

## Special Situations

**I'm turning over a new leaf. More than** once my readers have commented that I seem rather pessimistic, and I suppose that's true when it comes to the state of global finances in broad strokes. I do seek to balance my observations, be they negative or positive assessments, in an effort to be transparent and educate my clients. I always note how CUSH will positively respond to troublesome market conditions, and express appropriate caution and prudence when discussing the silver linings. One of the competitive advantages of CUSH is our conviction that regardless of conditions, there are always good opportunities out there for those willing to exercise the competence and discipline needed to ferret them out. The first rule is you have to know where to look, or, as a former colleague of mine used to say, 'you just have to dig where the gold is.' But how to find the gold amongst the emotional rubble of the markets is another story. This newsletter is devoted to a few relatively unknown opportunities called 'Special Situations.' Special situation investing can be quite lucrative, so it will make for a nice uplifting topic this month.

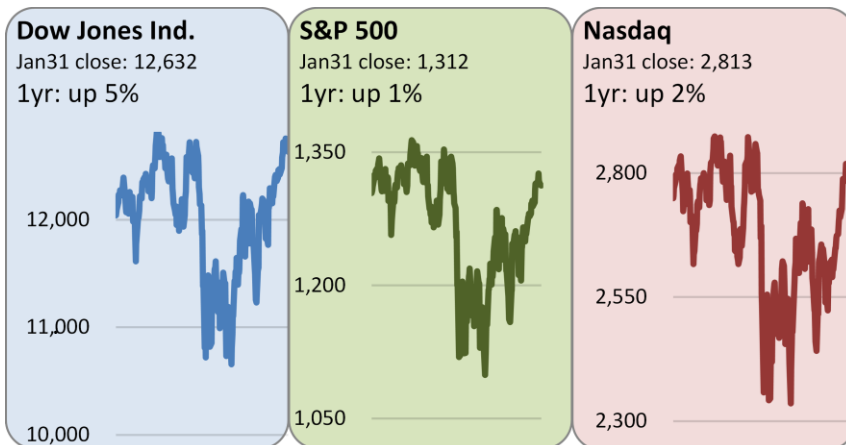
As you may recall, we first eluded to special situation investing after our annual trip to the Berkshire Hathaway shareholder meeting last spring. It was timely then because Warren Buffett has been using some of these strategies dating back to his original partnership of the 1950s. I recently sat down with a friend [and client] who posed the question [paraphrasing] . . . "I know you follow the strategy of investing greats like Warren Buffett, but I don't see us invested in any of the companies that he has so famously backed like Wells Fargo, or Coca-Cola or IBM?" To which I replied that while these are all great companies, Mr. Buffett is running up against the law of large numbers -- meaning that when you are steering a 200 billion dollar ship you don't have the same opportunities

available as you once did. This is an important distinction because if you analyze the holdings of Mr. Buffett's original partnership of the 50s and 60s you find much smaller lessor known companies, similar to some of the ones we invest in here at CUSH.

Buying great companies selling for less than their intrinsic value has served value investors well, but there are many different ways of profiting in the market without taking on a lot of risk. Some of these strategies have even produced blockbuster returns (reference Mr. Buffett circa 1950s), but even Warren admits that is not replicable given his firm's size today. My friend was impressed with our understanding of successful value investing (Buffett's and others). He recommended I share the same story with more of our clients because it's not consistent with the image that some people have of the staid, boring, buy and hold approach associated with Buffett today. So, with that in mind my goal this month is to shine a light on some of the strategies and investment opportunities that may be unknown. We call this special situation investing and it involves investing in companies whose stock price is temporarily depressed for reasons that are not economic to a company's underlying business. What we look for in a special situation is an investment opportunity with a high likelihood of success in the near-term based on some idiosyncratic

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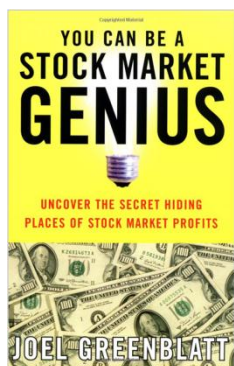
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Source: CUSH Capital Management, LLC / Yahoo Finance

characteristic that is independent of whether the market as a whole moves up or down. As my long-time readers know we are always on the lookout for investments with bright prospects independent of the broader market. The key difference with special situations is timing as they tend to have an identifiable catalyst acting on the investment in the shorter-term.

