Exclusive Outlook

West Coast Asset Management
The Entrepreneurial Investor™

OCTOBER 2007

Casting for Value: Where do Professional Investors Get Their Ideas?

People often ask why we rarely share stock ideas in our newsletter or podcast. In our experience, people misuse such information more often than not, because they act without fully considering each investment's unique role in their financial strategy.

Everyone's goals, risk tolerance and timeframes are different, and individual portfolios should reflect this. People should be learning to fish, but instead they ask (and sometimes pay) others to throw fish at them. This is a good way to get smacked in the face with a fish, end up with a foul-smelling pile of carcasses, and learn absolutely nothing about where, when and how to catch fish on one's own.

Many professional investors reap great rewards by investing in obscure companies, so individuals want to know where we find what one newsletter refers to as "hidden gems." Those willing to do a little legwork soon learn that many of these gems are hidden in plain sight.

IDEAS ARE EVERYWHERE

While it's true that one can discover investment opportunities by noting businesses with long lines or a lengthy backlog of orders, professional investors need a more systematic and reliable process for maintaining a full pipeline of possibilities. Here are five tools we use as our market "radar."

1. Public Filings

One of our co-workers is a huge film buff, and a big fan of Wall Street Journal film critic Joe Morgenstern. "Not only is Morgenstern a great writer," says our associate, "but over the years I've come to trust that his tastes are similar to my own. I know that if he loves or hates a film, there's a high probability I will also." Similarly, we monitor the "13F" filings of like-minded investors – those who have proven to share our entrepreneurial approach. "13F" refers to an SEC rule requiring quarterly disclosure of the investment holdings of those who manage more than $100 million in equities. This has proven to be a great source of new investment ideas.

Another public filing is the 13D, a required disclosure for activist investors who own more than 5% of a company. 13Ds can alert one to special situations that may present unique investment opportunities. Yahoo! Finance and the Edgar websites are good resources for this sort of information.

2. Industry Periodicals

A large supermarket magazine rack may appear to have a slick periodical for every imaginable consumer interest, but believe us; they barely scratch the surface of what's out there in the business world. We continuously review publications focused on drug delivery technology, confections, supermarkets, alternative energy, oil and natural gas, healthcare, home healthcare, restaurants, apparel and beverages. New periodicals are added to the list regularly, as we seek to expand our circle of competence.

Industry publications are helpful because they not only keep us informed about trends affecting the industry, but they also alert us to companies operating on the periphery, providing tools or services to the main players, as well as new companies with unique offerings. The people who provided picks and shovels during the California gold rush became much richer than the miners themselves, so it pays to keep an eye on business opportunities adjacent to the main industry. These magazines also provide intelligence on the sources of and structures of financing.

3. Traditional Media and Conferences

Publications such as Value Investor Insight, The Wall Street Journal, and Barron's are essential resources, providing social, political and financial context as well as specific investment ideas. Study of these publications also provides insights into herd mentality; one should not follow the herd, but should be aware of its movements to keep from getting trampled. Sometimes we find intriguing competitors to companies profiled in the mainstream media, for example someone operating in the same market space but with better capital allocation skills.

We also attend industry & investing conferences, which are as valuable for the establishment of networking contacts as for the seminars and keynote addresses. Such networks mutually benefit the attendees, sponsors and presenters. Our own address at the 2007 Value Investing Congress West introduced us to many like-minded investors, both professionals and individuals, each with a list of interesting opportunities.

4. Data-Driven Stock Screens

One of our proprietary screening processes compares a company's stock price to its net tangible assets (e.g. cash, real estate, and working capital) and cash flow. We slice and dice the numbers in a variety of ways, churning the data to bring ideas to the surface. We also use our computer stock screens to search for significant insider net purchases and stock buybacks, to better understand management commitment and direction.

While professional investment managers tend to purchase very powerful and customizable screening products, many online services offer easy-to-use screening tools to help investors identify companies that may interest them. Fidelity.com, for example, allows clients to design their own stock screens or to use templates designed by professional money managers. Yahoo! Finance offers a useful search and screening capability for use by anyone.

One of our analysts hastens to point out that we run these screens constantly, and they often go nowhere. But really, that's the idea: the whole point of a "screen" is to screen out ideas that don't fit our strategy. Only unique opportunities get through.

5. Eyes and Ears

We believe it is important to know what we know, know what we don't know, and know who does know the things that we don't know. One can always expand or reinforce one's circle of competence through interaction with trusted experts. All of our business associates and clients have their own areas of expertise, and we often turn to them for ideas.

It also pays to consider the products and services we see and use in our personal and professional lives. One of our colleagues switched his company to new customer relationship management software a few years ago, and it was so far superior to his previous experience, he immediately invested in the company. He had switched from one of the most popular products on the market, and he knew that when others experienced the new software, they would switch too. This proved a wise decision.

