

Making Every Stock Count

Unappreciated companies always have a story about how things will get better. Mariko Gordon has proven adept at picking the stories with happy endings.

Mariko Gordon's college friends – she was a comparative literature major at Princeton – still have a hard time reconciling her career choice. “People not in business can view it as this scary, suspicious enterprise,” she says. “But classic, bottom-up stock picking is much more of a creative exercise than they think.”

Gordon's creativity as an investor is well documented. Now with \$1.2 billion in assets, her Daruma Asset Management has earned a net annualized 11.6% since inception in 1995, vs. 6.1% for the Russell 2000.

In search of small-cap companies exhibiting “accelerating rates of positive change,” she’s finding opportunity today in such areas as digital-media technology, dollar stores, industrial equipment, emergency transport and natural gas. [See page 2](#)

INVESTOR INSIGHT



Mariko Gordon
Daruma Asset Management

Investment Focus: Seeks companies in the process of remaking what they do or how they do it, the prospects for which are being underestimated by the market.

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Investor Insight: Mariko Gordon

Mariko Gordon, Mort Simpson and Brad McGill of Daruma Asset Management explain what they look for in turnarounds, how portfolio construction helps them battle inertia, how the tenets of Zen Buddhism are relevant to investing, and why they see significant upside in Rovi, 99 Cents Only Stores, Gardner Denver and Advantage Oil & Gas.

You manage your portfolio more as if you focused on big companies rather than the small ones you favor. How did that come about?

Mariko Gordon: I had the good fortune in the 1980s to work for Chuck Royce [of Royce & Associates], a true pioneer in small-cap investing. At one point he gave me a small piece of a partnership to run – with something like \$1 million in assets to start – with the basic rule of engagement being that I could only buy something the firm owned, which was around 800 stocks at the time. It was a way for him to see what I really liked a lot, and the \$1 million wasn't going to risk upsetting the partnership's performance.

In the process of running that portfolio, I realized the thrill of the hunt for me was in finding situations where big things were happening and warranted larger and more meaningful bets. I'd learned well the lesson that you don't want to be so concentrated that the inevitable mistake can kill you, but I also wanted to make sure every stock earned its keep and could make a difference if you were right.

Describe how that insight drives your strategy today.

MG: We typically hold 30 to 35 stocks, with market caps at purchase of \$2 billion or less. People in this business love sports metaphors, so we're looking for "fat pitches," where our estimate of the potential upside is at least three times the downside and that upside produces at least a 50% gain over a two-year period, without making greater-fool assumptions about multiple expansion. We cap any one position at no more than 6% of the portfolio, but we won't put anything in the portfolio at less than a 2% position.

Setting things up this way keeps us from being distracted, makes us dig that

much harder for truly interesting ideas, and forces us to make active decisions. Any one holding is too important to let slide if it's not working, and there's always healthy pressure on existing holdings from new ideas. We want to take away the drag of inertia, which can be very strong in human psychology.

One fear with a concentrated portfolio is that the outliers drive results, both good and bad. Our goal is for the core of the portfolio – which we define as everything that isn't a top-three performer or a bottom-three performer – to drive the bulk of our performance, while getting an added kicker from our big winners outperforming our big losers. We believe that's a more sustainable way to deliver value and so far it's working: 75% of our outperformance over 14 years has been generated by core holdings, while the other 25% comes from our positive outliers beating the negative ones.

What situations tend to serve up the fattest pitches?

MG: We're looking for the prospect of an accelerating rate of positive change. That means we're naturally drawn to management changes, turnarounds, or, more generally, to situations in which changes in the macroeconomic, competitive or regulatory landscape require a company to remake what it does or how it does it. Sometimes it's even more straightforward, where we see unrecognized assets that can generate significant value, or when a company blew something like an acquisition or a product rollout and we believe the fix will happen more quickly and with less pain than the market expects.

The guiding principle is that the best time to buy is not just when a stock offers good value, but when we can also clearly define what might drive the share price



Mariko Gordon

Following the Narrative

Very little about Mariko Gordon's background and education pointed to her pursuing an investment career. She grew up on the French Caribbean island of Guadeloupe, where her parents ran a rental-car franchise, before moving to her mother's home state of Hawaii at age ten. After high school (she was a classmate of Barack Obama's), she studied comparative literature at Princeton. "I thought I'd be a writer, an academic or maybe a journalist," she says.

