Pragmatic Investing:

Equities, Fixed Income, Real Estate

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SN Valuation History

The idea of a research firm and growing into a principal investor sprouted after the layoff in 2008. Questioning my role as an analyst, I began to wonder what value-add I offered to my former employer. Was I leeching off a bank, and will I continue to be a leech at different institutions in the future? I always wanted to be a key performer, but at the time, unfortunately I could not pull my weight.

So I began to question whether I was fit to pursue an analyst career and struggled over this thought for a few weeks. The life of an analyst was much different than what I had read about in college. I obtained solid grades in my finance classes so I assumed I would be able to pick up the content when I was working.

However, I was utterly shocked when I realized none of the DCF valuation models, which was the sum of my business education, were used in the particular bank as a research analyst. It was all multiples and analyzing business models, more so than valuation. I didn't understand the logic behind a multiple that was plucked from the comp table average, when by itself, the multiple carried little meaning.

I felt betrayed by my confidence in my education, felt like an underperformer from my work performance as a jr. research analyst, and felt desperate while looking for another finance job at the end of 2008. Not a great time to be looking for a job in finance.

With a distraught mind and weighed down heart, I began to look for refuge in God. I was in prayer for a few days and I asked God for direction.

I felt God was asking me, "what do you have in your hands?" I was jobless, confidence shot, so my initial reaction was, nothing. But I got around to considering my education, 1 year experience as an analyst, free internet, and a network of people who would be able to help. Also, I had God on my side. So, I realized that I had the tools to build a website. The biggest issue though, was I had zero experience and background with website building. However, over a few weeks, I came across a free website builder and began to learn HTML coding on the side, and the rest is history.

We are not even a blip in this vast finance world, but when we first started off, it was like I was obtaining the world. It was exhilarating to think I was an owner of a website, and I was going to make my own reports at my own discretion. I realized the freedom associated to the ownership was not an advantage, since I wasn't sure whether my writing even made sense, and it didn't. Now, it is not much different but thanks to God, we have been in business up until now.

Investing

Investing has been romanticized by the media, with vintage reels showing the 1920's market mania and staple clips of traders in the pits shouting at the top of their lungs while flailing their arms to signal the number of purchases with their hands.

Investing is much more than emotion, or scheming as displayed in the movies and tv shows. A pragmatic investor will spend hours on end, researching a company's financials, digging deeper into their business model, to find the company's weaknesses and strengths, all to make the ultimate conclusion, will I get back my money and then some with this investment?

Over the past 4 years, SN Valuation has written over 500 reports, mainly covering US equities and the remainder being Korean stocks, financial institutions, fixed income and real estate topics. We have put together the writings into this book with hopes of cleaning up the main overview points in an easily readable writing style, which we hope will be used by other investors and students. There are countless websites and printed material from which we have benefitted and we would like to pass our nugget of knowledge to those who are willing to read through this writing. We consider it our magnum opus, as we have not compiled a written piece over 5 pages.

The most important aspect of investing is valuation. Without valuation, one can't determine whether a security, property is worth the time, concern and money. An investor could spend 10 years, millions of dollars on an investment, which had no intrinsic value in the first place.

Valuation helps the investor understand the expected return on the investment, the components of the return, whether it be from periodic cash flow distributions, or capital gains, and helps the investor understand whether an investment is a sound decision.

Golden Goose, Golden Eggs

An illustration I love to use is one of the golden goose and the golden eggs. Imagine a golden goose that is worth $100, by itself. It lays eggs worth $1 every day. Let's assume after I sell the goose, the goose will stop laying eggs.

If I own the goose for 7 days and sell it on day 7, how much could I sell the goose for on day 7 and how much return would I get on my $100 investment?

Since the goose would lay zero eggs after the sale, the golden goose would only be worth $100. So, over the course of the 7 days, I would have collected 7 golden eggs, valued at a combined $7. So with my $100 investment, I would have received $7 over the 7 days, and then $100 when I sell

the goose, or a combine $107. This would translate into a 7% return (107/100) in 7 days, or roughly 365% annually. But, if I was an irrational investor, and I put down $200 for the investment, I would have taken a near 50% loss on my investment, since I would have only recouped $107.

By valuing the investment beforehand, I would have skipped on the investment if the sales price on day zero was $200, or been first in line if the sales price was $50 on day zero. Valuation helps the investor to critique the investment decision before depositing the hard deposit, thereby preserving capital. Valuation doesn't guarantee absolute returns because many of the assumptions may be inaccurate, or unforeseen factors may come into play, altering the return on the investment. However, in the long run, the investor would be better off, especially during volatile economic conditions as seen a few years ago.

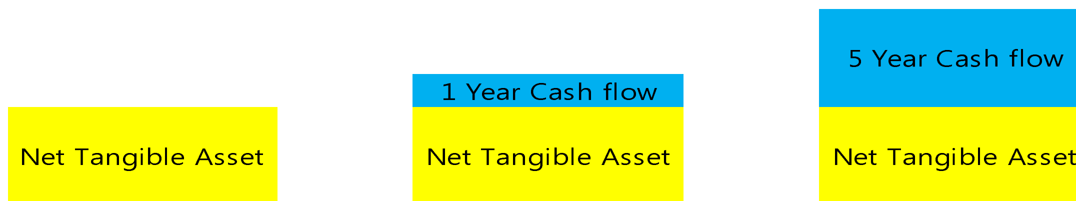
The illustration above reveals 2 of the most important concepts linked with valuation – the value of assets and the value of cash flow. These 2 components will help determine the disposition price, or the price at which the investor sells the investment come the exit period.

Cash flow + Assets

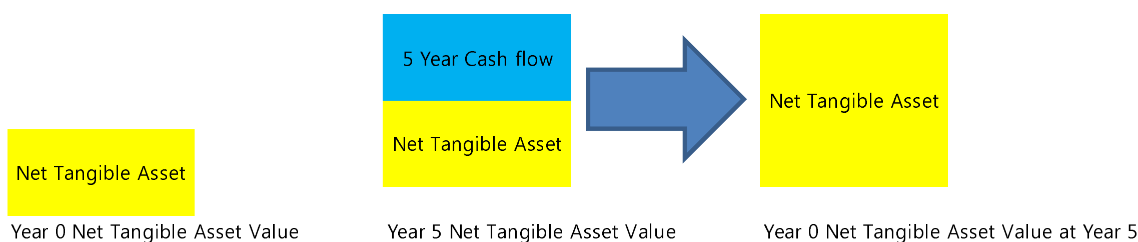
The goose represents the underlying assets of a company. The eggs represent the cash flow generated on an annual basis. Aside from the money generating capabilities, the machines and equipment and buildings have intrinsic value in and of itself. This is called the liquidation value of the assets, or scrap value or residual value. A lot of the valuation methods disregard the asset value, and solely focus on earnings and the cash balance and the debt value. This might be valid for most companies, since startups, small cap companies derive most of their value from future earnings potential, and not the assets on hand.

However, let's consider a company with a $1 BB asset base, which generates only $1 in cash flow every year. The co. has no debt and no cash. Would the co. be valued at $5- $10 because the cash flow is $1 for 5 to 10 years? Of course not. The assets alone would warrant a higher valuation, but many of our applied valuation methods disregard assets, which may undervalue an investment target, thereby skipping on a gold mine and missing an opportunity, or selling the current portfolio, or investments acquired, at a discount to their intrinsic value, thereby lowering the IRR.

So we like to value our investment using a net tangible asset value as our base, then adding 5 years of cash flow on top of the book value, assuming a 5 year holding.



This would value the Year 0 value, which is the net tangible asset + the value grown during 5 years of operation, derived from 5 years of cash flow. Cash flow would be 5 years of Free Cash Flow (FCF). Essentially, the 5 Year FCF+Year 0 Net tangible asset, would equal the Net tangible asset in Year 5, which would become the Year 0 Net tangible asset for the new acquirer in Year 5.



In effect, this would reset the Year 0 Net tangible asset for a new ownership cycle, as the initial investor gets ready to dispose of the investment. This is when the disposition price will become the Terminal Value of the investment.

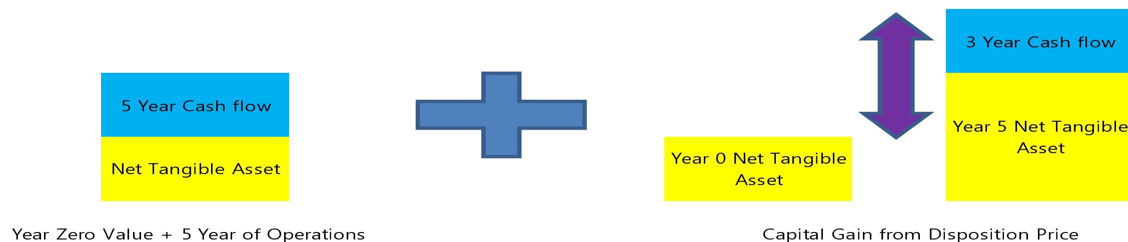
The Terminal Value is the most blurred, uncertain component of the investment value, but constitutes the largest portion of the entire valuation and can be easily manipulated by an analyst. An analyst may slap an arbitrary "comp multiple" to the Year 5 EBITDA and call it the Terminal value.

