FATALPHA
VALUE INVESTING

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By
Sophocles
Sophocleous, CFA

INSIDE CURRENT ISSUE

"Garbage In, Garbage Out"

"On two occasions I have been asked, "Pray, Mr. Babbage, if you put into the machine wrong figures, will the right answers come out?" ... I am not able rightly to apprehend the kind of confusion of ideas that could provoke such a question."

- Charles Babbage, Passages from the Life of a Philosopher

"Somebody reminded me the other night that I once said "greed is good." Now it seems it's legal. Because everyone is drinking the same Kool-Aid."

- Gordon Gekko, Wall Street Never Sleeps

"To big to perform."

- Sophocles Sophocleous

The portfolio closed the month on par with the S&P 500 at 5.49%. The biggest gainers were TRN (27%), VLO (17%), and VOYA (13%) while GTS (-22%) was the largest loser following a disappointing earnings announcement.

I spent several hours this month looking through various Bloomberg data, as it is can be disappointingly inaccurate. Absolutely shocking. At one point I started questioning my sanity. My favourite error was the number of shares of Anthem (ex-Wellpoint). Anthem being one of my largest holdings during the 2014 was familiar to me and when Bloomberg data showed that shares outstanding were 293m and not 270m I knew something was wrong. I went through the filings and then after two hours with the Bloomberg help desk… they escalated the problem.

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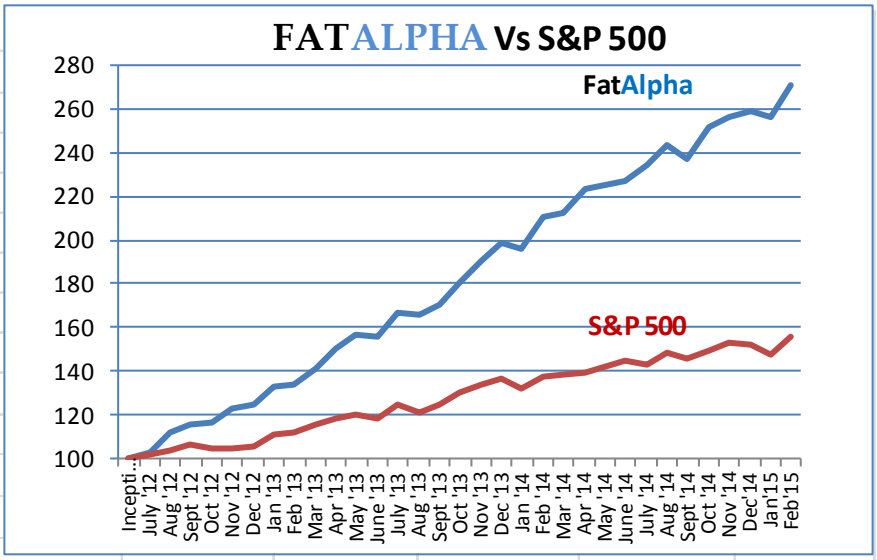
Performance

MONTHLY PERFORMANCE								
Yr/Mo	2015		2014		2013		2012	
	FatAlpha	S&P 500	FatAlpha	S&P 500	FatAlpha	S&P 500	FatAlpha	S&P 500
January	**-0.83%**	-3.10%	**-1.76%**	-3.56%	**6.45%**	5.04%		
February	**5.49%**	5.49%	**7.64%**	4.31%	**0.71%**	1.11%		
March			**0.91%**	0.69%	**5.35%**	3.60%		
April			**5.08%**	0.62%	**6.47%**	1.81%		
May			**0.97%**	2.10%	**4.19%**	2.08%		
June			**0.83%**	1.91%	**-0.73%**	-1.50%		
July			**3.17%**	-1.51%	**7.45%**	4.95%	**2.89%**	2.13%
August			**3.67%**	3.77%	**-1.00%**	-3.13%	**9.12%**	1.98%
September			**-2.39%**	-1.55%	**2.78%**	2.97%	**3.03%**	2.42%
October			**6.21%**	2.32%	**6.26%**	4.46%	**0.66%**	-1.98%
November			**1.78%**	2.45%	**5.50%**	2.80%	**5.58%**	0.28%
December			**0.86%**	-0.42%	**4.34%**	2.36%	**1.79%**	0.71%
Year	**4.61%**	2.21%	**29.95%**	11.39%	**59.01%**	29.60%	**25.14%**	5.60%
FatAlpha beat S&P 500 25 out of 32 times								

