited a little while longer with the balance of it, and we sold the balance of it at $21.25 or something like that.

Unlike buying, theoretically in selling, time is on your side in that the asset is, presumably, going up with the passage of time. Now you get into the calculus of, is it going up fast enough to be helping your performance or is it actually hindering your performance even though it’s still going up? There are all those kinds of considerations. But you never really know how popular something can get. We have had a couple of peculiar situations in the past where things really went crazy on the upside.
somewhere around $11 a share. Within six months, by December, the stock had gone to $35 a share. It had gone from $11 to $35 in five months! And we sold it out of tax-exempt accounts.

And then we hesitated a little bit in January and ended up selling it in taxable accounts in February at $51 a share. So this stock between August and February went from $11 to $51! And then we sold some more after because we were scaling out of it. We didn’t sell it all at $50, we sold a third of it at $50. And we sold another third at $41 on the way down. And then we suffered with the remaining third, and it went down, and it went down, and it went down, and it ultimately went down to $13. We ended up selling the last third at a price of $21 because from $13 it rallied back to the low $20s. So that one was one of the wildest, craziest things that I’ve ever witnessed in my career.

TWST: What would you say are the differentiators that distinguish your particular investment approach from that of other companies?

Mr. Beimfohr: I think that we have an advantage in being small, and we are taking advantage of that. We don’t want to play the same game as the people who are managing $20 and $50 billion portfolios. And I think that’s key. It’s not that what we’re doing is top-secret crypto; that’s not the case. There have been excellent books by Seth Klarman, David Dreman, Bob Hagin and Jim O’Shaughnessy for example, and I should mention Peter Bernstein on behavioral finance. This has all been written about. But there are very few people out there who are trying to assemble a portfolio of this kind of stuff. I could tell you a couple of others who are very close to doing the same sort of thing, but I’m not going to mention their names here in print.

It’s a small universe. Our life has been made a little more difficult by hedge funds because the hedge fund people are all out there looking at the same trades. And when you’ve got a trillion dollars in hedge funds and you’ve got a couple of hundred billion looking for the same kinds of things that you’re looking for, that’s a lot of money sloshing around. So we have to be very willing to pass on something that isn’t compelling. Ideally, we would like to buy a stock that’s undervalued relative to its peers in the industry, and then we’d like the industry to be undervalued, ideally, relative to the S&P 500. And then we’d have mean reversion potential not only from the stock relative to its group, but also from the group relative to the market averages. That’s the best of all worlds.

And then the third wonderful thing that can happen to you is that you can buy it as a value stock and sell it as a growth stock! Corning looks like that’s the case. I think at the time that we bought it, if you had asked people, “Is Corning a growth stock or a value stock,” well, I think they would probably have called it a value stock at that point. But I’m quite sure that now it would be considered a growth stock. So that’s the best of all worlds. It doesn’t happen every day, but ideally, life would be truly wonderful if it did.

But we’re trying to operate in an arena where we can add value with what we do. This is a very tough, competitive business, and every investor has lots of options, and so we take our self-imposed mandate very seriously.

Our roots are that we managed money for individuals. We do have some modest institutional business at this point, but we just take our mission seriously and this is the way we can add value, we think. At least, we’ve been able to do it for 14 years.

TWST: Thank you.

Note: Opinions and recommendations are as of 12/14/05.

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