This is complete non-sense to us. The analyst probably spent hours adjusting the margins, and growth and balance sheet figures, so that they could calculate the annual cash flows from Year 0 to Year 5 as well as the net tangible asset value at Year 0. But the integrity of the entire valuation process could be compromised by one disposition multiple. The potential for compromise is especially high for equity and real estate valuation, since the disposition value in Year 5 is unknown, unlike fixed income which settles at par, or 1000, should the investor hold for the term of the bond.

The best alternative is to calculate a conservative figure for the Terminal value by using a lower multiple, or for real estate, a higher cap rate. Another idea, we propose, is to substantiate the terminal value by calculating the Net tangible asset value at Year 5, and then add 3 years of FCF on top of that, to be used as the disposition price.

We are getting ahead of ourselves, but at Year 5, if we are marketing the company to potential investors, they will want to know that they can operate the business for another 5 years, or today's Year 10, and sell it at Year 10, to another acquirer who will want to know they could operate the business for another 5 years.

So, in other words, we need to forecast cash flows for 15 years, but we calculate the disposition value as the net tangible asset value at Year 5 + 3 years of FCF, a conservative estimate assuming the company has no going concern. The co. could be easily sold for 5x FCF, but we are assuming extremely conservative estimates so that we don't pay $200 for the goose and eggs.



This provides the investor with a large margin of safety, which was an idiom coined by Seth Klarman, or another individual who influenced his thinking. We immensely enjoyed reading his book and we don't take credit for this principle.

Investing requires much forethought, researching the market, researching the business model, analyzing the competitors, product obsolescence risk, credit risk, cash flow viability, liquidation value, and discerning management's true intentions, whether it is self serving, or seeking value for investors.

Some may playoff fund managers, especially during times of downturns, which is fresh in our memories, with some well respected managers retiring or shutting down funds due to poor performance, and say investing is a game of luck, a tossing of a coin. Some reference the infamous monkey and darts.

However, we like to cite the likes of Buffett, who doesn't time his invests, but rather looks into the core business of each investment and sees whether the business is sustainable during bear cases and picks them up at discounted price for the long haul, or even at a premium, if he thinks the business can grow and return value to shareholders in the long term.

Investing is not following the market. Investing is not reaping 20% annual return. Investing is purchasing, acquiring businesses, real estate, fixed income securities at reasonable prices relative to their valuation, which can be substantiated by the intrinsic value of assets and sustainable cash flow.

We invest money to make money. Plain and simple. On an annually compounded basis, with reinvestment rate the same as annual return over a 5 year period, one would need to realize a **15% gain annually to double the initial money and 25% gain to triple the return**.

I wouldn't be happy if my broker returned to me $120 after 5 years, when I gave him $100 to start with. I would throw the money back at his face and yell, what have you been doing over the past 5 years? Per our 5 year chart table, one would only have to realize a 3-4% annual return for a 5 year 20% return. Yet, many seem content with an annual 3-4% return. Why? As long as they are not losing money, its bearable. Nonsense.

All of the hussle and bussle in the investment firms, with analysts from Ivy Leagues, and fancy algorithms, is to accomplish this very task – generate high reuturns. Some investments take time for it to unravel, play out in the market. Yet, the long term trend better be stellar. Over 5 years, I would want it to at least double. Is it too much to ask? Yet the average institutional, retail investors are happy with 3-4%, rather than 3-4 baggers.

Many people will reference quotes supporting their 3-4% annual return by citing power of compound investments, and investors who will be ahead if they preserve capital. All of this is Psolid advice, but irrelevant comments, when it comes to being smart with our money. Let's not try to defend our 3-4% return so we can sleep well at night.

We invest money to make money. If that is not being done, then that investment vehicle has failed. It is like going to a McDonalds, which is horrible at making burgers. They might have fancy pamphlets, menu signage, clean restrooms and a lot of secondary strengths, but if their hamburgers taste awful, then they have failed. End of story. Period.

Initial Investment
100

		Years				
		1	2	3	4	5
Annual Returns	1.00%	101.00	102.01	103.03	104.06	105.10
	2.00%	102.00	104.04	106.12	108.24	110.41
	3.00%	103.00	106.09	109.27	112.55	115.93
	4.00%	104.00	108.16	112.49	116.99	121.67
	5.00%	105.00	110.25	115.76	121.55	127.63
	6.00%	106.00	112.36	119.10	126.25	133.82
	7.00%	107.00	114.49	122.50	131.08	140.26
	8.00%	108.00	116.64	125.97	136.05	146.93
	9.00%	109.00	118.81	129.50	141.16	153.86
	10.00%	110.00	121.00	133.10	146.41	161.05
	11.00%	111.00	123.21	136.76	151.81	168.51
	12.00%	112.00	125.44	140.49	157.35	176.23
	13.00%	113.00	127.69	144.29	163.05	184.24
	14.00%	114.00	129.96	148.15	168.90	192.54
	15.00%	115.00	132.25	152.09	174.90	201.14
	16.00%	116.00	134.56	156.09	181.06	210.03
	17.00%	117.00	136.89	160.16	187.39	219.24
	18.00%	118.00	139.24	164.30	193.88	228.78
	19.00%	119.00	141.61	168.52	200.53	238.64
	20.00%	120.00	144.00	172.80	207.36	248.83
	21.00%	121.00	146.41	177.16	214.36	259.37
	22.00%	122.00	148.84	181.58	221.53	270.27
	23.00%	123.00	151.29	186.09	228.89	281.53
	24.00%	124.00	153.76	190.66	236.42	293.16
	25.00%	125.00	156.25	195.31	244.14	305.18
	26.00%	126.00	158.76	200.04	252.05	317.58
	27.00%	127.00	161.29	204.84	260.14	330.38
	28.00%	128.00	163.84	209.72	268.44	343.60
	29.00%	129.00	166.41	214.67	276.92	357.23
	30.00%	130.00	169.00	219.70	285.61	371.29

Bagger	Annual Return
1.05	1.00%
1.10	2.00%
1.16	3.00%
1.22	4.00%
1.28	5.00%
1.34	6.00%
1.40	7.00%
1.47	8.00%
1.54	9.00%
1.61	10.00%
1.69	11.00%
1.76	12.00%
1.84	13.00%
1.93	14.00%
2.01	15.00%
2.10	16.00%
2.19	17.00%
2.29	18.00%
2.39	19.00%
2.49	20.00%
2.59	21.00%
2.70	22.00%
2.82	23.00%
2.93	24.00%
3.05	25.00%
3.18	26.00%
3.30	27.00%
3.44	28.00%
3.57	29.00%
3.71	30.00%

Generating 20% Returns

I've taken a hiatus of sorts over the past couple weeks for multiple reasons: 1) cold/flu, 2) searching for jobs for other people and myself, 3) personal matters, 4) burn out.

However, it has been a rewarding period as I read through the annual letters by Warren Buffett. His letters dates back to 1957 and I was left with a great respect for his investment legacy, growing investor money at 15% annually during the 50 year stretch. Another detail that left an impression on me was his young age. He was born in 1930, so he was 27 when he was running his partnership. Along with his investment prowess, I was taken back by his writing style and content.

The power of compound returns is surprising. Basic arithmetics makes one assume a 20% return on an $1,000 investment over 10 years would return ($1000 x 20% = $200 x 10 years = $2000) around $3,000 at the end plus another $1,000 from compounding. However, the reinvestment return and interest on interest actually dwarfs the interest on the principal. A 20% return over 10 years comes out to $1000 x (1.20)^10 = $6,190.

This is why PE funds, VC funds, and Warren Buffett himself aim for the 15-25% annual return because this does wonders on the initial investment over a matter of a few years. Think about a 3-4x bagger in 5 years.

So how do we generate a 20% return annually? What investment vehicle can guarantee such returns, without the risk of losing on the principal, otherwise known as principal preservation? This question is sooooooooooooooo crucial as it is for this very purpose, investment firms exist in this world.

Warren Buffett said his portfolio consisted of generals, workouts, and direct controlled. Generals were underpriced stocks he would take a minority stake in, somewhat like our SNV Value Focus Fund. Workouts are like arbitrage plays which are not easily found in today's "efficient" market. Lastly, direct control are companies he would buy a large stake in and make some changes and sell, like a PE firm.

