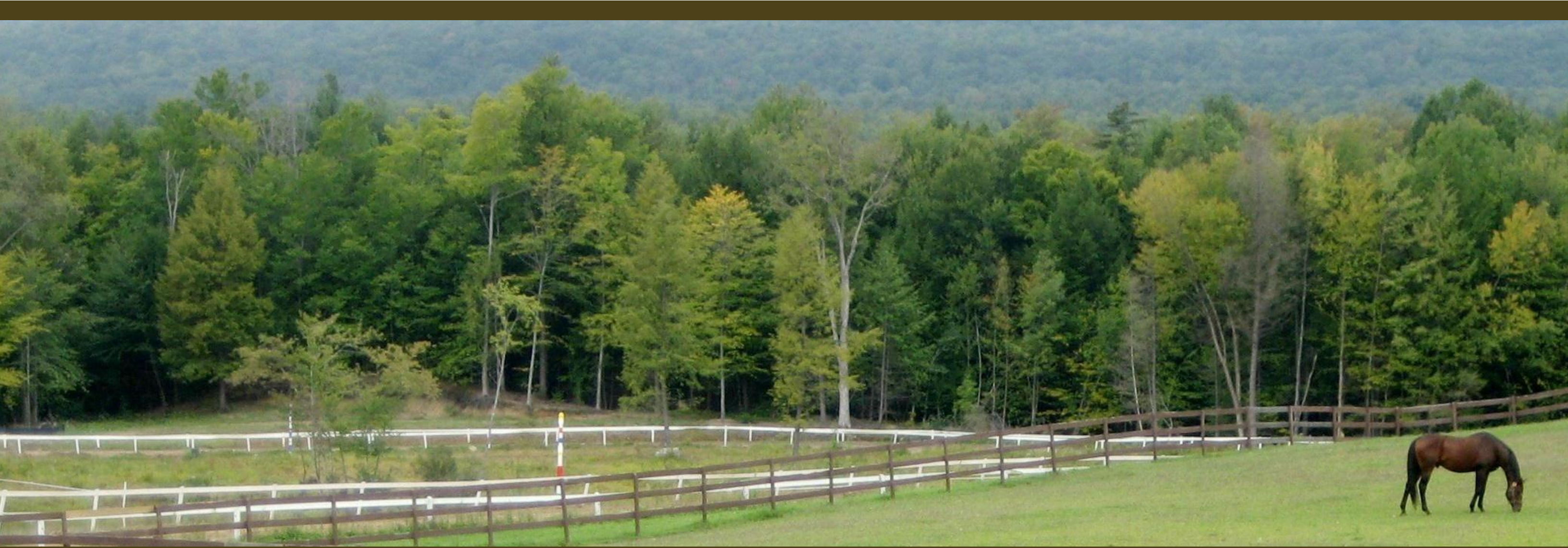
SIRE LINE
Capital Management



The Sire Line Capital Way

Spring 2011

Value Investing

At Sire Line Capital, we are value investors. Value investing, which is a set of principles that form a philosophy of sound investing, involves identifying a company's underlying economic value and investing only when its stock price is trading at a significant discount to this underlying value. Other investment strategies also claim to "buy low and sell high." However, what makes the value philosophy stand apart from the rest is that it segregates information affecting valuation into distinct categories and only uses that information which is most tangible and reliable to calculate a company's true economic worth.

The first seeds of value investing were planted by Benjamin Graham and David Dodd in the early-1930s in their book titled *Security Analysis.* From 1928 to 1955, Graham taught an investment course, which was based on the principles of value investing, at Columbia Business School. Warren Buffett, the most recognized value investor today, was a student of Graham's at Columbia, where he graduated in 1951. Over the next fifty to sixty years, Buffett took the lessons that he had learned from Graham, which were mostly quantitative in nature, and blended them with more qualitative lessons from other important influences—mostly Philip Fisher and Charlie Munger—to create a more modern version of value investing than the one Graham and Dodd taught. In the early-1990s, Bruce Greenwald revitalized the investment management program at Columbia Business School, picking up where Graham (and his successor, Roger F. Murray) left off, by reintroducing value investing into the curriculum and incorporating Buffett's modern version into his lectures. Sire Line Capital's founder, Daren Taylor, was a student in Greenwald's value investing program at Columbia Business School, where he received his M.B.A. in 2003.

