

# DOWNSIDE PROTECTION REPORT

Edited by the Research Team of  
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THE MANUAL OF

## SPECIAL EDITION

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With  
**John Mihaljevic, CFA**  
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### Inside This Special Edition

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### About Downside Protection Report

Our mission is to uncover stocks with a large margin of safety and bring them to you once a month.

John Mihaljevic, editor, is a fund manager, former banker and analyst. He is a member of Value Investors Club, an exclusive community of top money managers, and has won the Club's prize for best investment idea. John is a trained capital allocator, having studied under Yale chief investment officer David Swensen and served as research assistant to Nobel laureate James Tobin. John holds a BA in Economics, *summa cum laude*, from Yale and is a CFA charterholder. He resides in New York City with his wife and two kids.

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### Dear Fellow Idea Seekers,

I am pleased to bring you an exclusive interview with up-and-coming value investor H. Kevin Byun in this special edition of *Downside Protection Report*.

Byun is the founder and managing partner of Denali Investors. Investment funds managed by Byun generated a gross return of +28% for the full year and +43% for the fourth quarter of 2008.

Denali employs a strategy of investing in special situations, including spin-offs and other major corporate events. As a result, Denali's performance has been relatively uncorrelated to that of the broader stock market, with outperformance generated through the careful selection of special situations.

In addition to the enclosed interview, we recommend Byun's recent letter to Denali investors, available at [www.manualofideas.com/files/blog/denali2008.pdf](http://www.manualofideas.com/files/blog/denali2008.pdf)

Sincerely,

☺

### EXCLUSIVE INTERVIEW

**H. Kevin Byun,  
Founder and Managing Partner, Denali Investors, LLC**

**Your fund was up 43% in Q4 and 28% for the full year 2008. Are these gross or net figures?**

The year end figure is the gross return. The performance fee is determined at the end of the year. It's the 1950s Buffett Partnership structure of 25 net 6, meaning no performance fee until a 6% hurdle with one quarter of performance above that.

**Can you tell us what drove your performance in Q4? Was your fund net short?**

The fund has a handful of short positions but was net long the whole year. Also, the fund was majority cash the whole year until Q4. I had a healthy respect for what I considered to be upcoming dislocations. So I waited. Then the landscape totally changed in Q4. The fund shifted from majority cash to almost fully invested. There were a number of air tight self-tender offers with high yields that came up one after

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the other. There were a number of grossly mispriced spin-offs. There were a number of grossly mispriced merger situations. All the new special situation investments had life cycles within the quarter.

**How are you positioned differently today than you were in Q4? What is your view on the major traps awaiting equity investors over the next twelve months?**

The incremental capital put to work in Q4 has gone through its life cycle and has defaulted back to cash. So the fund is back to majority cash and I'm working on other ideas.

I'm not a macro expert but I would say that one area that could trap investors is the class of companies that look cheap but have weak fundamentals, weak capital structures, or weak management. Defaults have just started off of a historic low base. This tends to be a long multi-year cycle so jumping in front of ostensibly cheap situations could be harmful, notwithstanding that it's always case by case. But, I just don't think a decades long orderly leveraging unwinds and corrects in one year. So there is plenty of time to wait for the right opportunities. Overall, I believe the market will continue to offer outstanding bargains in what is shaping up to be a choppy environment.



**H. Kevin Byun**  
Founder and Managing  
Partner, Denali Investors LLC

**Please describe your investment approach for us.**

It's value-based and special situations investing. I believe in concentration in best ideas (five to ten positions) and net cash/no leverage. Investments fall into two buckets. The first is "Generals", which are undervalued longer term investments. The second is "Workouts", which are better known today as special situations investments and include mergers, reorganizations, spin-offs, recapitalizations, etc.

The weighting between Generals and Workouts is a function of what the market offers. Spreads and risk-return ratios today are remarkable, so recently the positions were weighted to Workouts. On the other hand, my watchlist of cheap long-term Generals keeps getting bigger and there will be a time to move on those that stand out.

In my view, selectively employing both Generals and Workouts allows for safer, yet greater compounding of capital over time.