S&P DOWN MONTHS		
Month	FatAlpha	S&P 500
Oct-12	**0.66%**	-1.98%
Jun-13	**-0.73%**	-1.50%
Aug-13	**-1.00%**	-3.13%
Jan-14	**-1.76%**	-3.56%
Jul-14	**3.17%**	-1.51%
Sep-14	**-2.39%**	-1.55%
Dec-14	**0.86%**	-0.42%
Jan-15	**-0.83%**	-3.10%
Average	**-0.25%**	-2.09%
Median	**-0.78%**	-1.77%
FatAlpha beat S&P 500 7 out 8 times		



SINCE INCEPTION:	FatAlpha	170.5%	Vs	S&P 500	55.8%

Reviews

About once a year I like to check out what paid sources exist out in the market. I google to find some free samples and may also do a trial. With regard to research, I highly recommend Value Line, Morningstar and S&P Outlook. However until recently I had not found even one newsletter that I liked or found provided insight or potential leads. And despite looking at so-called award winning letters, these too are largely disappointing. For example, one such "top" letters with a multi-year record recommended stocks that ended up at zero (eg. Wet Seal) and didn't pay much attention at all to company stewardship. Or course with deeper value plays you don't run into the best management, however there is a line all investors need to draw.

December 30, 2014

ValueInvestor INSIGHT

The Leading Authority on Value Investing

Courage of Convictions

The keys to investment success, says David Herro, are skill in valuation and having the discipline to actually buy low and sell high. He would know.

He's seen it all from his vantage point as one of the industry's top international investors – Morningstar named him Foreign Equity Manager of the Decade in 2010 – but even David Herro is impressed with the level of economic turbulence today. "There's always a lot going on," he says, "but we're probably closer to a peak than a trough on that front right now."

Herro has proven more than capable in navigating turbulence. He manages or co-manages some $55 billion for Chicago-based Harris Associates, and the Oakmark International Fund he's run since 1992 has earned a net annualized 10.6%, vs. 6.4% for the MSCI World Index (ex U.S.). Among areas of upside he's uncovering today: luxury autos, farm machinery, asset management and private banking. See page 2

INVESTOR INSIGHT

David Herro
Harris Associates

Investment Focus: Seeks temporarily out-of-favor companies with the fundamental strengths and capital-allocation acumen to solidly grow business value over time.

Safe and Cheap, 2.0

Here's a detailed look at how Chip Rewey is managing the difficult task of stepping into the spotlight at a firm whose founder casts a long shadow.

INVESTOR INSIGHT

Chip Rewey
Third Avenue Management

Investment Focus: Seeks companies meeting three criteria: creditworthiness, an ability to compound net asset value, and a share price sharply discounted from a conservative estimate of that asset value.

In an effort to ultimately be proven right in his research, Chip Rewey approaches the task in a somewhat counterintuitive way: "We're actively seeking out the data points that would make our case wrong," he says. "If we can disprove those, we're a much stronger-conviction holder. If we can't, we have no business in the stock."

Rewey's success in judging risk and reward recently landed him one of value investing's plum assignments, taking over in June a value equity team managing some $4 billion in assets for Marty Whitman's Third Avenue Management. Fully in sync with Whitman's "safe and cheap" investing approach, Rewey is finding opportunity today in such areas as forest products, regional banking, agricultural equipment, and broadcast and cable TV. See page 9

Inside this Issue

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Seeing beyond economic turbulence to find mispriced value in Daimler, CNH Industrial, Daiwa Securities and Credit Suisse. PAGE 1 »

Investor Insight: Chip Rewey
Betting on longer runways of success than the market currently envisions for Weyerhaeuser, AGCO, Comerica and CBS. PAGE 1 »

Strategy: Daniel Malan
Questioning today's safety-in-quality mantra to focus on global stocks that are "completely overcooked on the downside." PAGE 10 »

Of Sound Mind
Why too few investors have the data or the discipline to truly work at improving their skills, and what to do about it. PAGE 20 »

INVESTMENT HIGHLIGHTS

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Other companies in this issue:
Apache, BNP Paribas, BP, Caelor, CGG, Devon Energy, Diageo, Encana, Gazprom, General Motors, Hendersons Land, Intel, Intesa Sanpaolo, Lloyds, Melco Crown Entertainment, Orica, Petrobras, Richemont, Sberbank, Swatch, Total, Valmet Industries, Wesfarmers

December 30, 2014 www.valueinvestorinsight.com Value Investor Insight 1

This all changed when I did a trial of Value Investor Insight (VII). I found out about VII when I was reading a forum about another newsletter that was recommended by Greenblatt in one of his books. Unlike other newsletters, VII was created by a real fund manager (Whitney Titman) who manages real money. In it, they interview two fund/portfolio managers in a publication that runs at around 25 pages. The managers (eg. Jeff Smith, Bill Ackman) discuss their investment approach and ideas they find interesting. Every manager has their twist on value. I found these interviews very insightful, and the ideas they discuss are truly value. I know this as a fact because a few of the ideas are companies that have appeared on my radar as well. The letter though doesn't stop there but also provide a few more articles. I understand these are not fixed but cover a variety of topics such strategy, investor letters, reviews, and other investment topics.