As the reality of any of those career paths struck her as less interesting than the theory, Gordon found her calling after landing "old-style apprentice" positions at investment firms Manning & Napier and Royce & Associates in the 1980s. After joining a successful money-manager start-up in 1990, she struck out on her own in 1995.

Her literary training, she says, hasn't at all been wasted: "Financial statements are really just a narrative that tells a story, and some do so in a much more logical and consistent way than others. As with literary analysis, in looking at stocks you're trying to find where your assumptions are affirmed or contradicted – that's where the information value lies."

higher – which, in most cases, is better-than-expected sales, earnings or cash-flow growth. Accelerating fundamentals plus a value price provides a great balance between risk and reward.

Our strategy is particularly tailored to small-caps. Simpler business models are easier to analyze and cross-check, while at the same time change happens faster in small companies, making for more investable inflection points. One or two people can also make a big difference, quickly. For example, our success so far with [Internet photo company] Shutterfly [SFLY] – which we think is just hitting its stride – can be directly tied to the arrival of Mark Rubash as CFO at the end of 2007. The early changes he put in place had an impact within weeks. You can't do that at IBM.

One of our largest holdings is Allscripts-Misys [MDRX], which the Street hated when we first started buying it earlier this year. The stock had tanked because of a poor new release of its software, which physicians use to manage electronic health records. There was also a lot of uncertainty over its effort to diversify into doctor practice-management software by buying a division of Misys.

As we got into it, we found a company with excellent market share that was going to be a meaningful beneficiary of a tidal wave of demand coming from the already-passed American Recovery and Reinvestment Act of 2009, which allocated \$36 billion to drive adoption of electronic healthcare records as a means of reducing healthcare costs and improving outcomes. The market seemed overly fixated on what we thought were temporary product and integration issues, while not paying attention to this game-changing legislative event. That's not atypical of the type of opportunity we look for.

Has that particular thesis played out?

MG: The stock has nearly tripled off its March low, so clearly the market is starting to appreciate the potential here. The emphasis now is on the operational changes Allscripts is making to meet new demand and how well it actually delivers. We still have a significant stake and see

plenty of upside, but the character of the investment is changing.

How sensitive to cycles do your holdings tend to be?

MG: They can certainly be in somewhat cyclical businesses, but we rarely if ever buy something only because we're trying to time the cycle right. Air Methods [AIRM], which provides helicopter emergency transport of patients to and between hospitals, is an example. The

ON ECONOMIC SENSITIVITY:

Operating turnarounds – if you're right – should do relatively well regardless of how healthy the economy is.

company had been a highflier in recent years, growing into the industry leader with 20% of what is a roughly \$2.5 billion U.S. market. As the recession hit, however, fewer people were on the road for work or vacation, reducing the types of accidents that end up driving Air Methods' flight volumes. That, combined with high fuel costs and unusually high maintenance expenses, hit both earnings and the stock price hard.

The company is dramatically reorienting its fleet, consolidating flight bases, and is again likely to take advantage of the types of acquisition opportunities that have been accretive in the past. The result is an increase in earnings power – across potential economic scenarios – that we don't think the Street is grasping. When the cycle turns, all the better.

In general, we build the portfolio one stock at a time and don't really go offensive or go defensive based on what we think might happen in the macro environment. We'll always have things in the portfolio that will do better when times are tough or when times are good, but they tend to balance each other out. When you focus as much as we do on operating turnarounds, those kinds of stocks – if you're right – should do rela-

tively well regardless of how healthy the economy is.

Do particular themes ever drive your new-idea search?

MG: Usually our investment theses are so company-specific that there really isn't a way to look sideways for other ideas. We did go looking for other beneficiaries of all the spending on electronic healthcare records we saw coming, and found a great opportunity earlier this year in Perot Systems. The company had enough non-healthcare business lines – some of which were struggling – that no one seemed to be recognizing how significant the benefits to it would be as that \$36 billion of government money started to be spent. We'll never know for sure how right we were, as we got taken out at a very nice premium when Dell announced it was buying Perot Systems in September.