1) Security selection, or Generals

This is very difficult, and is highly dependent on the market swings, economic conditions, and in-depth research, which is very difficult to do over a long stretch. People like Lou Simpson of Geico, Peter Lynch of Fidelity, Charlie Munger of Berkshire Hathaway, Seth Klarman of Baupost and the likes are one of a few. It is very difficult to beat the market, although the selected stocks may be underpriced – where price is lower than intrinsic value. This is called a value trap, where the stock

doesn't budge for years.

For SNV Value Focus Fund, we have selected 47 stocks over the past 1.5 years and have returned a total return of 5%, while our YTD is 10%, trailing the S&P 500. Some were missed calls, some were overreaction by the market, and some were right on, homeruns.

Security selection, or generals will add maybe 5-10%, but on a weighted basis, will bring down the average. Leveraging, or what will act like floats, which are insurance reserves, will help add additional, unearned points to the total return. Finally, we believe the bread and butter will come from direct controls.

2) Leveraging, or Workouts. Also, it is similar to Insurance Floats.

		Return of High Yield	Cost of Borrowing	Return	Return on Capital	Cash Return	
Borrowed Money	50,000.00	4,000.00	2,500.00	1,500.00	**3.00%**		
Cash Investment	10,000.00	800.00	-	800.00	**8.00%**		
Total Investment	60,000.00	4,800.00	2,500.00	2,300.00	**3.83%**	**23.00%**	2,300/10,000
High Yield Bonds	8.00%						
Cost of Borrowing	5.00%						

In the above scenario, we can use leveraging to generate additional income from borrowed money. This is somewhat an arbitrage play since the lending rate is lower than the return on a high yield portfolio, so if we can lock in a high coupon paying bond and financing the purchase with a lower cost loan, then we will generate a positive spread over years. A 1-2% spread may not seem like much, but it will definitely add some extra return points, when calculating the return on cash.

When the trade is closed out, we can sell the bonds and repay the loan. The net spread will be left, and that $1,500 will be included with the cash investment return, so instead of $800 return, it will be a $2,300 return on the $10,000 cash investment, or a 23% return, rather than a measly 8% return.

Yet, this is difficult as well since the return on high yield bonds are subject to fluctuations on the value of the bonds, if sold before maturity. There is also insolvency risk on the underlying entity, or the issuer. High yield bonds nowadays are so overly priced, we don't expect the NAV of the bonds to stay above par for long.

2b) Interest rate swaps

Another mechanism to support the 1-2% spread may be entering an interest rate swap. There

may be opportunities in the market where it will be beneficial to pay for the swaps.

3) Direct control

Buffett would build a majority stake, or just take it out at once in an existing business, if the FCF and the FCF/investment yield were satisfactory. We believe this is valid, but also believe building a business from scratch and reinvesting the proceeds into the existing business, or a new subsidiary, will be as conducive to alpha creation as the buyout/acquisition model.

This of course takes more capital and time. One can see direct control developing into the prominent position at Berkshire Hathaway over time, when initially, generals and workouts created most of the value creation. Access our direct control Excel model on our website. Screen shot is below.

Cash Cow	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**	**11**	**12**	**Annual**
Revenue	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	120,000
Expense	6,000	6,000	6,000	6,000	6,000	6,000	6,000	6,000	6,000	6,000	6,000	6,000	72,000
Income from Cash Cow	4,000	4,000	4,000	4,000	4,000	4,000	4,000	4,000	4,000	4,000	4,000	4,000	48,000
Dividend Income from New Business	0	0	0	0	2,000	2,000	2,000	2,000	2,000	2,000	2,000	2,000	16,000
Combined Income on Holding Level	**4,000**	**4,000**	**4,000**	**4,000**	**6,000**	**6,000**	**6,000**	**6,000**	**6,000**	**6,000**	**6,000**	**6,000**	**64,000**
Investment by Owner	50,000	50,000	50,000	50,000	50,000	50,000	50,000	50,000	50,000	50,000	50,000	50,000	50,000
ROI from Solely Cash Cow	8.00%	8.00%	8.00%	8.00%	8.00%	8.00%	8.00%	8.00%	8.00%	8.00%	8.00%	8.00%	96.00%
ROI from combined entities	8.00%	8.00%	8.00%	8.00%	12.00%	12.00%	12.00%	12.00%	12.00%	12.00%	12.00%	12.00%	128.00%
Reinvested Capital into Cash Cow													0
Total Investment	50,000	50,000	50,000	50,000	50,000	50,000	50,000	50,000	50,000	50,000	50,000	50,000	
Cash flow available for New Business	4,000	4,000	4,000	4,000	6,000	6,000	6,000	6,000	6,000	6,000	6,000	6,000	
Capital Deployment into New Business	4,000	4,000	4,000	4,000	4,000								20,000
Retained Earnings before Dividend	0	0	0	0	2,000	8,000	14,000	20,000	26,000	32,000	38,000	44,000	
Dividend													0
Retained Earnings as Cash	0	0	0	0	2,000	8,000	14,000	20,000	26,000	32,000	38,000	44,000	
New Business													
Capital Deployed from Cash Cow	4,000	8,000	12,000	16,000	20,000	20,000	20,000	20,000	20,000	20,000	20,000	20,000	16,667
ROI	0.00%	0.00%	0.00%	0.00%	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%	96.00%
Revenue					10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	80,000
Expense					8,000	8,000	8,000	8,000	8,000	8,000	8,000	8,000	64,000
Income	0	0	0	0	2,000	2,000	2,000	2,000	2,000	2,000	2,000	2,000	16,000
Reinvested Capital into New Business													0
Total Investment into New Business	4,000	8,000	12,000	16,000	20,000	20,000	20,000	20,000	20,000	20,000	20,000	20,000	
Cash flow available for Dividend to Cash C	0	0	0	0	2,000	2,000	2,000	2,000	2,000	2,000	2,000	2,000	
Dividend to Cash Cow					2,000	2,000	2,000	2,000	2,000	2,000	2,000	2,000	16,000
Retained Earnings as Cash	0	0	0	0	0	0	0	0	0	0	0	0	
Investor Money	50,000	50,000	50,000	50,000	50,000	50,000	50,000	50,000	50,000	50,000	50,000	50,000	
Cash Cow	4,000	8,000	12,000	16,000	20,000	24,000	28,000	32,000	36,000	40,000	44,000	48,000	
New Business	0	0	0	0	2,000	4,000	6,000	8,000	10,000	12,000	14,000	16,000	
Total Invested and Value Creation	**54,000**	**58,000**	**62,000**	**66,000**	**72,000**	**78,000**	**84,000**	**90,000**	**96,000**	**102,000**	**108,000**	**114,000**	

Legend	
'Enter Data Here'	
Cash Flow	
Key Value Points	

Equities

2013 was a fantastic year, the market posting 29%. We underperformed at 28%, but nonetheless, a great year for value investing.

However, in retrospect, we fell prey to the trading psyche, not able to hold on to the investor mindset. We wanted short term gains, instead of allocating capital for long term, investor minded reasoning. We were enamored by the paper gains posted on our Excel file. We didn't care about management, about the business climate, about the business fundamentals. We thought and acted like a trader. We want to become investors.

Equities, stocks, companies are the driving force of entrepreneurship. We became interested in stocks when we realized, working up the corporate ladder was futile, because at the end, the shareholders could kick us out if we reached the CEO, or chairman position. At the end, the CEO and management works to please the shareholders. So the 갑, the upper hand, the whale, or the top dog is ultimately, shareholders.

Activist shareholders such as Ackman, Icahn force change in a company by taking large stakes in companies and placing people in the Board.

What is equities? Equities is simply the residual value of the enterprise value after adding cash and subtracting the outstanding debt issued by the company. In other words, considering the intrinsic value of the business operations, how much value could the owners of a company keep after paying back debtors?

It is a strange logic to value the equity of a company by comparing with other companies, or plugging arbitrary multiples to arbitrary financial figures. Where is the science? Where is the reasoning behind this practice? How is it that the medical profession spends years to obtain their license to practice, where individuals handling vast sums of money are doing their work so carelessly, with zero justification? Of course there are certifications such as CFA, CPA and the like, which teach individuals to value equities correctly. But it seems to lack a concrete method, that is universal to all brokerage houses, IBanks and buyside investment firms. It seems I went on a tangent, but there is a lack of scaffolding to support the valuation out there.

SNValuation focuses on equities for the sole purpose of acquiring new companies that have the potential to generate excessive alpha for the long term, with a greater emphasis on FCF than the capital gains, as capital gains is fleeting when the FCF is slim and volatile.

Equity valuation is an art, since there are so many moving parts and each moving part has a large

impact on the overall operations. Also, equities represent ownership in an entity controlled by infallible people, prone to errors and human tendencies and vices which are never factored into a valuation model.

