



R U B A L C A V A ■ C A P I T A L ■ M A N A G E M E N T

13075 Pacific Promenade #108 Los Angeles, CA 90094 Phone 310.622.4476 Fax 310.622.8719

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Second Quarter 2007

Dear partners,

What a bumpy ride! After an incredible – yes, incredible! – April, the rest of the second quarter was decidedly less enjoyable, as we gave back some of our gains in May and June before beginning to make money again towards the end of June, a trend that continues into July. For new clients – and we're excited to be welcoming many new clients this quarter – it's important to realize that short-term volatility is to be expected from our style of concentrated value investing. As contrarian investors, we often find ourselves looking foolish for extended periods of time, though our research and rigorous stock selection discipline usually allows us to enjoy the last laugh. Please remember: we are never as good as our good months (like April) and we are never as bad as our bad months (like May).

Turning to our portfolio, most of our large positions continue to post solid business results. **Investools (SWIM)**, which is by far our largest position, exemplifies this trend. While their core investor education business is going through a bit of a slow period, thanks to slower sales among their third party distribution partners, their newly acquired advanced brokerage business, Think or Swim, continues to post blistering growth. Consider the following metrics from June:

- New accounts opened, net, 5,375; 348% higher than June 2006
- New accounts funded of 3,050; 307% higher than June 2006
- Funded accounts of 39,075 as of month-end; 168% higher than June 30, 2006
- Retail DARTs of 23,400; 225% higher than June 2006
- Active Trader DARTs of 33,200; 127% higher than June 2006
- Client assets of \$1.78 billion as of month-end; 125% higher than June 30, 2006

No other brokerage firm of any kind is experiencing such rapid growth as Think or Swim. Looking back at the deal, announced almost a year ago, it's now apparent that the idea to merge the customer acquisition monster of Investools and the next generation trading tools of Think or Swim was simply brilliant. For this, full credit must go to Investools CEO Lee Barba and Think or Swim CEO, Thomas Sosnoff.

Nevertheless, the stock is doing terribly. After peaking near \$17 earlier this year, SWIM now trades barely above \$10, for a market cap of under \$700 million. Last year, the two businesses (separate at the time) generated about \$65 million in free cash flow. This year, free cash flow might come in slightly above the 2006 number, held down by merger costs, changes in the Investools education segment (which we've gone through before), and investment to support the hyper growth of Think or Swim. No matter. The story with SWIM is 2008 – when I expect free cash flow to exceed \$100 million, giving the stock a price to expected free cash flow multiple of just less than 7. No company with such high returns on capital and high growth rates should trade at such a slothful, sclerotic multiple. Indeed, I believe that the intrinsic value of SWIM could be in excess of \$30, making it one of the most



undervalued companies I can find anywhere. Thus, it represents the largest position in our fund today.

In the second quarter, we added two new positions, and I'm glad to say that both began working in our favor almost instantly. It doesn't always work that well, but we'll take it when we get it. The first was **Calamos Asset Management (CLMS)**, a firm that manages assets for clients through mutual funds, institutional mandates, and separately managed accounts. Longtime clients will recall how much I've spoken of the attractive characteristics of asset management firms, where costs are largely fixed and most revenue growth flows straight to the bottom line. Indeed, Calamos joins **Epoch Holding Corp (EPHC)** and **Diamond Hill Investment Group (DHIL)**, two other asset management firms in our portfolios.

Calamos specializes in growth equities and in convertible bond funds. They use a team approach and quantitative systems to manage risk. Though they don't disclose those systems for competitive reasons, they clearly work – Calamos was one of the few growth funds that managed to hold its value during the tech crash of 2000 to 2002. Indeed, up until 2006, the flagship Calamos Growth Fund (CVGRX) had beaten the market every year this decade. But last year, managers John Calamos Sr. and Nick Calamos shifted the fund away from cyclicals and into blue chip growth companies, a move that appears to have been made too soon, as the fund appreciated only 1.5% last year, when the market was up by about 15%.