Are there industries you typically favor?

MG: No, but there are a few we usually avoid. We won't buy REITs. We typically underweight financials, whose fortunes tend to be overly tied to macroeconomic factors like interest rates. We don't do biotech, where the individual company outcomes are usually binary. Also, given that we're looking for increasing rates of change, it's hard for us to buy something like a utility that is heavily regulated.

You have two positions in the for-profit education area, DeVry [DVI] and ITT Educational Services [ESI]. How are you assessing the general risks and opportunities there at the moment?

MG: This has always been sort of a hot-button sector, where scandals or fears over regulatory changes can indiscriminately hurt all the stocks in the industry. The most recent kerfuffle has to do with the extent to which the government will change regulation of for-profit education. The short thesis is that as the government significantly curtails its support, the industry goes down in flames.

Our job is to look dispassionately at any proposed changes, assess how likely

they are to happen, and figure out the potential actual impact on DeVry's or ITT's revenues, cash flows and valuation multiples. When we do that, we still conclude these stocks are very cheap.

DeVry has always been one of the class acts in the industry, and ITT has remade itself into one after some brushes with regulators several years ago. Given that we have an administration that is committed to education and that these for-profit schools actually do a pretty good job of educating the underserved, we think there's plenty of opportunity for the best operators to prosper.

Tell us about the behavioral-finance research project you recently participated in with Cabot Research.

MG: I had read that Cabot was looking for potential beta sites and called right away to volunteer. I've always been a big believer that investing is as much about decision-making as it is finance, and decision-making is very much about psychology. The more we can know about how and why we make the decisions we make, the better.

I'm oversimplifying, but the research basically looks at all your buy and sell decisions and – based on 20/20 hindsight – isolates how each one adds or detracts from the overall value of the portfolio. For example, they found that we generally did a good job of selling losers and of holding on to winners. Where we didn't do so well was in buying more of things that were falling in price – which is interesting, given how much we as value managers love averaging down. We still have more to learn about this, but I would say we've become even more mindful when looking at whether to buy as something gaps down.

Do you follow any general rules when it comes to selling?

MG: One thing about our process that I believe helps us when it comes to selling is that we lay out specific milestones in writing that we're counting on to support our thesis. We try to be as specific as possible:

inventory turns are expected to improve by this much by the end of 2010, or gross margins should increase from 82% to 87% within two years. Tracking reality against these milestones keeps you from being in denial when something isn't going the right way, and makes cutting it loose easier.

A relevant example here would be LodgeNet [LNET], which provides TV programming to hotels. We bought into it late last year as the economy tanked

ON HITTING THE WALL:

Entrepreneurial companies eventually need the systems and processes that are anathema to most entrepreneurs.

and concerns were building that as people increasingly downloaded TV shows and movies to their PCs and iPods, LodgeNet was going to get hurt. Our thesis was that the operating weakness they were seeing had more to do with transitional issues than with secular shifts in technology. But as more numbers came in, there was no other logical conclusion to draw than that digital downloading was a problem, so we sold. It's possible that other factors – like consolidation in their industry – may help compensate for that going forward, but that wasn't the bet we wanted to make.

Operating turnarounds are a common investment theme of yours. Describe how 99 Cents Only Stores [NDN] fits that bill.

MG: What often happens in small-cap land is that successful entrepreneurial companies grow to the point where, to continue to prosper, they really need the infrastructure, systems and processes in place that are kind of anathema to most entrepreneurs. That was the case with 99 Cents Only, where after hitting the wall in a variety of ways a few years ago, the company concluded it needed to professionalize and brought in a new Chief

Financial Officer (who is also the Chief Information Officer), a new head of store operations and a new head of logistics – all of whom had significant retail operating experience.

In retail, you don't want the top line and merchandising to be the issue, and that wasn't the problem here. The 99 Cents Only concept differs quite a bit from the traditional dollar-store format. Stores carry a wide merchandise assortment – with an increasing emphasis on fresh produce and consumables – and emphasize the quality of the shopping experience. The stores are well-lit and maintained and present their merchandise in unique and fresh ways. As a result, the customer base is quite a bit broader than you might think, spanning across income levels.