So aside from my gripes, let's now move on to valuing equities by following the steps:

1) Screen stocks using websites, Excel files to find desired stock attributes
2) Due diligence; Study the company history, business, and financials in 10K and 10Q
3) Run a valuation model
4) Decide whether to invest in the company
5) Manage the portfolio of invested companies

1) Filter database

A good stock screener or filter to use is Finviz.com. The website is responsive, not much clutter to slow down the computer, and it has a clean, simple layout for easy viewing. One could use cash flows, balance sheet support, or recent trading momentum as criteria to pick and narrow down the candidates for investment.

On a daily basis, the investor should review at least 5 stocks. There is plenty of time to review the financials, industry, competitors, product/service, and valuation, should one have a process in place. So, from the filtering, one should choose 5 stocks.

2) 10 K, 10 Q, and financial statements, due diligence

The first thing to do is to visit the SEC to locate the mandatory filings for the companies, which are uploaded on a quarterly, annually and material news basis. The investor can find the majority of the background information related to the company in the 10K and 10Q. I am going to save the readers and myself from the minutiae for each of the filings. The data can be found online on numerous websites. http://www.sec.gov/edgar/searchedgar/companysearch.html

However, I would like to go through the application of the filings for investing purposes. 10Q is the quarterly update and 10K is the annual update. I focus my attention on the 10K as it provides detailed description of the company's business model, industry, competitors, risks, pending lawsuits, and notes related to the financial line items in the statements. However, the most recent 10K might be 9 months behind, so the 10Qs help to fill in the gap.

I am a big opponent of adjusting the valuation model every quarter. Sure, market conditions change and customers come and go, but if one's investment decision is contingent having all the

ducks in a row, and the assumptions used in the valuation are all rosy, then that investment is bound to fail. This is why come valuation time, the assumptions must be sunk with giant sand bags, so that even in a worst case, bear scenario, the value of the company would still show its merit, almost guaranteeing the returns on the investment.

A great habit is to look at the 10K of the competitors as it will provide a comprehensive view of the industry as well as getting a sense for management's tone and possible bias in their writings.

A general rule of thumb is – don't trust management, both in words and deeds. They are great bluffers, actors, speakers, you name it. Don't take their words at face value. It is wise to develop a healthy sense of skepticism in the information provided by management to the public. This has been proven true, time and time again over companies in all industries and all sizes. If they say, growth is forecasted to be 10% in the next couple years, assume 5% growth and make sure to substantiate the 5% with your own research.

When an investor is aggregating data from multiple sources, it is tempting to plug in assumptions found from a random internet site, so that we can commend ourselves in our research and find solace should the investment turn sour, because we "justified" our investment decision. The assumptions used in our valuation are what distinguishes the average investor with the legends. The legends go out of their way to affirm and reaffirm their assumptions.

For example, a hedge fund was looking into a small cap firm that operated a manufacturing business, but held a large tract of land in Florida. The analyst analyzed the adjacent neighborhoods for signs of construction and development, which would boost the value of the real estate, thereby providing more downside support for the investment. He called real estate brokers in the region and created a comp table to show the validity of his point, as well as running valuations on the adjacent properties. The real estate holding was a sub-point, not even the big idea of the Buy thesis, but he fully convinced the audience the land holding was undervalued.

3) Run valuation model

Excel is key. Garbage in, garbage out is what the senior analyst always warned me of when I was running valuation models. Overly optimistic estimates would reveal attractive, yet unrealistic returns, and the loss would be magnified should the market turn.

One should look into SMF addin online, to find out how to automate the valuation model. The most aggravating part of valuation is inputting the data by hand, transposing the data from a website onto Excel. By automating the data feed from the import data function in Excel, or by

using coding to extract data automatically, one will save hours every day, which will translate into months of work on an annual basis.

The valuation model needs to incorporate a 1) summary page for the investment, 2) Income statement, 3) balance sheet, 4) cash flow statement, 5) credit and cashflow analysis. The difficult part is linking the sheets accordingly so that a change in the cashflow statement would be reflected in the balance sheet.

Cash flow statement and income statement drives changes in the balance sheet. The balance sheet should only affect the cash flow statement, should one decide to input the "Change in Capital" by hand in the balance sheet.

Understanding the underlying valuation principles, briefly mentioned in the above "Investing" chapter, will save the investor from headaches and confusion. The financial statements may be linked and everything may run smoothly, but if the numbers do not make sense to the investor, then the model will not serve its purpose, which is to help the investor decide whether to make the investment or not. For example, if the income statement reveals a large loss in the most current fiscal year due to impairment charge, but the cash flow statement reveals no change in the Operating cash flow, the investor may wonder about the impact impairment has on the cash flow and whether the cash flow is sustainable.

4) Decide whether to invest in the company

IRR vs. risk is key. We don't want single digit returns for a risky investment. We want at least a 20% average annually. Granted, there may be short term investors out in the investing world who generate envious returns on their investment, but we want to approach investing, not as a mechanism to generate spreads, or front running the market. No, we want to approach investing with a full on, business acquisition perspective. We don't want to dabble in companies where there is great hype to generate 10% in 3 months, when there is a considerable risk of capital loss because of the underlying business fundamentals.

Therefore, when investing in the company, the financials need to be sound, the data aggregation from the due diligence needs to provide proof for a strong industry, product, competitiveness, the valuation needs to indicate strong IRR in the bear case, and finally, the investor must discern, based on all the aforementioned factors, the company will be around in the next 15 years.

We made the error of investing in companies which was attractive because our valuation model said to buy. We didn't conduct proper due diligence because our emotions stirred up bias in our decision making, and we shot from the hip and felt the valuation model validated our decision.

For example, we looked into a company which imported goods from China and branded them with an American brand label, which was in business for over 100 years. We were alerted by the high sales concentration in the hands of 2 large US retailers, but brushed off the concern because we presumed the relationship was amicable. However, in the past month, the largest customer announced they would drop 2 product lines from their stores, driving down future revenues and the co's stock price. The idiosyncratic tail risk materialized and we learned, we should stay away from business models which have a high concentration of sales on 1-2 customers.

5) Manage the portfolio

We believe a handful of high conviction stocks is much more efficient and a better indicator of manager performance than building a 50 to 100 stock portfolio. If the investor wanted to smooth out individual bumps, it would be better to invest in ETFs or funds, which have dedicated fund managers evaluating the performance on a daily basis. Dynamic asset allocation funds offer a unique solution to the issue of adjusting the portfolio by reinvesting gains in underperforming sectors or asset classes, while maintaining the long term portfolio mix.

Oftentimes, investors are tempted to add one more new stock into the portfolio to offset the losers in the pool, but more often than not, those new additions may become a loser too, as the investment thesis hinges on a weaker rationale. So, we believe investors should purchase maybe 5-10 stocks and stick with them for the long haul. Know them inside out and wait until they are at a proper trigger point.

Investors are actually minority, or in some cases, majority stakeholders of a business. Therefore, they should think and be patient like a business owner. For traders, who go in and out of a particular stock within a matter of a couple days, they don't necessarily have to focus on fundamentals like financial statements and industry overview, other than picking for possible catalysts. Investors are not traders.

Therefore, investors need to be able to stomach, or digest paper losses, in order for the investment thesis to pan out over a course of a couple years, or more, if need be. This is a diametrically opposite investing paradigm relative to conventional investing wisdom in the fund community today. Funds are ranked on a quarterly basis and if they don't measure up to the investors' standards, then they are redeemed and reinvested into a different "star" performer.

In fact, investors should be swooping up shares when the price falls, creating a buying opportunity for the investors, thereby reducing the average purchase price and improving returns.

SNV Focus Fund

Over the course of the past 20 months, from December 2011 to August 2013, we have been analyzing, selecting and tracking 60 stocks and named the portfolio, "SNV Focus Fund". We screened hundreds of stocks on free cash flow and book value to equity price, as well as margin and growth rate. We wanted high cash flow (less than 8x P/FCF) and low book value (less than P/B 2x) stocks. Also, we wanted positive net income, with double digit EBIT margins, and positive growth rate. As a result, the consequent portfolio consisted of mostly tech/industrial companies whose equity prices fell with the economic conditions in 2011. We felt if these companies experienced positive growth rates over the 2008-2011 period, then they had a sustainable business model, which was able to weather most economic storms.

To date, 45 of the 59 have reached their target price and have averaged a 13.4% return. About 5 are trading at a 5% loss, while 8 are trading at a 10% loss. So, a 75% success rate. YTD in 2013, the fund has outperformed the S&P 500 by 4%.

By and large, value stocks have been selling at historically unprecedented discounts to their book and intrinsic value. But history has shown, these discounted value stocks will rebound and they snap back at a steep appreciation rate. It is naïve to hold on to duds, expecting a rebound, and they should be sold off. However, the rare gems, whose underlying business are valid, but for secular reasons, or past operating underperformance, the stocks may be selling at a discount are the stock which should be held until the price target is met.