**Special situation investing, by definition, is quite different from long-term investing. What are the key variables that drive your decision-making in event-driven situations?**

Sure. Special situation investments are investments with a timetable or catalyst. For me, it's important to get conviction on the ratio or relationship, in part a function of price, between potential downside and potential upside. This means thinking about various potential outcomes with various probabilities. It's important to factor in the basic motivations of all the parties at the table. Then you step back and add it up to get a big picture view.

In addition, I have found it helpful to invert the process and look down, instead of look up, which tends to be more common. For example, in the area of merger arbitrage, I followed a couple simple rules of thumb in 2008. First, was the acquirer a financial sponsor/private equity? Second, was financing needed? If the answer was yes to either, I moved on. Although the absolute spreads tempted some, it was a stretch for me to accept that this vintage of deals predicated on peak fundamentals, peak multiples and uncommitted financing would close smoothly. So just asking simple questions like that allowed me to sidestep a lot of potholes. The remaining addressable set of strategic acquirers and fully financed deals had much better risk-return ratios anyway.

**How do you generate new ideas? Are there any must-read publications for special-situation investors?**

Finding new ideas is a mixed bag. I read a lot. I talk to a few very smart people I trust.

Unfortunately, I don't subscribe to any special situation publications. Special situation investments have always been underappreciated, and that's just the way it is. Fortunately, plenty of information is readily accessible if you do happen to be interested.

**Let us in on a specific past investment of yours, if possible. What was your thesis and how did things actually play out? Did you come away from the investment with some broader lessons?**

Sure, I'll talk about one from Q4 that may be useful.

PNX, which I followed throughout the year, spun out VRTS in December 2008. It was a name that had been picked over by hedge funds and was impacted by forced selling, creating a large disconnect from underlying value and a reliable margin of safety. Each piece alone was worth multiples of the market price. The event that would help unlock some of that underlying value was the spin. I purchased shares in mid December right before the spin and felt the market would not come close to full value but that 50% upside on the spin was quite realistic. PNX/VRTS was a triple by the end of the month. PNX is pretty much the same company spin or not, but the market had no choice and was forced to assign a value to VRTS. This is why an investment was sensible.

I would say that a couple of broader lessons are that it's a big advantage to have ready cash when there is motivated/forced selling and to be prepared to act when the right opportunities come around.

**Which investor do you admire most and why?**

Joel Greenblatt. Level headed, modest, hard working, plain speaking, nice guy that picks his spots carefully. It's a good model to follow. It was a great privilege to take his investment course at Columbia Business School.

**Merger arbitrage spreads appear to be at or near all-time highs. Are you finding compelling opportunities in this area? What other types of "special situations" do you find interesting at the moment?**

Yes. Right now, because of the continuing dislocations in the market, most categories within special situations are compelling. Tender offers, spin-offs, merger arbitrage, A/B share spreads, etc. The dislocation has really created a field day for special situations investors with ready cash. During the next few years, the wave of bankruptcies, and especially companies reemerging from bankruptcies, should create very interesting opportunities across the capital structure.

**You don't discuss actual investments in your letters to partners. However, several value investors with a similar approach have invested in Steak N Shake (SNS) recently. While not a typical event-driven situation, the company is undergoing major change, with new management in place and significant hidden asset value. If you are familiar with SNS, would you care to comment on how you see this situation?**

Actually, I prefer to steer clear of revealing the company names, but I do discuss and outline the thesis for positions in the letters.

Regarding SNS, I'd followed the company for years and it was on my radar because of the tremendous asset base. However, I only became involved last year due to the change of the management and board, which I expected would unlock embedded value.

SNS has a combination of two great characteristics. First, there are, as you say, major positive changes taking place which are being pushed forward by an activist investor now leading the company. The operations, capital structure, deep asset base, costs, etc. are all being properly aligned. Second, the market is not paying attention. So you have a company that is improving and taking all the right steps with no corresponding recognition by the market. This is the type of situation in which time works for you.

**Find out which books H. Kevin Byun is recommending:**

[http://manualofideas.com/blog/2009/02/kevin\\_byuns\\_book\\_recommendatio.html](http://manualofideas.com/blog/2009/02/kevin_byuns_book_recommendatio.html)

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