The good news then is that this has really been an operational fix – improving distribution efficiency, upgrading cost-accounting systems, standardizing best practices. All of that is extremely important when you're dealing with huge volumes of low-value items. The bad news is that putting in more efficient and productive systems and processes at a company that was notoriously bad at such things – and that handles four to five million units every day – can take a long time.

Has the progress made so far shown up in the numbers?

Brad McGill: Yes, but we still believe there's plenty of room to go. Operating margins, not including the Texas operation, have gone from close to zero a few years ago to a run rate of 5% in the latest quarter, which is a seasonally low-margin quarter. Some of the progress in recent years has been masked by problems in Texas, which accounts for only about 10% of revenues, and by rising fuel, labor and workers' compensation costs, all of which appear now to at least be under control.

The big opportunity from here is in reducing store-level expenses, particularly labor costs. Retail operating expenses are running at about 24% of revenues, which

should move below 20% over time, in large part from the company giving store managers the tools they need to make better labor-management decisions. Overall, we think a high single-digit operating margin is well within reach.

Is there a growth story here?

MG: The company isn't aggressively opening stores at this point, but certainly could once they get their operating house in order. There is also significant opportunity to increase revenues per store. Last year they implemented a more flexible pricing structure, allowing things like sell-

ing paper towels for 59 cents each rather than packaging two at a time and selling it for 99 cents. We also think they should start carving out special niches like Trader Joe's has in selling \$3 bottles of wine. That wouldn't go against the overall pricing ethos, but could have a dramatically positive impact on sales per square foot.

We don't need to count on any of those things to justify owning the stock. As all the operating changes continue to make their way through the system, we believe there's tremendous unrecognized earnings power just from expanding operating margins.

How are you looking at valuation, with the shares currently at \$13.20?

BM: Over time, we think it's reasonable to expect a high single-digit operating margin, which would translate into \$1.20 or so in earnings per share. Combined with \$2 in cash per share, a market multiple would push the stock close to \$20.

The founding Gold family is still prominent in running the company. Is that a concern?

MG: David Gold, the chairman, has his detractors, but he's also proven to be a great merchandiser and buyer and still has great passion for the business. The expansion into Texas has been a bit of a black eye, but as Brad mentioned, the worst appears to be over there. In general, the company wouldn't have been able to make all the progress it has if the founding family were holding it back. We don't consider that a problem at all.

Talk about another operating turnaround with more of a cyclical bent, Gardner Denver [GDI].

Mort Simpson: Gardner Denver is a global manufacturer of compressors, blowers and pumps that are used in virtually every industrial market sector. They're organized into an Industrial Products Group, serving the industrial manufacturing, transportation, mining and construction industries, and an Engineered Products group, servicing the oil and gas, petrochemical, pulp and paper industries. Energy is the highest-revenue end market, with about 20% of the total.

MG: GDI hit our radar screen when we learned that Barry Pennypacker was coming on as CEO in early 2008 after leaving another of our portfolio companies, Wabtec, where he'd done a great job. He originally came out of Danaher, which is justifiably well regarded for the highly developed "operating system" they apply to make the companies they buy more productive. That background was particu-

INVESTMENT SNAPSHOT

99 Cents Only Stores
(NYSE: NDN)

Business: Retailer of consumer goods and closeout merchandise, sold in units priced at less than \$1, through stores based in California, Texas, Arizona and Nevada.

Share Information
(@12/29/09):

Price	13.22
52-Week Range	6.86 - 15.45
Dividend Yield	0.0%
Market Cap	\$910.6 million

Financials (TTM):

Revenue	\$1.34 billion
Operating Profit Margin	4.5%
Net Profit Margin	2.9%

Valuation Metrics
(@12/29/09):

	<u>NDN</u>	<u>S&P 500</u>
Trailing P/E	23.9	73.0
Forward P/E Est.	16.9	17.6

Largest Institutional Owners
(@9/30/09):

<u>Company</u>	<u>% Owned</u>
Primecap Mgmt	8.7%
FBR Capital	8.3%
Select Equity Group	4.4%
Daruma Asset Mgmt	4.0%
Barclays Global Inv	4.0%

Short Interest (as of 12/15/09):

Shares Short/Float	13.4%
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NDN PRICE HISTORY

THE BOTTOM LINE

The installation is well under way of more efficient and productive systems and processes "at a company that was notoriously bad at such things," says Mariko Gordon, but there's much progress still to be made. Assuming operating margins reach the high single-digits, the shares at a market multiple would trade closer to \$20, she says.