"Research shows that the market's cheapest stocks outperform "growth" stocks—the market's faster-growing, and more expensive, companies—over long periods. That hasn't been the case in recent years. From the beginning of 2009 through the end of 2011, the Russell 1000 Value Index—the stocks in the Russell 1000 index with the strongest value characteristics—returned 39%, versus their growth counterparts in the Russell 1000 Growth Index, which returned 64%"

Source: Wall Street Journal

We decided to analyze the losers, stock for stock, starting off with our biggest losers.

EXM – 83%; a maritime shipping co. based in Greece; we initially called for BUY because of the supposed undervalued ships, relative to historic prices. We felt a global economic rebound would lead to a higher valuation of the ships. However, the global economic rebound is not in place. The co. generates $100MM in operating cash flow and has been paying back their debt balance. Co. needs to repay $257MM in 2014, which is where the discomfort by the equity holders are coming to play and they feel the co. will not be able to service the repayment. (Table from 20F).

Period	Principal Repayment
January 1, 2012 to December 31, 2012	$107,622
January 1, 2013 to December 31, 2013	107,622
January 1, 2014 to December 31, 2014	257,622
January 1, 2015 to December 31, 2015	93,061
January 1, 2016 to December 31, 2016	488,825
January 1, 2017 thereafter	37,800
	$1,092,552
Less: Unamortized debt discount of the 1.875% Unsecured Convertible Senior Notes	(24,438)
Total	$1,068,114

ASYS – 70%; We came across this solar play since we are bullish on renewable energy for the long term. Solars have been crushed as of late, with overcapacity depressing ASPs and complicated legal development in Europe and US related to subsidies distorting forecasts for the business. Revenue has been cut in half in FY 2011 vs 2010. The co. sells equipment to solar cell manufacturers and the orders can be delayed or cancelled by the customers at any time. Along with the 50% reduction in revenue, the stock price plummeted 70%. We were bullish on the industry for the long term, but picked up the wrong stock. We anticipate further cash burn and book value attrition. Earnings forecast by analysts are bearish and we believe there is a going concern within a 3-4 year window. We believe for the solar play to work, need to invest in the best of breed because choosing the discounted, but low on the totem pole co., will lead to permanent capital impairment.

MBND – 50%; Not a high margin business. Remedial work, installing dishes on behalf of DirecTV. They receive a fee per installation. Also, they manage subscribers for multi-unit properties on behalf of DirecTV in the Southeast and Midwest. The co. was not a great investment from the beginning, but we realized this fact, after we tweaked our valuation model.

POZN – 27%; A medical research house, which sold some royalty and collecting licensing, but honestly, we were not familiar with the industry, nor the company's products. We are not sure whether the revenue is stable or if the products are competitive. We should stick to the business that we are familiar with and we have come to the realization that biotech/medical is not our forte.

NEM – 26%; We wanted to purchase gold, since it performed well in the down-market, as a hedge like VIX, in the event the market turned sour. We think of it as a 90/10 hedge, but in reality NEM is a cash cow and we wanted to scoop up a discounted co. with upside potential should gold price run up as well.

PDEX – 20%; The co. was cheap, relative to the book and the co. had low leverage and generated positive cash flow. A month after our coverage, the co. decided to sell the motor business, which

accounted for $3MM in sales, revealing a $4MM loss in revenues, from existing operations. Also, the operation was sold for only $800K, for a $3MM revenue business, which understates the value of the business, possibly hinting at concerns for the entity. Continued underperformance and possible solvency concerns from cash burn is weighing on the stock.

"This compares to fiscal year 2011 when our two largest customers accounted for 69% of our sales with the largest customer accounting for 51% of our sales. We have no plans to discontinue the sales relationships with our existing significant customers and have no knowledge of them discontinuing their sales relationship with us, except that in December 2009 our largest customer (the "Customer") informed us that it was in the process of developing, and planned to eventually manufacture, its own surgical devices which were functionally comparable to the products the Company provided to the Customer at that time. Pro-Dex had been the Customer's exclusive manufacturer of these products since they were developed. In June 2011, the Customer informed us that its product development had progressed to the point where it did not plan to place any new orders with us for these products beyond those orders already placed with delivery dates through May 2012, and we have received no such new orders.

In addition, the Customer indicated that it planned to limit repair requests from us to those Products A and B that are covered by our product warranty. Although we continue to receive repair orders from the Customer, there is no assurance that the Customer will continue to place repair orders with us, in which case repair revenue (for out-of-warranty products) would decline to zero or a negligible amount. "

We question the co's going concern in the next couple years.

Forecasting Revenue

Growth is one of the key drivers of value creation. Growth implies greater acceptance by existing clients and/or new clients, which means market penetration and establishing brand loyalty. However, growth can't be greater than the implied market penetration of the entire industry and shouldn't outpace the industry average. For example, let's assume a toothpaste manufacturer sells $1 MM and the total toothpaste sales is $100MM, or a 1% market penetration. Let's assume the market grows to $110MM or a 10% growth rate. If we forecast a 50% growth, then sales would be $1.5MM or a 1.5% market penetration, which may seem excessive, but still within the confines of the entire industry sales of $110MM. If we forecast sales of $120MM, then we know we are clearly wrong since the entire industry sales is $110MM. This tip comes in handy when forecasting 5 years out at 20% annual growth. 20% compounded annually for 5 years with starting revenue of $1BB is $2.5BB. If the market penetration goes from 30% to 90% in 5 years, then we know our forecast is off. We need to justify our assumptions with reality.

Korean Equities

Korean equities are a joy to invest in. Not only are the P/B exceptionally discounted, the companies are cash cows and deliver respectable returns over the equity investment. So, there is appreciation on both the book (unlocking the P/B to at least 1x) and cash flow fronts.

One play we are seeing across many of the holdings companies are a discount on the sum of parts of their holdings, relative to the market value. One exemplary stock was Samick Instruments, which held a 30% ownership of a publicly traded, US based co., Steinway Music. Steinway Music's share price jumped on news of a potential acquisition from 2 private equity bidders, but Samick Instruments' stock price did not reflect the holding's appreciation for a whole month. Granted, the offer was not finalized, but it provided an asymmetric risk/reward investment, with the downside fully compensated by a justified 30% jump.

However, in some cases in Korea, there are much larger discounts, which have been undisclosed for many years. These can be value traps which will require a lot of activity on the investors' part to communicate the investment appeal to the community. But the numbers don't lie and there is prime picking in Korea.

On the flipside, the value is offset by the higher volatility found in the market, with big price swings on bad news in the economy, geopolitical developments, or the US market.

Korea's market is still in its early stages, but is very well managed by large asset management companies. Many of the analysts have CFAs, and utilize a lot of the valuation methodologies found in other more advanced markets. Korea's derivative market is one of the largest in the world, so it will only take a few more years for the other products to catch up. Also, with a larger retiring population coming online in the next few years, more investments will move into the equity market.

SN Valuation Korean Portfolio

As of 2013-08-26

Buy

Name	Ticker	Market Price*	Entry Price	Date	Gain/(Loss)
Idis Holdings	054800	14.75	13.00	07/16/2013	13.46%
Moatech	033200	3.59	3.61	07/12/2013	-0.69%
Danawa	119860	8.82	9.38	07/22/2013	-5.97%
Kishin Elec.	092440	8.38	6.64	07/23/2013	26.20%
BYC	001460	192.50	196.50	07/29/2013	-2.04%
Korea Exp. Exc.	002200	25.20	25.90	07/31/2013	-2.70%
Biosmart	038460	2.38	2.58	08/01/2013	-7.95%
Dae Woong	003090	33.05	33.05	08/26/2013	0.00%
Chungdam	096240	15.15	15.20	08/01/2013	-0.33%
Average Total Return					2.22%

Follow

Name	Ticker	Market Price*	Entry Price	Date	Gain/(Loss)
China King	900120	2.46	2.30	07/17/2013	6.96%
Silla Trading	004970	25.20	29.70	08/05/2013	-15.15%

Fixed Income

The 3 components which create the Yield to Maturity or YTM, are:

1) Coupon rate
2) Capital appreciation
3) Reinvestment yield, on the cash from coupon

Market Rate (Target Rate)	2.75%
Coupon Rate	5.00%
Reinvestment Rate	1.56%
IRR	1.56%

Spread	-1.19%
Lower Purchase Price	

Par	1,000.0
Purchase Price	1,100.0
Capital Gain	- 100.0
Coupon	150.0
Reinvestment	2.4
Total Additional Cash Flow	**52.4**

Disbursed Cash Flow Table

	0	1	2	3	Total	% of Total
Coupon	0.0	50.0	50.0	50.0	**150.0**	**286.50%**
Capital Appreciation	0.0	-33.3	-33.3	-33.3	**-100.0**	**191.00%**
Reinvestment	0.0	0.0	0.8	1.6	**2.4**	**4.50%**
Total	**0.0**	**16.7**	**17.4**	**18.2**	**52.4**	

Cash Flow Table

	0	1	2	3
Cash Flow	-1,100.0	50.0	50.0	1,050.0
IRR	1.56%			

IRR Growth

	0	1	2	3
Cashflow growth at IRR	1,100.0	1,117.2	1,134.6	1,152.4
Annual Growth		1.56%	1.56%	1.56%

Sensitivity Table	
Purchase Price	**IRR**
500	34.15%
600	25.71%
700	19.02%
800	13.55%
900	8.95%
1000	5.00%
1100	1.56%
1200	-1.47%
1300	-4.18%
1400	-6.61%
1500	-8.82%

1) Coupon rate is self explanatory. It is the cash flow for the investor, which can be reinvested in a bank, or other holdings, or held in a safe yielding zero. The higher the risk, the higher the coupon rate.