In addition, there is a bonus content which is sent via e-mail. During my trial I received two such e-mails. These contained links to other articles, letters, and commentaries. All of these were again insightful, helpful and educational. So when it comes to amount and quality of content I judge it a 10/10. When it comes to value ideas, I'll tell you my story: I had received one of the trial letters but did not had time to read it. That day, I put on two trades. It was late so I printed out the letter to read it at home. Before throwing it into my bag, I quickly scanned the ideas managers were talking about. And bam! There was one of the companies I had just put a trade on! VII is the ONLY newsletter I have found worth paying for, and will soon subscribe to it myself. It is a true service to investors. If you want to find out how fund managers really think and invest then check it out at www.valueinvestorinsight.com. Free trials are available. It costs $349 a year.

The Wall Street Journal tracks all the startups worth $1 billion. Chinese smartphone maker Xiaomi is number 1 with a $46 billion valuation. Check them out here:

http://graphics.wsj.com/billion-dollar-club/

Tim du Toit of Quant Investing looks at stop loss strategies and papers written on the topic. It's worth checking out regardless of your views on stop losses.

http://www.quant-investing.com/blogs/general/2015/02/16/truths-about-stop-losses-that-nobody-wants-to-believe

Bitcoin has a lot of believers and followers. I am not one of them, and here is a must read news item on what happened at Mt Gox. Apparently it was an inside job. How do you feel about that?

http://www.cnbc.com/id/102442027

Thanks to Jeff for showing me this Bloomberg article on Kellogg and a discussion on breakfast: "Who killed Tony the Tiger? The breakfast cereal business is in decline and Kellogg is paying the price."

http://www.bloomberg.com/news/features/2015-02-26/for-kellogg-cereal-sales-recovery-may-be-lost-hope

Blackrock's Chief Investment Strategist shares his outlook and answers questions. Thanks to Kevin for showing me this:

http://www.ishares.com/us/library/market-perspectives?c=e90&cmp=marketperspectives&chn=EMC&cid=emc:marketperspectives:e90:e90

Hal 9000 Investing

$$Z(v) = \frac{1}{\sqrt{\pi}}\int_{-\infty}^{\infty}\frac{e^{-t^2}dt}{t-iv} = i\int_0^{\infty} e^{-vt-t^2/4}dt \qquad \int_{-\infty}^{\infty} e^{-x^2}dx = \left[\int_{-\infty}^{\infty} e^{-x^2}dx\int_{-\infty}^{\infty} e^{-y^2}dy\right]^{1/2} = \left[\int_0^{2\pi}\int_0^{\infty} e^{-r^2}r\,dr\,d\theta\right]^{1/2} = \left[\pi\int_0^{\infty} e^{-u}du\right]^{1/2} = \sqrt{\pi}$$

Last month, I did a review of O'Shaughnessy investment classic "What Works on Wall Street". It's only fitting that this month I present one of O'Shaughnessy's multi-factor models. This can easy be used as a starting point to find a potential investment. After running the model, an investor can do traditional bottoms-up analysis to pick the best opportunities. Or even apply a second filter like Piotroski's F-Score which was described in last month's letter. Please see my article in Seeking Alpha which used both O-Shaughnessy and Piotroski: http://seekingalpha.com/article/2941736-use-oshaughnessys-screen-to-find-value

O'Shaughnessy's book displays a value composite model that consists of the following six factors:

1) Price to Book
2) Price to Sales
3) Price to Cash Flow
4) Price to Earnings
5) Enterprise Value to EBITDA
6) Shareholder yield

Factors 1-5 are well known, however shareholder yield may be unknown to readers. It is a combination of dividend yield and share buybacks. For example, a company's shares outstanding have dropped from 100m to 97m due to buybacks. This is a 3% change. If the dividend yield is 2% then the Shareholder yield is 5%. Basically each stock is ranked by each factor and then a combined ranked is calculated.