Sources: Company reports, other publicly available information

larly relevant to GDI, as the company had for many years been a serial acquirer focused on growth. Barry saw tremendous opportunity to improve operations by integrating the acquisitions more tightly, and by overhauling manufacturing processes to make them more efficient.

Fortunately, because we were worried about the company's end-markets in a deteriorating economy, we decided to watch and wait for a better entry point into the stock. When Gardner had proved it could weather the economic storm without coming apart at the financial seams, we started to buy during the third quarter of this year at around \$30.

Describe the types of changes underway.

MS: It's really a fundamental cultural change in how the company operates. The elements are familiar – a multi-year cost reduction and restructuring program, implementation of best practices, a renewed customer focus and a drive toward leaner manufacturing. Mariko and I visited the plant that makes highly engineered products, and the contrast between areas that had been transformed into just-in-time production cells (better lit, neatly labeled and not a superfluous item in sight) and those that had not, was striking. Barry is very skilled at giving

people clear goals and then supporting them with the expertise and tools necessary to reach them.

Has the dismal industrial economy masked any progress so far?

MS: With industrial capacity utilization in the U.S. plumbing new depths and drilling activity way down, the economic environment has been tough on GDI. But typically with these types of operational turnarounds you can see early benefits show up on the balance sheet, in things like faster inventory turns, lower overall inventory levels and reduced receivable days sales outstanding. We've seen all that here, which gives us confidence that the operating leverage when the economy does rebound will be significant.

As an example, the goal in the industrial-products group is to reach a 14% operating margin by 2014, up from around 7% in the most recent quarter. We think that's a reasonable goal and that they're likely to get there sooner.

What upside do you see in the shares, now trading at just over \$43?

MS: Without assuming any pickup in the economy, we believe just from margin improvement the company could earn well over \$4 per share in 2013, from a base of around \$2.40 in 2009. If they demonstrate the turnaround is working, they should get at least a traditional group multiple of 16-17x, which conservatively produces a target share price two or three years out of more than \$65.

There are options on the upside for which we don't believe we're paying. One is that the economic picture improves and GDI's revenues rebound from today's depressed levels. Another is for the company to re-engineer its products to put emphasis on aftermarket sales. The typical industrial manufacturer earns 40-45% of its revenues from aftermarket parts and service, while GDI is closer to 20-25%. Also, we wouldn't be surprised if over time the company finds accretive acquisitions to do in similar or adjacent product areas with the same distribution channels.

INVESTMENT SNAPSHOT

Gardner Denver
(NYSE: GDI)

Business: Designs, manufactures and markets compressor, vacuum and fluid-transfer products used in a wide variety of manufacturing and industrial applications.

Share Information
(@12/29/09):

Price	43.12
52-Week Range	17.22 – 43.82
Dividend Yield	0.5%
Market Cap	\$2.24 billion

Financials (TTM):

Revenue	\$1.85 billion
Operating Profit Margin	11.2%
Net Profit Margin	(-9.3%)

Valuation Metrics

(@12/29/09):

	GDI	S&P 500
Trailing P/E	n/a	73.0
Forward P/E Est.	16.9	17.6

Largest Institutional Owners

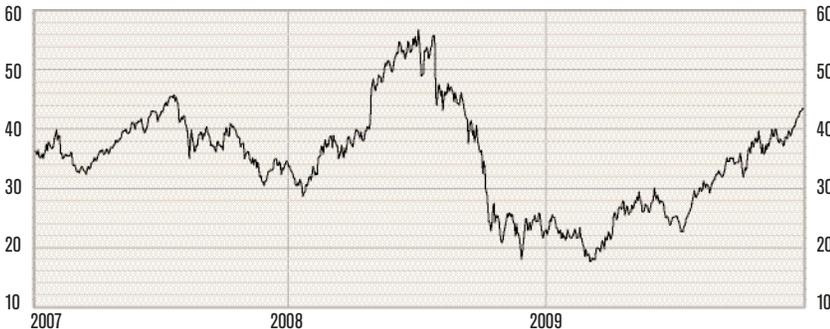
(@9/30/09):