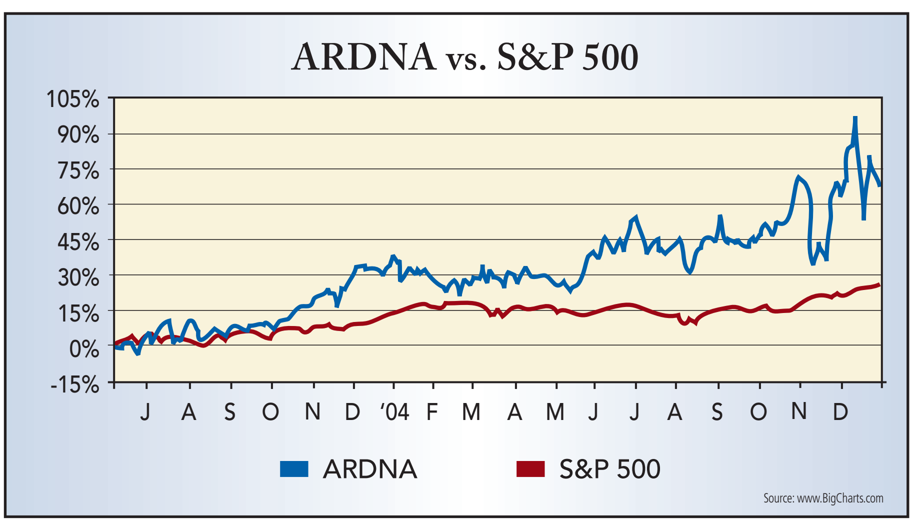
TOO MANY IDEAS?

With over ten thousand public companies to choose from, one could easily be overwhelmed by opportunities, so it is important to start with a well defined investment strategy or philosophy. For example, although we do not discriminate based on so-called "style boxes" or market caps, we do maintain very specific criteria for stocks on our watch list. As we detailed in the August issue of Exclusive Outlook, once a company shows up on our radar, we quickly evaluate its business model, competitive advantage, recurring revenue, inventory risk, internal alignment of interests, culture, organizational structure, reinvention risk, capital requirements, and demographics. Few companies make the cut, so we don't mind starting with a large number of ideas.

At the outset we alluded to the old adage that "if you give a

YOUR OWN EYES AND EARS

In 2003, many shoppers already knew Gelson's (ARDNA) markets as a high quality alternative to crowded supermarkets. Gelson's featured excellent fresh produce, meats, baked goods, dairy and more in wide-aisled, well-lit stores staffed by friendly, helpful people. The quality of these stores turned some shoppers into investors. When labor troubles at the area's big supermarket chains made the news, business picked up at Gelson's, and many shoppers thus exposed to Gelson's quality merchandise and beautiful stores became long-term customers. The catalyst (strike) was not predictable, per se, but people who invested in quality they could see with their own eyes were rewarded when the catalyst came.



man a fish, he eats for one day, but if you teach a man to fish, he eats for the rest of his life." One could hike all day along a river before deciding where to fish even though, technically speaking, the entire river has fish in it. But when you know what fish you want to catch, you also need to know where that fish might be at various times of day, what the fish likes to eat, and what line and hook will be adequate for the task at hand. Mastering these skills brings the joy of self-sufficiency; freedom from dependence on middlemen. Likewise, good investing ideas can truly be found anywhere, but the best ideas come through focused, methodical and consistent search techniques. And as any fisherman will tell you, the results are delicious. ▲

The Entrepreneurial Investor

To celebrate John Wiley & Sons' December 2007 publication of West Coast Asset Management's *The Entrepreneurial Investor: The Art, Science and Business of Value Investing*, we are offering excerpts from the book in the October - December issues of Exclusive Outlook. Please enjoy.

INTRODUCTION: IS INVESTING AN ART OR A SCIENCE?

Business bookshelves overflow with titles promising formulas for success in the stock market. It makes one wonder why everyone is not yet wealthy. Could it be that there is no magic formula? Could it be that investing well requires talent, education and hard work?

Unfortunately, the answer is yes, no and maybe. You may be able to work many hours of each day, but your money and your ideas can work 24 hours a day, seven days a week, and they should. Wealth accrues to people who know how to make money while they read, while they watch television, while they eat, drink, work and yes, even while they sleep. Investing through the stock market is one way to do this, and it is our passion and our business.

OBSESSION WITH CHARTS AND GRAPHS DOES NOT EQUAL SCIENCE

Many brokers, analysts, and other professionals rely on statistical analyses and tools like Monte Carlo simulators (a highly sophisticated computer model that accounts for thousands of variables to predict the future value of a portfolio). Despite these obsessive forms of measurement and projection, they still must concede that past performance is no guarantee of future results. We're not taking cheap shots at our colleagues - we use a wide range of analytical tools as well, but we harbor no illusions that these tools provide answers. Rather, we use them to sharpen our questions.

ARTISTS, SCIENTISTS, AND BUSINESSPEOPLE

Entrepreneurs are often accused of operating too intuitively, relying more on their gut than their data. But as the saying goes, "Data is not information, information is not knowledge, and knowledge is not wisdom." Experience refines one's judgment beyond the mere collecting of facts. To improve investment results, entrepreneurial investors behave like scientists and artists, using tools and traits refined over years of practice. But are we practicing an art or a science? Perhaps neither. An entrepreneurial investor views investing as business, a noble discipline with its own craft, conventions, and aesthetics.

It is our belief that success or failure in equity investing depends on your ability to think and behave like a business owner. In other words, even if you have never owned your own business, entrepreneurial thinking will make you a better investor.

Ultimately, investing in stock gives you benefits of ownership without many of the headaches. But the likelihood of outstanding returns improve when you treat investing itself as a business. Thus, entrepreneurial investing operates on two levels: 1) managing your investments as if investing were your business, and 2) acting as if the companies in which you invest belong to you; lock, stock and barrel.

This is simpler than it sounds. In fact, this book is an argument for simplicity in your approach to investing. Some Wall Street firms work very hard to overcomplicate and dramatize investing. We think there is a better way for people to approach the stock market, and it starts with an understanding of this fundamental concept: the stock market is in fact just a market. We believe that what you buy - and why you buy it - matters more than where you buy it. But "the market" still matters, because it influences prices. We focus on individual companies so we can understand whether they are undervalued by the market. This simple idea animates West Coast Asset Management's entrepreneurial investing style. ▲