2) Capital appreciation is the difference between the disposition price and the purchase price. Let's assume we purchase at 1,100 and we hold until maturity, and receive 1,000. This means, in the capital portion, we will realize a loss of -100, or over 3 years, -33.3 each year. Why would anybody purchase a bond, to realize a loss in the capital portion, which is a large portion of the total return? Bill Gross, fund manager at PIMCO, discussed the same dilemma for US Treasury investors. They are purchasing the bonds at a premium, which will result in tiny returns, probably less than 2%. So he sold off on his Treasury holdings, but his call was off because Treasuries actually rose in price, which made even less rational sense. Europe turned sour, pushing investors to safe havens like USD, JPY and US Treasuries was a safe bet. Although it was practically a zero return, and on a real return basis when taking into consideration inflation, a negative return, but it was safer

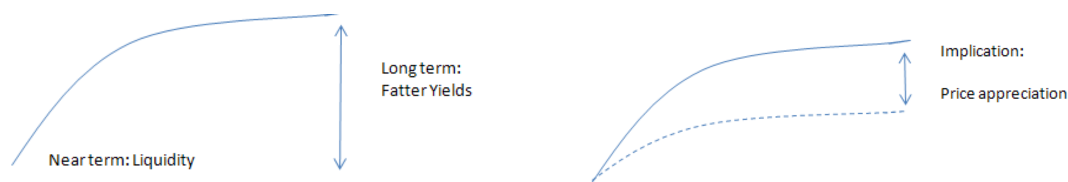
than parking the capital into the equities market. Some funds are obligated to keep a high capital invested ratio, so they put it into bonds, instead of cash.

3) Reinvestment yield is a tiny part of the total yield, but is an important concept to consider. YTM, or IRR, assumers the cash received from coupon payments are reinvested in another security yielding the same rate as the bonds' IRR, which is a lofty and uncertain assumption. So if we receive coupon payments of $50 annually, IRR assumes we reinvest in another investment that yields 1.56%, which may not be the case, if we keep the cash in a bank account. So, it is safer to zero out the reinvestment rate, and be surprised with a higher return at disposition, rather than assume a high reinvestment rate and be humbled by the weaker results.

Strategies

Now that rates have bottomed out, the potential for capital appreciation is limited. We believe the fixed income money will flow out to real estate, or dividend paying companies, or High yield bonds, as investors rode the interest rate fall with QE stimulus packages, as well as the post-2008 crisis capital appreciation upswing as well. Now, corporate bond prices have leveled out and interest rates have nowhere to go but up.

Barbell Investing comprises investing in near term maturities for liquidity and far term for yield. Also, importantly, barbell investing assumes a flattening of the yield curve, which implies far term's yield will diminish, which means the price for the long term maturities will appreciate. So, on top of the fatter yields, there will be a capital appreciation.



Let's assume a 3 year bond is selling at 1,000, or par, and coupon is 5%. Then the annual yield would be 5%. However, if the market yield decreases to 4%, this would imply a price of roughly 1035, or a 3.5% capital appreciation.

Market Rate (Target Rate)	4.00%		Spread	-0.26%
Coupon Rate	5.00%			
Reinvestment Rate	3.74%		Lower Purchase Price	
IRR	3.74%			

Par	1,000.0
Purchase Price	1,035.0
Capital Gain	- 35.0
Coupon	150.0
Reinvestment	5.7
Total Additional Cash Flow	**120.7**

Disbursed Cash Flow Table

	0	1	2	3	Total	% of Total
Coupon	0.0	50.0	50.0	50.0	**150.0**	**124.29%**
Capital Appreciation	0.0	-11.7	-11.7	-11.7	**-35.0**	**29.00%**
Reinvestment	0.0	0.0	1.9	3.8	**5.7**	**4.71%**
Total	**0.0**	**38.3**	**40.2**	**42.1**	**120.7**	

Cash Flow Table

	0	1	2	3
Cash Flow	-1,035.0	50.0	50.0	1,050.0
IRR	3.74%			

IRR Growth

	0	1	2	3
Cashflow growth at IRR	1,035.0	1,073.8	1,114.0	1,155.7
Annual Growth		3.74%	3.74%	3.74%

Laddered investing involves purchasing maturities along the yield curve and rolling the yield by reinvesting the proceeds from matured securities into the long term tail of the yield curve, thereby mitigating interest rate risk and receiving predictable returns.

We would like to point out the steepness of the yield curve is most prominent from years 5 to 10, then flattens afterwards. So, the sweet spot is from 5-10 years, when implementing this strategy. One could allocate 10% of capital on an annual basis from year 1 to 10, and roll the near term maturities with a 10 year maturity in Year 11 and so on.

Duration is the change in price from 1% change in the rate. Long dated securities are more volatile to the rate changes while near term securities don't fluctuate as much. Traders are more willing to trade in and out of long term as maturity is still years away, so they could enjoy higher yields for longer periods of time, whereas short term securities don't offer a long term benefit to holders.

Market Data and Strategy

1) Thought, 2) Action, 3) Result. For example, 1) they saw a divergence between US and European growth rate, with Europe facing a mild recession. 2) They overweighted (Buy) US Treasuries, and chose long duration, or typically longer maturity bonds which would react with more volatility. They underweighted (Sell) German duration but moved toward neutral position by end of the quarter. 3) US Treasury bond yields declined, which was prompted by an appreciating US Treasury bond price from flight to safety, and the higher duration bonds would have responded with a

more pronounced movement. German Bunds didn't move down as anticipated, so they lost a little money there, but they also underweighted Spanish and Polish bonds.

Intel issued $6 bln of senior notes. $3 bln matures in 5 years (2017) and rate at 1.35%, $1.5 bln 10 years at 2.7%, and $750 mln 20 years at 4% and $750 mln 30 years at 4.25%. The co. will use proceeds for general operational usage and repurchase shares. The cost of debt is much cheaper than cost of equity, so they will have a better corporate cost of capital by locking in the low rates. Intel has a strong, healthy balance sheet with minimal leverage and ample cashflow to service the debt. The book runners, BOFA and JP Morgan, took a 0.375% cut, or $22.5 mln and the co. is issuing slightly under par, around 99.50%.

I personally wouldn't touch these securities since they are low yielding. What is an annual 1.35% for a 5 year hold? Also, there is no material appreciation for maturity, so YTW, as it is not a callable bond, is same as YTM. We wonder where rich individuals place their capital? If they put it in the bank where they receive less than 1% interest, on a real term basis, they are losing value. We wouldn't expect them to keep in a single bank, more than what is guaranteed by the FDIC. So if they have about 10 bank accounts, they could hand the cash with a certain sense of assurance for about $2.5MM, or 250k each bank. So the remaining cash, we imagine they would place in fixed income funds, which are generating at least 5%, with the possibility for appreciation, although the trade has nearly run its course, relative to the discounted prices last year when Europe's problems came to the forefront.

However, many investors are still willing to invest in these bonds, since they are yielding slightly higher spread (1.3%) versus comparable 5 Year Treasuries (0.6%), or a 0.7% spread, which is the premium for the Intel bond. Of course, there is entailed risk since it is a corporate entity and Treasuries are considered risk free. Individual investors are better off holding monthly distribution funds, where payments are received monthly. Let's assume a 6% annual distribution, or a monthly 0.5%. If the investor holds the bond for 3 months, they might be able to obtain a 1.5% return on a par investment, and keep the cash in a bank for the remainder of the year and still generate the same returns, if the exit is also at par.

Look at the paltry returns the Treasury securities are creating for the investors. All for conserving capital?

Date	1 mo	3 mo	6 mo	1 yr	2 yr	3 yr	5 yr	7 yr	10 yr	20 yr	30 yr
12/03/12	0.13	0.10	0.14	0.18	0.25	0.34	0.63	1.05	1.63	2.37	2.80

It doesn't seem rational to be content with measly returns, for the sake of principal preservation.