The following are the core set of value-based principles that Sire Line Capital follows to protect and grow our clients' assets:

1. Focus on underlying economic values, not stock prices
2. Make sure there is a significant margin of safety in every investment
3. Focus on your best ideas
4. Stay within your circle of competence
5. Never speculate, invest
6. Buy high-quality businesses at rational prices for the long term

Let's explore each one in greater detail.

1. Focus on underlying economic values, not stock prices

Philip Fisher, a great teacher and investor, appropriately said, "The stock market is filled with individuals who know the price of everything, but the value of nothing." Being able to

understand the concept that price is what you pay and value is what you get is critical to successful investing. A company's underlying economic value is distinct from its quoted market price. The quoted price of a company's stock can be found daily on a stock exchange or in a newspaper. The underlying economic value of a company, however, is not so easily found. It must be calculated. The true value of a company is determined by the net cash flows expected to occur over the life of the business discounted at an appropriate interest rate. At times, a company's stock price and its underlying intrinsic value are in agreement. However, most of the time they are not, as stock prices experience much more volatility than underlying economic values. Investors need to realize that a decline in a company's stock price does not always equate to a decline in its economic value. Fear and greed in the stock market push and pull stock prices in the short term. Assets and earnings drive economic value over the long term.

When calculating a company's underlying economic value, we focus on that information which is more tangible and dependable—the balance sheet and current cash earnings power—rather than that which is less reliable—uncertain future growth. Digging into a company's financial reports takes time and energy. Since the average mutual fund holds well over 100 stocks and has an investment universe running in the thousands, most professional money managers try to simplify the valuation process by relying on a multiple-based valuation approach. The most commonly used multiple-based approach is the price-to-earnings (P/E) ratio. We believe that the widespread use of the P/E ratio as a primary valuation measurement is one reason why most professional money managers and individuals underperform the broad market over the long term. Why is this? Simply put, P/E ratios do not reflect a company's balance sheet, which is often the most important source of value for a business.

To give you an example let's assume that there are three identical companies—Company A, Company B and Company C—all having a total enterprise value (equity plus net debt) of $100 million. We focus on a company's enterprise value rather than just its equity value because we believe that there is no fundamental difference between buying a company outright and buying shares in a company. If we were to buy a company outright, we would not only be buying the company's equity, but the company's debt and cash as well. The same is true when only buying part of a company. Let's assume that Company A, Company B and Company C are identical in every way, except that each carries a different level of debt financing. Company A has no debt, Company B has $25 million of debt and Company C has $50 million of debt. All else being equal, which company should have a higher P/E ratio? As you can see in the chart below, the company with the least amount of debt should have a higher P/E ratio.

P/E Multiples and Debt Financing

		Company		
	(in millions, except per share)	A	B	C
	Enterprise value (EV)	100	100	100
-	Debt	0	25	50
+	Cash	10	10	10
=	Equity Value	110	85	60
/	Shares outstanding	10	10	10
=	Equity value per share (P)	11.00	8.50	6.00
/	Earnings per share (E)	0.50	0.50	0.50
=	P/E	22x	17x	12x

At Sire Line Capital, we never forget that when we invest in a company we are partnering with a management team and we are buying a balance sheet. Investors that use P/E ratios as a shortcut to valuation rarely make the necessary adjustments to include important items that are found on the balance sheet. When they do this they are mixing bad information with good information, which always leads to bad decision-making.