Company	% Owned
Royce & Assoc	10.9%
Barclays Global Inv	4.9%
Vanguard Group	4.3%
T. Rowe Price	3.7%
Capital Research Global Inv	3.3%

Short Interest (as of 12/15/09):

Shares Short/Float	4.2%
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GDI PRICE HISTORY



THE BOTTOM LINE

The cyclical industrial downturn is masking the operating leverage building in the company's business model as it implements a multi-year restructuring program, says Mort Simpson. Assuming a flat economy, he expects earnings of more than \$4 per share within three years, resulting in a share price (at a typical group multiple) of around \$65.

Sources: Company reports, other publicly available information

Rovi [ROVI] has taken you on quite a ride over the past couple of years. What upside do you see in it from here?

MG: This is the former Macrovision, which we've held since 2006. We originally bought it when they named as CEO Fred Amoroso, who after a successful career at IBM ran two smaller companies, CrossWorlds Software and Meta Group, which were successfully turned around and sold. He had a history of creating value and we expected – and continue to expect – him to do the same thing here.

The company's traditional business is in providing technology to protect copy-

rights on software, DVDs and CDs. The lock they have on this from an intellectual-property standpoint translates into very good economics, but one of the challenges Fred Amoroso has had to address is how Rovi prospers in a world of increasing digital distribution of software and media.

A big part of his answer came from the acquisition a couple years ago of Gemstar-TV Guide from News Corp. Gemstar had other stuff like a horse-racing channel and *TV Guide* magazine, but the core of what Rovi bought was the digital interactive programming guide technology that Gemstar sells to cable systems

and satellite-TV providers, and that is now being built into digital TVs and other consumer-electronics devices. The technology basically facilitates the search and access of digital programming and information. Say you love the actor Kevin Bacon and want to find and download all the movies he's ever been in. Rovi technology can allow you to do that, rather than search for movies by name, or by when they're on.

The Gemstar acquisition certainly didn't go over big on Wall Street last year. Why?

MG: Yes, we did walk through the valley of the shadow of death with the stock last year. The acquisition came together just as the credit crisis was hitting, so a complicated transaction involving a great deal of debt and uncertainty wasn't well received. The market basically said, "Call me when you're done, but get me out of here right now."

The question for us was whether we bought into Fred's vision and his ability to sell off the unwanted pieces of the business, to focus on being an important player as digital convergence took hold. Our conviction held firm and we bought more shares as the stock fell below \$10 in October of last year.

At a recent \$31.80, the shares have come back strongly. Where do you see upside from here?

MG: We're already seeing the first results of the turnaround – the operations have been cleaned up, the strategic pieces are in place, they're hitting their revenue targets, and they're starting to pay down debt.

But we think earnings have a lot further to run. We expect revenues to grow 10% or so per year, as their technology gets put on a greater number of systems worldwide – Rovi has 90% of the North American programming-guide business, but only 20% so far internationally – and on a greater number of device platforms, like high-definition TVs. Margins should expand as their technology adds more value and average royalties and selling

INVESTMENT SNAPSHOT

Rovi Corp.
(Nasdaq: ROVI)

Business: Formerly Macrovision, provider of technology solutions that enable the distribution, management and access of digital media across multiple channels.