O'Shaughnessy found that this model generated a geometric return of 17.3% vs 11.3% for the "All Stocks" benchmark from 1964 to 2009. I ran the model using Bloomberg data from midday March 10th. The top 30 stocks are shown below. Please note that I have not checked the input data for correctness.

GLF, EPE, SDRL, SPN, TPLM, CHK, DNR, DO, VLO, GTS, GIFI, MUR, ELRC, MN, UFS, CLD, HES, AGCO, TEX, SD, CLMS, NOG, VTG, TRN, NOV., MNI., ANF, CKH, CVX, HOS

Trades

Date: **February 26th, 2015**
Ticker: AXL
Name: American Axle
Transaction: Sold
Price: $25.13
Size: ½ the position

Note:
The investment theme for this purchase was cheap momentum. As momentum relative to the universe slid, it was time to take some profit.

Date: **February 26th, 2015**
Ticker: COF
Name: Capital One
Transaction: Sold
Price: $79.41
Size: Exited position

Note:
Sold the remaining position in COF as the stock has moved away from value. This is still a cheap financial services stock, but my preference has been for much cheaper plays. The increasing provisions remain an issue and the lack of rate hikes from the fed will not help the financial sectors. I believe the market has been miscalculating when the Fed will raise rates, which could happen later than expected due to a stronger dollar and weak global economy.

Date: **February 20th, 25th & 26th, 2015**
Ticker: HPQ
Name: Hewlett Packard
Transaction: Sold & Bought & Sold
Price: $38.09 & $35.25 & $34.29
Size: ½ the position

Note:
On the 20th I sold 1/2 the position in HPQ. The stock has appreciated in value and while there is a little space to go, my models show that its relative value position has deteriorated. Also from a technical standpoint the stock has been struggling to keep up with the market. This, along with the opportunity cost led to the reduction in the position. On the 25th I doubled my position in HPQ at $35.25. The drop due to earnings looked excessive as

margins improved while operating profit was flat and EPS increased. This type of play worked before in HPQ as initial market negativity quickly changed gears. However this time, free cash flow was much worse off. This was mainly due to breakup costs. While large, this size is not unheard-of. Management though should have been more forthcoming earlier. On the 26th, I took off the additional position in HPQ $34.29. News came out that HPQ was in talks with Aruba. This meant an even further reduction in free cash flow from the already reduced number. Based on the pre-Aruba numbers it already looked like buybacks were done, because if we include the potential dividends along with Q1 buybacks then the minimum 50% FCF return to investors as promised was met. With the Aruba deal, shareholders shouldn't expect any more buybacks for the year…

Date: **February 12th & 26th, 2015**
Ticker: JEC
Name: Jacobs Engineering
Transaction: Bought & Sold
Price: $42.77 & $44.66
Size: No position (entry/exit same month)

Note:
This turned out to be a short-term trade. JEC was a borderline value play. As the stock appreciated, its relative value position deteriorated much more quickly and out of my comfort zone, so I took profits. This is unusual and was the first time this happened.

Date: **February 23rd, 2015**
Ticker: CTB
Name: Cooper Tire & Rubber
Transaction: Bought
Price: $35.25
Size: Added to position

Note:
Added to position in CTB at 35.25. At one point the stock reached -9.5% vs the previous day due to an earnings miss. This made no sense to me as the company did grow operating income, improved margins and EPS despite the miss. An opportunity to add. These theme is quite common and investors should be on the lookout for companies whose results are much better than the market reaction. Most of the time if these are value plays, they will rebound nicely.

Date: **February 20th, 2015**
Ticker: GTS
Name: Triple-S Management
Transaction: Sold
Price: $20.09
Size: ½ the position

Note:
Reduced position in GTS in 1/2 at 20.09. Earnings results deteriorating vs trend of previous years while stock price has appreciated to higher levels. In other words, weaker earnings at a higher price, so the drop was reasonable despite the large size percentagewise.

Date: **February 19th & 20th, 2015**
Ticker: UFS
Name: Domtar
Transaction: Sold
Price: $44.36 & $43.30
Size: Exit Position

Note:
On the 19th, I sold half the position in UFS at $44.35. The stock has appreciated in value, and I don't feel comfortable with the risk return profile. According to the company outlook they "expect North American demand for uncoated freesheet to decline in 2015 with long-term secular trends" while a weak Euro will affect the Personal Care division. I suspect there are a lot of screens showing this company as the P/E is around 6x. However this needs to be adjusted for the tax benefits and one-time items. Adjusted numbers are over $3 but if we apply a normalized tax rate of 25% (based on historicals) to operating profit then we get an EPS of $3.04 which we can assume will deteriorate in 2015 per management outlook. Hence the stock appreciation is an opportunity to take profit in this stock which I have a cost of $37.28. On the 20th, I sold the remaining position in UFS.