Could this be the differentiator between mediocre investors and Graham Doddville class investors? Would the elite investors be content with 1% returns in the name of principal preservation, or would they aggressively pursue multi-baggers? We think they would be in the latter group.

US Treasury 10 year yields at 1.60%. Yields crimping from risk aversion and flight to safety picks up as we approach fiscal cliff deadline. Talks of Korean central bank to raise rates after 3 successive rate cuts as of late. For the short term, buy the 30 year US treasuries as yields decline, boosting prices and will receive an amplified return from higher duration, longer maturity securities. Recent Treasury auction participation was strong, fueling the scramble for safer investments. Once the fiscal cliff hurdle is past, expect less demand for Treasuries so should anticipate a sell off pushing yields back up. One could pick up some short Treasury ETFS to partially hedge the long Treasury, or go with full conviction and take a short position, which we err towards.

The chart compares the Short ETF (Blue) and the Interest rate (Red). If the rate increases, the price of bond decreases. However, since we are shorting the bonds, we will make money with the increase in yield.

Compare the above chart to the chart where the Short ETF (Blue) is an inverse return relative to the Long 20 Year Treasury (Red). The Short ETF is much more reactive and volatile, most likely since it is a leveraged portfolio.

Yield Curve Spread

Yield curve spreads are used to compare the yield curve for differing credit securities. It is an intuitive, useful tool to measure the risk adverseness in the market, similar to peer P/E multiple averages in equities. However, in itself, it carries little meaning as it does not reveal the intrinsic value of a bond. The value of the bond is based on the assets of the entity which secure the bond, be it the cash flow or the already acquired asset.

Prospectus

The prospectus for publicly traded corporate bonds can be found in the SEC website under the 424B2 filing.

Current Events

Commentary - Economics enraptures the entire financial, business system and a recent read helped to nail this home for us. The writer hit on the following points below. Economists analyze countries, while analysts analyze companies. Hurricane Sandy, weak Christmas season, Fiscal cliff on the radar, but no mention of the still unfolding European crisis, which seems like a deliberate censoring, rather than an observation of an actual defusing situation. China's recent indicator hinting of improvement easing concerns of a hard landing. What has happened in the past month to fix these previously abhorrent, looming financial crisis i.e. hard landing, European crisis? Central bank interventions? Currency dumping? Do these monetary policies fix the underlying, core issues? We think not. Don't write off the crisis so easily. It has yet to rear its' ugly head.

GDP – Strengthening economy (3.1% vs. 2.7%). Fiscal cliff has been avoided for now, but kicked the can down the road. Weak Christmas season offsets the slight improvement to investor sentiment. May see a weakening in Q2, when the budgetary issues need to be addressed.

Employment – Strengthening as well; rate at 7.7%. In particular, California and New Jersey.

Business Activity – Stronger durable goods activity. Machinery sales slowed, as companies are hesitant to invest in capital goods at this juncture. When this data point strengthens, recovery is firmly in place. Increased business activity with the current machinery, but zero future investment, can't translate into future growth. Business activity is the key driver for growth, not consumer, nor

construction. Surely, the actual manufacturing could take place outside the border. So we must check Chinese machinery orders, since they will purchase them and Japanese/German exports, since they manufacture a majority of the machines.

Construction Activity – Single family prices are raising steadily, on back of low rates and prices. Inventory of homes around 5 months.

Consumer Activity – tax withholdings related litigation will have a large impact on consumer spending habits. Christmas season was weak and will stay pat until employment figures improve. Pundits raise concerns over inflation stimulated by the QE activity, which will dampen spending in the mid-term. Also, read supply concerns over commodities will also pressure prices.

Interest Rates – rates at lows ranging from 0.7% to 3%. German/Treasury spread at 0.3% for 10 year as German bund rallying, not over safety haven but increased liquidity. Tax exempt bonds on the board for review under the fiscal cliff related legislation. Yields were lower relative to taxable, but now even, implying probability of losing benefit of full tax exemption for interest payments to the top tax bracket. Greek/Portuguese yields at teens.

There are a few more points we did not include in our update, primarily due to food coma, but bond investors aggregate all these data points and make a conclusion of how interest rates will move, which affects the bond price (duration, convexity).

The FED

Eye opening material right here boys and girls. Mr. Gross discussed how the central bank operates and put it in plain English. We love zerohedge, but so much of their material is difficult to interpret, so we appreciate Mr. Gross' succinct explanation. The FED purchases Treasuries at no cost since the sellers, or primary dealer banks such as BofA receive a credit, known as reserves, kind of like an IOU from the FED to the banks. Although the FED itself is purchasing trillions of dollars using their credit system, they don't have the assets to support, or put up collateral for their debt – a highly leveraged operation, and we know what happened to the high flying, debt machines during the Great Recession.

The FED receives annual interest, which is paid by the government through taxpayer money. The FED then sends the interest money back to the government, thereby paying down the cost of the financing for the Treasury. In essence, they are financing their Treasuries with zero interest bearing IOU, and then repaying the IOU with the interest received on their Treasury investment. This is why the FED could print trillions of dollars in cash, and purchase $85 billion in mortgage

securities/month. In fact, the more securities they purchase, the more interest revenue collected by the central bank. The central bank supposedly only remits the profit to the Treasury, after issuing 6% dividend to the member banks, which are the primary dealer banks plus some others. But when one considers the zero cost of financing through the credit, reserves, then the interest received will essentially flow down to the bottom line. So, $2.5 trillion of investments, and let's figure 3% interest, then that alone is $75BB annually.

It's like COMPANY A, issuing corporate bonds and INVESTOR A, purchases the bonds and remits the interest received back to COMPANY A, thereby reducing COMPANY A's debt outstanding, and in due time, washing out the debt completely. Where did INVESTOR A get the money to purchase the bonds? INVESTOR A gives credit to LENDER A because LENDER A is a friend of INVESTOR A. INVESTOR A could, would bail out LENDER A, should LENDER A run into future trouble. That, my friends, is the system we have in place today.

What does the government do with the money received from the Treasury issuance? They have more USD and they use it in their budget to buy more stuff and spend more stuff for defense and non-defense budget. The US defense budget comprises more than 50% of the budget, mainly attributable to the financing in Iraq and Afghanistan. So more USD printed. If Korea, or a non-super power installed a system like this, the system wouldn't last for long because only the USD has the clout as the global trade currency to support the system, which is why the USD isn't devaluing into toilet paper.

Bond Unwinding

If one takes a look at a typical fixed income portfolio, you will notice most of the bonds were purchased near par, or above it. I would say 90% of a bond was purchased at par or above. The long term implication is a devaluation of the portfolio as the bond approaches maturity. Also, with rates at historic lows and an improving economy, the FED may take a more hawkish stance in the next couple years and start increasing rates, thereby further devaluing the bonds, from the unprecedented historic highs seen today. So, if a bond has an average weighted nominal coupon rate of 6%, the total return on the portfolio will be south of the 6%. The reason why there was a flurry to the fixed income space was 1) safe haven, 2) more importantly, the bonds which were selling at depressed prices during the Great Recession at 20-40 range, appreciated like an equity and investors were reaping 15-25% annual returns during the past couple years. Now that fixed income prices have stabilized for the most part and interest rates globally have hit bottom, the only investment proposition provided by the fixed income portfolios is 1) safety haven. We can anticipate returns very near the average weighted coupon rate of the portfolio from now on.

Duration

With the FED's imminent tapering announcement, possibly as early as Q3 2013, interest rates will rise, meaning bonds with a higher duration will react more negatively to the news. Bonds with longer maturities, higher coupons, will realize lower returns versus their lower duration peers.

In the August edition of Insight by Pimco's Bill Gross, he writes that carry, or returns, can be improved by different strategies, other than extending the maturity, or investing in longer dated bonds. These options include credit spread, which would mean riskier sovereign bonds, and corporate bonds. Also, currency gain from investing in different currencies.

In other words, to generate the returns seen from 2009 to 2012, one needs to invest in more riskier, more complex investments, to replicate the gains received by simply investing in a US treasury in a downward trending interest environment.

In a tapering environment and higher interest trending mode, one can expect lower than coupon total returns. There is no way around this.

Real Estate

Current State of Affairs

Fiscal cliff concerns, global economy slowing, possible US recession. IMF, FED anticipating slower growth and concerns related to the $1.2 trillion in spending cuts and tax cut expiration. Consumer confidence, job growth slowing, and slower existing home sales are indicators of the choppy waters ahead. We can see apartments are rated the highest among investors, with hotels/industrials coming in at 2nd. Apartment vacancy rate is 4.7% and rental revenue growth is 3.1%, the lowest and highest among the sub-classes. Also, NCREIF realized returns were 13.2%, top of the sub-classes. Realized and implied cap rates ranged from 5.5% to 7% among all the different property types. Apartment median sales price was about $100K/unit. Historically, even with the real estate market collapse in 2007-2009, real estate investments have performed better than any other asset class.