Share Information
(@12/29/09):

Price	31.82
52-Week Range	11.64 – 34.77
Dividend Yield	0.0%
Market Cap	\$3.28 billion

Financials (TTM):

Revenue	\$464.1 million
Operating Profit Margin	16.7%
Net Profit Margin	(-56.4%)

Valuation Metrics

(@12/29/09):

	ROVI	Nasdaq
Trailing P/E	n/a	43.8
Forward P/E Est.	16.9	20.1

Largest Institutional Owners

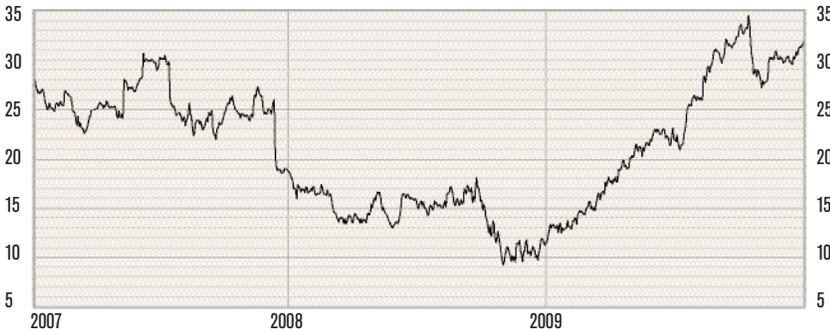
(@9/30/09):

Company	% Owned
T. Rowe Price	7.6%
Capital Research Global Inv	4.6%
Barclays Global Inv	4.0%
Vanguard Group	3.8%
Fidelity Mgmt & Research	3.7%

Short Interest (as of 12/15/09):

Shares Short/Float	5.0%
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ROVI PRICE HISTORY



THE BOTTOM LINE

Following its originally maligned acquisition of Gemstar-TV Guide, the company is well-positioned to prosper in a world of increasing digital distribution of software and entertainment media, says Mariko Gordon. At 18x the \$2.30 per share she expects the company to earn by 2011 – up 50% from this year – the shares would trade at \$41.

Sources: Company reports, other publicly available information

prices go up. They're also continuing to delever the balance sheet to the benefit of earnings. All in, we expect EPS to grow another 50% by 2011, from \$1.50 this year to around \$2.30 in 2011.

In terms of share-price upside, at what we think is a reasonable 18x our \$2.30 per share EPS estimate, the shares would trade at \$41.

What could go wrong here?

MG: There's some risk that the traditional DVD business starts to erode faster, or that consumer adoption of more sophisticated consumer electronics utilizing Rovi technology is slower than expected.

What's nice is that we don't have to count on a healthier economy to generate the top-line growth. If the economy does improve, we think there's considerable potential for Rovi to start generating advertising-related revenue, as their technology facilitates the delivery of ads based on who is watching and when.

Do you expect Mr. Amoroso to eventually find a suitor for Rovi?

MG: Yes. It doesn't change our thesis at all, but there are solid reasons why companies like Google or Cisco would want to own this one day. If the price is right, I have no reason to assume he wouldn't take it.

Your last idea, Advantage Oil & Gas [AAV], would appear to be much more of an asset play than a turnaround.

MG: We got particularly interested in this after retaining a geological consultant, Ross Smith Energy Group, to evaluate the potential development opportunities in the Montney shale gas formation in western Canada, where Advantage owns significant property. Their basic finding was that a full review of the geology and new drilling results signaled that the size of the Montney reserves were likely much higher than expected.

As we looked further into the company, other aspects of the story made it interesting. First of all, we think it's rela-

tively undiscovered and off most people's radar. Until mid-July, Advantage was a royalty trust, which meant that most of its shareholders were retail investors focused much more on the dividend than any fundamental prospects of the business. The Montney is also kind of a Rodney Dangerfield property, primarily because very few U.S. companies have exposure there. If a high-profile Chesapeake Energy or Petrohawk owned reserves there, there's no doubt the multiple would be higher.

The second key finding was how inexpensive it was to get the Montney reserves out of the ground, which we estimate at a

fully loaded cost of only \$3.50 per Mcf. We went to Calgary and met with many companies drilling there, all of which had robust drilling programs underway even in the face of hideously low natural gas prices. We also like that Advantage is spending heavily to expand its gas processing facility, which is expected to lower its processing costs significantly over the next twelve months.

We like cases like this in energy where the primary driver is that we see considerable upside to the reserves that are currently valued in the stock. That way we don't really have to make a bet on where oil or gas prices are going to be.

INVESTMENT SNAPSHOT

Advantage Oil & Gas
(NYSE: AAV)

Business: Oil and gas producer based in western Canada, primarily focused on the development of its natural gas resources located in Glacier, Alberta.