Date: **February 12th & 20th, 2015**
Ticker: GPRE
Name: Green Plains
Transaction: Bought & Sold
Price: $26.25 & $25.15
Size: No position

Note:
This stock was bought as a value play on the 12th. I later discovered a Bloomberg data error. Adjusted for this, the stock still remained cheap, but based on the story and risk, it was not cheap enough to justify holding on.

Date: **February 9th & 19th, 2015**
Ticker: ALK
Name: Alaska Air
Transaction: Sold
Price: $63.39
Size: Exit Position

Note:
Sold remaining position in ALK at $63.39. The stock's valuation has risen a great deal since the initial purchase at $43.76. The drop in the oil price has helped push this stock to new highs but the longer term weekly chart appears to signal the beginning of an underperformance. I can't justify holding this neither value nor value growth as sales only rose 4% in the past year. Oil appears to be stabilizing and the only remain justification would be to hold for a further oil price decline. This I believe would be gambling. I am in the business of stock picking. Taking profits of over 40% and moving on. Thanks for the ride Alaska!

Date: **February 3rd, 2015**
Ticker: GMCR
Name: Keurig Green Mountain
Transaction: Bought
Price: $126.05
Size: Exit short position

Note:
Took my 10% profit in GMCR ahead of earnings. Anything could happen after earnings. Still overvalued but I think on shorts you need to be careful. Plus this is no ANGI (for those who have been reading this letter long enough, know what I mean). This has growth, a story and is highly profitable. If it's a no event then I may re-short it.

Commentary (Continued from page 1)

Their response: "Thank you for your question regarding [ANTM] and the Shares Outstanding value for the most current period. ...we have realized that there was an error in our data and the correct number has been reflected on FA. We are very sorry... In this case for [ANTM] the data was not updated from the correct source... ...We will do our best to ensure this error does not happen again. Thank you for your understanding and patience, and thank you for using Bloomberg Help!"

Unfortunately, this was not the only case. During the month I had to reverse a trade I had put on. To be perfectly honest, the correct input didn't change the conclusion by very much but it changed the balance in the opportunity and of course the risk-return profile. Please note that the market cap info was correct and used the correct data, as did the EV page. The problem was with the FA page and exporting data.

Furthermore, for those of you who have looked at Bloomberg backtesting and what they state as "point-in-time"… well my advice is to think twice about it. I spent two full days on it and my conclusion was that there were way too many problems with which data was made available to be dependable. I tried to explain this to Bloomberg, but I gave up in the end. I'm currently writing an article on some of the data issues I have seen and will publish it soon on Seeking Alpha.

The delay in sending out this letter was due to my trip to London to attend two conferences. Bloomberg hosted a hedge fund startup conference. There were providers of fund related services (i.e. prime brokerage, legal, etc) and an interesting panel on seeding if you can call it that… To me it looks like the seeding business is dead. Yes, dead. There a tons of articles and stories about seeders investing in new funds. However, today's seeders are no longer looking for startups. They are looking for established funds to help take them to the next level. What does this mean? It means if you have $50m under management and want to push higher to generate the mega-fees then you can approach a seeder. Can't a manager get by with $50m? Sure he can! Some of you may disagree but depending on the strategy and asset class there are cheap structures where a small team can do extremely well with $50m. Not only can they do well, but also have the flexibility due to size. The larger you are, the smaller the investible universe. And as there are way too many megafunds around, this investible universe is much more efficiently priced. When I worked at an EM hedge fund, our best returns came during the years we were small. A few good investments went a long way. The larger you are the bigger the deals you need to make to make. Hence I've coined the term "too big to perform". Now I can understand it if you are dealing in EM bonds and you need to size in order to get the flows and to generate enough in fees to cover an expensive offshore and onshore structure. But what about all the equity guys?

With the availability of data and cheap research sources, the Peter Lynches of the world can re-emerge. There are plentiful opportunities for both long and short positions. Small managers can easily outperform the market thus providing a service to investors while generate a good income for themselves. At the conference I heard from seeders that generating alpha was the least important and that structure and team were more important. I was shocked to hear that. I can understand an investor's concern if the manager is taking excessive risk, but assuming this is not the case, it's sad to hear where the industry is going. If returns are no longer important then why should an investor bother? They should just go passive and save the costs and the effort. The argument is that risk is more important and protecting from the downside. But has that been proven empirically by anyone?