One of the better books on the topic is [\*You can be a stock market genius!\*](#) Despite the hokey title this isn't a get-rich quick scheme. The book is actually written by Joel Greenblatt, Columbia University Professor and founder of Gotham Capital, a private investment partnership achieving 50% annual returns over a period of 10 years before closing its doors, so Greenblatt definitely practices what he preaches. The book is filled with many detailed examples and analyses which help investors understand some of the inefficiencies that lead to these opportunities where the odds are tilted in your favor. These include Spin-offs, Mergers/Risk Arbitrage, Merger Securities, Post Re-org Bankruptcies, Restructurings, Rights Offerings, Recapitalizations and more.



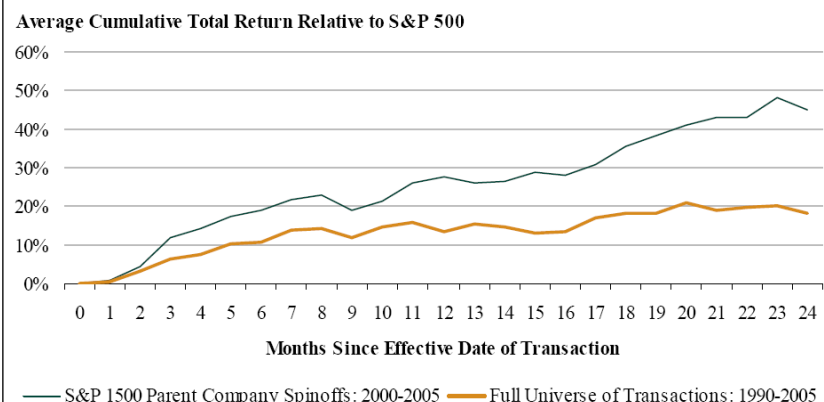
Let's take spinoffs as a classic example. Spin-offs usually aren't all that glamorous. In fact, spin-offs are often the result of a parent company wanting to rid itself of a subsidiary or peripheral division in order to focus on their core business. One of Steve Jobs' success secrets was his discipline in jettisoning many very good and promising projects so he could focus resources on the core ones, decisions he knew were difficult but necessary. More traditional companies maintain these non-core divisions but they are usually neglected (why else would they be spun off to begin with?) yet they often hold vast potential. Freed from the inflexibility and lack of proper attention brought on as a

result of being part of an uninterested corporate juggernaut, a young, talented, and motivated management team can make huge strides in improving profitability rather quickly. The key to a good spin-off opportunity, Greenblatt explains, is management having skin in the game. If their compensation is based primarily on performance, they will tend to perform well.

One of the peculiar aspects of a spin-off is the "churning" of the institutional shareholder base. Say for example, a large company splits itself into two smaller companies. Many mutual fund managers and large pension fund managers which are beholden to a certain style of investing (Large Cap Value for example) find that the new businesses violate their investing mandate. This creates forced selling which has nothing to do with the underlying fundamentals or economics of the business. For the nimble value investor this creates an opportunity to buy a valuable business on the cheap.

The Spin-off effect is well documented. In the Journal of Financial Economics (1993), Penn State researchers Patrick J. Cusatis, James A. Miles and J. Randall Woolridge, showed that over 22 years ending in 1988, the stocks of spinoff companies outperformed the S&P 500 by about 10% a year in their first three years post spinoff.

Figure 2: Spinoffs – Average Cumulative Total Return Relative to S&P 500 for Two Years After Effective Date of Transaction



Source: Lehman Brothers, FactSet, FAME, and Bloomberg

Similarly, a 1999 McKinsey study of 168 spinoffs from 1988 to 1998 reported that the spinoffs recorded an annualized total return of 27% during their first two years compared to 17% for the S&P 500. More recently, a study by Lehman Brothers indicated that since 1990, the average spinoff has outperformed the S&P 500 by 13.3% in its first year as a stand-alone company and by 18.2% in its first two years as an independent entity. In addition, the average spinoff by an S&P 1500 parent company since 2000 returned 45% above the S&P 500 in its first two years.

Merger Securities: Another example of special situations are merger securities. These are generally non-standard, unusual securities originating from deep within the vagaries of merger negotiations, usually as some sort of compromise to get the deal done. As a result, practically nobody takes the time to understand these securities and even fewer people are interested in owning them. That gives the enterprising investor a leg up on the competition. Since these securities are so unpopular, they are often undervalued. The key is digging through all the documentation to figure out exactly what these securities are, how they work, and what they are likely to be worth in the future relative to more standard securities such as the common stock or senior debt. Since literally nobody else is doing this kind of research, you have a huge advantage with a team like Cush.

Corporate Restructurings: Most of the time, a corporate restructuring means something went wrong. Either the company wasn't performing up to snuff, management is trying to mix things up, or an outright bankruptcy occurred. Either way, that's not the type of company you'd want to invest in, right? Well, probably not the stock. But many of these companies also issue relatively safe senior debt in a restructuring you can pick up at a significant discount if you know what to look for. This is definitely an area where you want to pick your spots, though.