Share Information
(@12/29/09):

Price	6.61
52-Week Range	1.87 - 7.92
Dividend Yield	0.0%
Market Cap	\$1.08 billion

Financials (TTM):

Revenue	\$321.7 million
Operating Profit Margin	(-0.7%)
Net Profit Margin	(-50.0%)

Valuation Metrics

(@12/29/09):

	AAV	S&P 500
Trailing P/E	n/a	73.0
Forward P/E Est.	n/a	17.6

Largest Institutional Owners

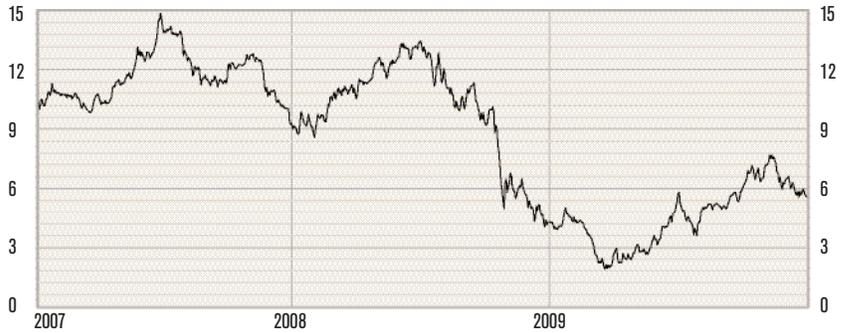
(@9/30/09):

Company	% Owned
Mackenzie Financial	3.3%
Natcan Inv Mgmt	2.7%
Barclays Global Inv	2.6%
Daruma Asset Mgmt	2.5%
CPP Inv Board	2.0%

Short Interest (as of 12/15/09):

Shares Short/Float	0.9%
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AAV PRICE HISTORY



THE BOTTOM LINE

Assuming futures-market natural gas prices of \$6 per Mcf, the company's asset value based on proven reserves matches its market value, says Mort Simpson. That means the market is ascribing no value to what he believes are significant reserves to be proven – worth \$4 to \$12 per share – at the firm's Montney properties in western Canada.

Sources: Company reports, other publicly available information

What gas-price assumption are you making to arrive at an estimated value for Advantage's shares, now around \$6.60?

MS: Futures markets are anticipating gas recovering to a price of around \$6 per thousand cubic feet and staying around those levels for quite some time. In our analysis, we're basically applying those futures prices to the proven and producing reserves the company has, as well as the future reserves we expect to be added as they continue with the new drilling program already defined.

When we do the math, we believe the company has an asset value of between \$6 and \$7 per share based on proven reserves alone. That's the current share price. The range of possibilities on new reserves from Montney is fairly wide, but we think that adds somewhere between \$4 and \$12 per share in value.

MG: The milestones here are clear. We just need for them to finish upgrading the

processing facility, continue the drilling program they have in place and, obviously, start proving out the additional reserves we believe are there. As that happens and the shareholder base continues to turn, the shares will get greater visibility and the share price should respond in kind.

Mariko, why did you choose Daruma for your firm's name?

MG: Daruma was a fifth-century Indian monk who reached China after a perilous sea voyage and became the founder of Zen Buddhism. The story goes that he crossed the Yangtze River on a reed and meditated continuously for nine years, losing his arms and legs in the process. You can see why I thought the name embodied resoluteness, perseverance and resilience.

I also think that many of the tenets of Zen – separating illusion from reality, non-attachment to emotions and ideas,

self-discipline, and embracing impermanence – are also keys to successful investing. We try our best to incorporate those qualities into our day-to-day work.

Any stories to tell about your high-school classmate, Barack Obama?

MG: There's a photo of him out there from high school where he's sitting in front of a building with a bunch of students, one of whom was me. The shot is of the people who worked on the literary magazine, and the reason Barry was in the photo was that he was walking by as we were setting up and two of his friends, who were artists for the magazine, called him over and asked if he'd sit with us so the staff didn't look so pathetically small.

He was smart and charming, but it certainly wasn't obvious in high school that he was going to be as driven and successful as he's become. It sounds silly to say it now, but he really found himself. **VII**