Another problem with relying on P/E ratios is that the calculation of the earnings number in the denominator is based on a less than perfect accounting system known as GAAP. Generally Accepted Accounting Principles (GAAP) are the widely accepted set of accounting rules, standards and procedures that companies use for reporting financial information. GAAP reporting is required by companies so that investors have some consistency in the financial statements they use when analyzing companies for investment purposes. However, these generally accepted rules for accounting have grown so complex over the years that their utilization is plagued with opportunities for misuse by both companies and investors. Because GAAP is subject to a great deal of variation, imprecision and possible manipulation, it should not form the basis for investment valuation. Yet, most professional money managers and individuals rely on GAAP earnings to make investment decisions every day. We prefer to use free cash flow, rather than reported GAAP earnings, to value a business. Free cash flow tells us how much cash we could theoretically take out of the company, after all capital expenditures are made to maintain the assets of the business, if we owned the entire company. Cash doesn't lie.

2. Make sure there is a significant margin of safety in every investment

In the financial world, risk is commonly measured by the term beta, which is defined as relative price volatility. We

believe a better definition of risk is the possibility of permanent capital loss. Ben Graham taught that the best way to minimize risk is to invest only when there is a significant margin of safety between the price being paid and the underlying economic value being received. Sire Line Capital will only invest in a business if we can buy its stock at a significant discount to its true economic value.

3. Focus on your best ideas

According to Morningstar, Inc., an investment research company, the average mutual fund holds well over 100 stocks in its portfolio. However, studies have shown that most of the risk-reduction benefits that diversification provides can be obtained by holding as few as fifteen securities across a range of industries and geographies. If this is true, why then do so many seemingly intelligent, professional money managers hold so many positions for their clients? We believe that most money managers are focused more on managing career risk (keeping their job) than managing portfolio risk (protecting and growing their clients' assets). If you are a money manager and you basically own the entire market in your investment portfolios, your performance will never be that different than the average, and you are less likely to stand out from your peers in a negative light. (It is always safer inside the herd than outside the herd.) We believe this is yet another reason why two-thirds of all mutual fund managers fail to beat their benchmark over the long term. After management fees and transaction costs are taken into consideration, a mutual fund that holds the entire market has little chance of outperforming the market.

The truth of the matter is that most investors over-diversify. As Warren Buffett said, "Wide diversification is only required when investors do not understand what they are doing." We believe that it is impossible for us to produce superior performance for our clients unless we do something different from the majority. Rather than count the number of stocks in a portfolio, we believe the price you pay relative to the value you receive more appropriately determines how much risk you are taking on.

It is extremely difficult to find 100 great investment opportunities. We have a hard enough time trying to find 30 stocks that are attractive to us at any given moment. Why would we want to put money into our 100th best idea when we can put it in our 20th or 10th best?

We also want to be very familiar with the businesses that we invest in. If we had over 100 stocks in our portfolio, we could never really get to know any of them very well. In addition, we want to allow our most attractive investment ideas to have a meaningful impact on our long-term performance. If the average mutual fund holds over 100 stocks, that would imply that the size of most holdings is less than 1% of the value of the total portfolio. A 1% position in a portfolio makes no sense to us. The underlying stock of a 1% position would have to double in price for the position to have only a 1% impact on the portfolio's total performance. At Sire Line Capital, our portfolios will typically have between 15 and 30 names at any given time.

4. Stay within your circle of competence

At Sire Line Capital, we keep things simple. We stay within our circle of competence, which means allocating our resources only to those businesses that we truly understand. The downside to doing this is that our investment universe is limited relative to the "go-anywhere" investor. The upside is that we are able to sleep very well at night knowing that our clients' assets are invested in high-quality businesses that we understand extremely well and feel comfortable owning for a very long time. If a business is subject to constant change, we will not attempt to guess its value. We stick to what we know. We stick to what is more predictable.