Predictably, some investors sold shares, and Calamos lost about 8% of their peak assets under management (AUM), a key metric for asset management firms. The stock overreacted to the news, falling from about \$45 to around \$22. We noticed the company on the 52 week low list, which we monitor daily, where it's highly unusual to find a quality company like Calamos. After completing our due diligence, we determined the following facts and hypotheses: the company was trading at a discount, on an enterprise value to AUM basis, from its major competitors; most likely, John and Nick Calamos did not suddenly forget how to manage money; AUM had been flowing negative for almost a year, and looking back at all major asset management firms, few had ever experienced more than 18 months of outflows in the absence of scandals; and the company has and continues to have a very strong distribution network for a company of its size. Thus, we bought the stock as a small position at prices between \$22 and \$23. The stock currently trades at \$26.75.

Our other purchase this quarter was a very large one, and a very controversial company: **Halliburton (HAL)**. It's hard to think of a company with a corporate image problem worse than Halliburton. Say the name, and people think *war profiteer, Iraq, asbestos, Dick Cheney*. However, these associations are all tied up in the company's government contracting business, Kellogg Brown and Root (KBR). The company had been trying to spin off KBR into its own separate company for many years, but had been held back by the asbestos liabilities of KBR. This year, however, the company finally resolved all outstanding issues, and KBR is now its own company.

What's left at Halliburton is a simple, world-leading, technologically-savvy oil services firm. The company helps oil companies explore, drill, manage, and clean up oil and gas fields. They do not explore for energy on their own and they take no risk of coming up empty when they drill a well. There are about six major players in this industry worldwide – the others are Schlumberger, Woods Mackenzie, Baker Hughes, Smith International, and Weatherford International – and Halliburton is a strong number two to Schlumberger. At our purchase price of around \$33 per share, we were buying Halliburton at just 10 times my expectation of



2008 earnings, despite the fact that the company operates in an industry that should see 20% annual revenue growth for as far as the eye can see, and the fact that Halliburton earns an amazing return on equity above 30%. The company recently announced strong earnings, pushing the stock up above \$37 per share.

Not all our recent picks have been as good. We continue to be disappointed by **Borders Group (BGP)**, the number two player in the book superstore market. We bought the stock knowing that the music category, the international stores, and the mall-based Waldenbooks chains were all experiencing business declines. Indeed, in the case of music sales and Waldenbooks, those declines appear to be permanent and irreversible. However, we expected that the company would shut those businesses down – which they are in the process of doing – to focus on the core book superstore business. What we did not expect was the decline in the book superstore business in 2007. Book sales are terrible this year, and even when there's an apparent bright spot, like the July release of *Harry Potter and the Deathly Hallows*, intense price competition between Borders, Barnes & Noble, and Amazon eliminated all profit from the event. What's more, Borders has evidently failed in their efforts to build a customer loyalty program to compete with the successful program operated by Barnes & Noble.

It's not the decline in the stock price from our purchase above \$22 to the current price near \$17 that bothers us. It's that our analysis failed to uncover the long term decline in the performance of the offline book retailing business. It appears that this is a mistake that will stick – we will likely be forced to sell this investment at a loss, with the only consolation coming from the short term tax losses that can be used to offset other income. At this point, it's hard to find lessons learned from this experience – the book business had been performing just fine for many years, and even today I struggle to see any warning signs that I might have missed seven months ago. I'm sure as I continue to analyze this investment, I'll find things to keep an eye out for in the future.

### **Portfolios**

Most RCM client portfolios currently have a sizable cash allocation of around 10% to 20%. We have many new investments percolating up our due diligence process, and we expect to make several new investments over the next 30 days that should bring all clients to a fully invested status. Keep an eye on your brokerage statements to see what we've been up to.

### **Miscellaneous**

Billing statements will be sent out via email in the next day or two; your prompt attention is much appreciated. For new clients, all statements will show adjustments for prorated fees. In addition, we're currently developing a web site which will archive all client letters, describe our firm in more detail, and host a blog to allow for more frequent idea sharing. Keep an eye out for a launch email in August.

Sincerely,

Alexander F. Rubalcava