Once again, in the interest of balance, it wouldn't be prudent to talk about special

situation investing without mentioning the specific and unique risks that can be involved. Investors have to be prepared to do the additional work and avoid mechanically or blindly investing on the recommendations of others. The over-riding theme of special situation investing is that if you want big returns, you have to search where nobody else is searching.

Our experience has taught us that there is still plenty of opportunity in some of these special situations. CUSH Capital is fortunate to be independent. We are not subject to an investment mandate that pigeon-holes our decision making into a particular style-box. Instead we try to take advantage of opportunities across the investing universe. Accordingly, we feel it's appropriate to reserve a slice of our portfolio for these kinds of opportunities which serve to diversify our returns in difficult markets.

I know some of our readers want specific examples. Unfortunately I don't have the space to provide that this month, but for those interested we wrote about one such opportunity in September 2010: [Premier Exhibitions](#). There are many other examples; this is just one we have already written about. Also, please keep in mind that we routinely share our in-depth research and thoughts on the market at our monthly client events: [What's the Big Idea?](#) (Our next event is Feb 16, 2012). We also have posted video (<http://cushcapital.com/videos.php>) of the events to the website for our out of town clients. As we continue to "*dig where the gold is*" we will share more of the unique insights and research that gives our clients some relative peace of mind in volatile markets. Please share your own good fortune by forwarding our newsletter to friends who could benefit from our wisdom. There's a big pie out there, enough for everyone willing to come to the table. •

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## Our Mission

CUSH Capital seeks to educate our clients about the market and serve as trusted advisor. By customizing and tailoring financial plans to each client, we strive to create a shared vision of your future. CUSH Capital provides our clients the tools and resources to implement this future. This is only made possible by our independence, which eliminates conflicts of interest and allows us to act as a fiduciary in all matters. We recognize the great depth of our responsibility with regard to our clients' financial future, and we don't take that lightly. Ultimately, our goal is to assist our clients in creating the most secure, comfortable and meaningful lives for themselves and for their families. In every way, in all that we do, we are committed to serving our clients with discretion, honesty, and integrity.

## The Strategy

At our core we are value investors, but in truth our philosophy so clearly differs from that of the herd. We have little difficulty distinguishing ourselves from the frenetic hyperactive trading strategies profiled on the financial news channels and common to so many other advisors. We offer a better alternative by selecting high quality stocks and bonds for the long-run. This low turnover, tax efficient approach is considered one of the most successful techniques for compounding wealth ever created. The key points are:

- 1) Targeting businesses with long-term sustainable competitive advantages.** This allows investors to compound gains and avoid excessive transaction costs. (Short-term selling and reinvesting can substantially eat up profits due to trading costs and tax consequences compounded over time).
- 2) Recognizing that stocks are businesses with an intrinsic value that correlates to success in the longer-term.** This intrinsic value CAN be measured, but it takes serious work to do that well.
- 3) Knowing that it is rare to find a great company with a sustainable competitive advantage trading at a discount to its intrinsic value.** When these opportunities present themselves you have to be prepared to invest with conviction.

## Vern Cushenbery, CFA, CPA Owner / Portfolio Manager

I founded CUSH Capital to deliver my clients the kind of trusted financial advice and portfolio management that is so rare in the financial community.

My years of experience in consulting allowed me to audit the portfolio strategies used by the very best. There is no substitute for hard work in this business -- no secret sauce. The only way to succeed in the long-run is to do your own research and think for yourself because if you follow the crowd or get caught up in the confusion of the financial press, then you are certain to fail.

CUSH Capital pioneered the concept of **wholesale investing**. We do our own research; we don't outsource, we **in-source**. Not only does this keep us independent, but it also lowers your fees. I publish this newsletter to keep clients involved and informed. I invite you to become a part of our team. Visit our website to subscribe to this newsletter today, or call me. I will be happy to answer any questions about your financial future.



CUSH Capital Management, LLC  
11020 Oakmont, Suite 100  
Overland Park, KS 66210  
(913) 660-0411  
[www.cushcapital.com](http://www.cushcapital.com)

Sincerely,

A handwritten signature in blue ink that reads "Vern".

Vern Cushenbery, CFA, CPA

Mr. Cushenbery has more than 13 years of experience in portfolio management and research. He was formerly Chief Investment Officer with Legacy Investment Management, and prior to that he was with Kornitzer Capital, sub-advisor to the Buffalo Funds. He holds an MBA and a Masters of Accountancy degree from the University of Missouri at Kansas City, and a BS in Finance from Kansas State University. As a CFA Charterholder and Certified Public Accountant, Vern is uniquely qualified as an investment advisor.

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