5. Never speculate, invest

The holding period for the average mutual fund is less than two years, and the average holding period for a stock on the New York Stock Exchange is only six months. When individuals and professionals buy stocks and hold them for such short periods of time, they are merely speculating on short-term price movements, which has absolutely nothing to do with investing. Investing requires taking a long-term view on the true worth of a company. Ben Graham was right when he said, "The value of an investment is not what it will earn this month or next, nor what this quarter's sales volumes will be, but what that investment can expect to return to an investor over a long period of time." Following this sage advice, we buy small pieces of outstanding businesses for long-term investment, not pieces of paper for short-term speculation.

6. Buy high-quality businesses at rational prices for the long term

It is only by purchasing high-quality businesses at attractive prices and holding them for a long period of time that an investor can receive the full benefits of compounding. The power of compounding is probably the least understood and least used weapon in the investor's arsenal. Simply put, compounding is the process of generating earnings on reinvested earnings. To harness its full power, three primary factors are needed: A predictable base level of earnings, an

adequate reinvestment rate and time. The following example will help us to explain how a long-term investment strategy, which receives the full benefits of compounding, is superior to a short-term investment strategy.

Suppose there are two investors—Investor #1 and Investor #2—with different investing strategies, each having $1 million to invest. Investor #1 is more of a short-term speculator whose average holding period is less than a year. Investor #2 is a long-term investor that prefers to invest in high-quality businesses that he can hold for ten years without selling. If they are each able to find investment opportunities that generate average annual pre-tax returns of 15%, how much money will each investor have at the end of ten years after factoring in taxes (for now we will assume no transaction costs)? As you can see in the chart below, after ten years the long-term investor has over $3.4 million while the short-term trader has only $2.5 million—an outperformance of over $900,000.

The Power of Compounding

Ending Balance in Year	Investor #1 Short Term	Investor #2 Long Term
0	$1,000,000	$1,000,000
1	$1,097,500	$1,150,000
2	$1,204,506	$1,322,500
3	$1,321,946	$1,520,875
4	$1,450,835	$1,749,006
5	$1,592,292	$2,011,357
6	$1,747,540	$2,313,061
7	$1,917,925	$2,660,020
8	$2,104,923	$3,059,023
9	$2,310,153	$3,517,876
10	$2,535,393	$4,045,558
Total profits, gross*	$2,362,143	$3,045,558
Total taxes paid**	$826,750	$609,112
Total profits, net	$1,535,393	$2,436,446
Ending value, net	$2,535,393	$3,436,446
Outperformance		$901,053

**Assuming average annual pretax returns of 15%.*
***Tax rate used: long-term=20%; short-term=35%*

This is made possible because of the power of compounding. The long-tem investor beats the short-tem investor in two important categories: capital gains and taxes paid. The long-term investor has a higher account balance than the short-term investor at the end of each year even though they are generating the same 15% pre-tax return. The reason for this is that Investor #2 is not giving 35% of his annual pre-tax gains to the government at the end of each year like Investor #1 is forced to do. Rather, Investor #2 is allowing 100% of his annual gains to be reinvested to earn additional interest until he finally decides to sell in year ten. This allows the long-term investor to generate roughly $700,000 more in pre-tax gains than the short-term investor.

What about taxes paid to the government? In year ten when the long-term investor finally does sell, he is only taxed at a 20% long-term tax rate (vs. the 35% short-term tax rate for Investor #1). This means that the long-term investor pays approximately $200,000 less to the government than the short-term investor.

To take this example one step further, the short-term investor would actually need to generate an average annual pre-tax return of 20.2%—5.2 percentage points above the long-term investor—just to match the after-tax performance of the long-term investor over ten years. And we have not even mentioned trading costs, which would no doubt be higher for a short-term strategy that buys and sells stocks every year. Said another way, the short-term investor constantly needs to work harder just to keep up with the long-term investor. This is the power of compounding.

Protecting and growing our clients' assets by using a proven investment philosophy that focuses on buying high-quality businesses at rational prices, and having a long time horizon to allow the power of compounding to work in our favor. This is the Sire Line Capital way.

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