GDP at 1%, trend is a slow down. Fed has kept rates at their lows since beginning of 2009. They have also conducted quantitative easing. Unemployment has improved since reaching peak at Sept 2009, but still not budging below 9%. CPI peaks in the summer and winter, with higher energy prices, and in the summer, with the drought news affecting food prices. Retail sales are dipping again to 4% YoY growth, after rising from -10% in Apr 2009, and peaking at Dec 2010. 2011 was the unfolding of the European financial crisis, and 2012 was the resolution year. Consumer confidence was at +100 up to mid 2007, but crashed to 20 at April 2009, then picked up again until it reached 80 at Dec 2010, but dipped in 2011 (Europe) and in the short-run, is dipping again. The curious economic index is related to real estate. Why are home sales stronger as of late when unemployment is still weak, Europe, fiscal cliff in the headlines? The fact is the economy has improved over the past 5 years, people saved up, apartment prices are expensive, rates are cheap, home prices are down, and different asset classes not returning favorable returns.

One must find the source for the real estate recovery news surfacing in the headlines. Why are people talking about a real estate recovery while others are focused on an impending recession? Is this hypothetical recession, a macro event triggered by the fiscal cliff, and the real estate recovery sector specific? Overall, optimism surrounding the economy in 2013 is steady amongst the analyst community.

We are set in our mind when it comes to analyzing a company or a specific investment security for its' investment merit. However, we don't have a strong grasp, and honestly, even an inkling of an idea, when gauging the economic barometer. Our due diligence consists of aggregating news clips from a variety of sources, so we can't see the full, true picture. To us, in

our gut, news of economic recovery doesn't sit well. How can the recovery be in place, when the system is defunct? Does recovery mean YoY improvement, but turning course on a dime from bad news in Europe, or is it a full-flung recovery, a flushed system, a full removal of 2008 gunk? The losses held by the private banks were transferred to the FED and the FED printed more money, so the burden has now shifted on the U.S. taxpayers. This is the spiel regurgitated by bloggers and columnists on the internet. Is this true? Sadly, we have more questions than concrete answers.

On the foreclosure front, filings have declined YoY as housing price improvements have lowered LTV figures, and some underwater mortgages are now in the black, providing incentive for mortgagees to keep current on mortgages. A recent survey completed by renters reveals they are inclined to purchase a property in 2 years, propping forecast estimates on the demand side, and another reason for current owners to remain current on the mortgages. As the distressed inventory sells off, and housing prices continue to climb in the single digit, we believe investors will allocate capital away from equities into real estate. Employment figures need to improve dramatically to set a firm footing for real estate related securities.

One columnist suggests 1) QE3, FED money and 2) mortgage banks holding real estate properties off the market to constrict the supply of for-sale properties, is contributing data points which signal improvement. QE3, where the FED would purchase mortgage backed securities, drove up the prices for these securities, lowering the yield. This affects the MREITs, which are REITS that purchase the MBS, and depend on the yield from the MBS to pay out dividends. MREITs typically finance the MBS purchases from repo financing, which have near 1% interest costs. With yields compressing on the MBS, MREITs are facing slimmer margins, placing some MREITS on the chopping board for short investors who are expecting dividend cuts.

Recovery for short term? Yes. In 2013? Yes. Full recovery, meaning home sale price improvement including shadow inventory? Not sure, and remain skeptical. We feel it is premature to participate in the real estate market right now, although it may be a great investment in the big scheme of things. Revert, always revert means things have a tendency to switch back to the mean, or the norm. Is the real estate norm the prices we saw in the run up to 2007? We think not. We think the norm is our current level, but anticipate investor frustration to fuel another bull rally in single-residential properties in 2013. In summary, short term 2013 rally, but not a fundamental, full recovery.

J Curve

The investment cycle, from acquisition to value add initiatives to disposition is commonly referred to as the J Curve, as the cash flow dips in the initial 2-3 years during the renovation period, then improvement accelerates as the property is positioned for a road show to potential bidders. The trough of the cycle will reflect a higher vacancy rate, lower rental prices, higher concessions, and most importantly, renovation costs, while the acceleration will include improving vacancy, increasing rental prices and a drop off of the renovation costs.

Unlike a conventional investment in a value property, where cap rates are high, and the investor receives fat checks on a routine basis, redressing and repositioning a Class B, or C to Class A property requires much capital, operational finesse, and negotiation skills. The core function in the due diligence, leading up to the firm offer, is modeling the cash flow and determining the concluding IRR from the investment. We have constructed a simple financial model, to provide a sample illustration of the J Curve in action.

Most of the line items are the same, except the cost of renovation must be included to calculate the IRR. Numerous assumptions must be incorporated, such as the market's reception to the renovation, on a dollar for dollar basis. If we invested $10,000 into a property, how much more could we reap at the time of closing? How much more rent could we charge with the upgrades? How much lost revenue will we realize during the construction period? Will the contractors fully deliver on their quotes and promises?

One issue we came across was whether we could continue to depreciate an asset, which has been fully depreciated by the previous owner. Let's assume a building was constructed 100 years ago and the previous held unto the building for 50 years. We could safely assume the owner took full advantage of lower taxable income by fully depreciating the building, where the carrying book value is now zero. However, at the time we assume ownership of the building, we purchased it for $1.25 MM. Then could we, as the new owner, anticipating 25 years of use for the building, depreciate the $1.25 MM for 25 years? If yes, then we can pay out less taxes in cash.

Before 1986, many investors would realize losses for taxable income and use the NOL carry forwards on their other income, which has now been amended so that tax shelter is only applicable to other forms of passive income. The sales price minus the book value or purchase cost minus the depreciated value, is taxed at 25%. The actual gain realized, or sales price minus the historic, non-depreciated value, minus the 25% taxable gain value, is taxed at 15%.

Purchase	1,250,000
10 year holding	
Depreciation over 10 yrs	454,545.45
Cost	795,454.55
Sale Price	2,500,000.00
Actual Gain	1,250,000.00
Paper Gain	1,704,545.45
25% Tax	1,250,000.00
15% Tax	454,545.45
25% Tax Amount	312,500.00
15% Tax Amount	68,181.82
Total Taxable	**380,681.82**

REITS

REITS are legal entities where they obtain most of their income from real estate properties, or mortgages and they pay out 90% of earnings as distributions to investors. The REITS obtain financing from equity investors and debt financing, rarely in the form of mortgages, or primarily bond issuances. Mortgages are property specific, whereas bond issuance provides a capital pool for use at the manager's discretion, for either investment or operational purposes. The spread from the return on the properties and the cost of financing is distributed out to clients and they can anticipate low single digit returns in today's market.

Since earnings are not retained, in order for REITS to realize growth, which would appease equity investors, the co. borrows more money to grow the portfolio size, thereby realizing a larger reported cashflow by taking advantage of the positive NIM spread, contributing to more distributable earnings.

NIM spread = EBITDA/book value of buildings – annual interest cost/book interest bearing debt value

REITS may be product specific – mortgages vs buildings, and sector specific – real estate properties owned solely by certain sectors.

With equity or fixed income portfolio management, a main concern is reinvestment risk. For RE portfolio management, the main concern is finding new tenants when leases expire. The leases aren't for long periods –maybe 5 years for commercial and annual contracts for multi-family, so it's like operating a short term bond portfolio.

When calculating the operational spread, or the return from assets purchased through debt financing compared to the cost of debt financing, we must use related figures. Let's assume, the co. borrowed $1BB at an annual cost of 5%, or $50MM, in annual interest. If the assets purchased

using the $1BB generates EBITDA, or cashflow before accounting for the next expense line, which is interest cost, greater than the annual interest cost, then we can anticipate a higher book value for years to come as retained earnings will grow SE.

Property Investment

The market has been volatile, to say the least, during the past 5 years. As a result, potential investors have been saving up their down payment stash and staying out of the market. They have been taking advantage of the lower interest rates by refinancing their mortgages and saving money from lower monthly mortgage payments. Also, with interest rates low at savings and Treasury investments, investors are seeking higher yielding securities, with fixed income and dividend paying equities absorbing the risk adverse capital. However, more and more optimism is surrounding the RE market in general. Large institutional investors have been swooping in to the distressed RE side and picking up great deals on single-residential properties either in foreclosure, or in down trodden markets like Los Angeles, Phoenix, Las Vegas, Dallas, Atlanta. Investors are coming out of the woodworks again and related suppliers and construction co.'s are picking up lost traction.

Financing

Property investment is the closest the average retail investor will get to managing and operating a LBO deal. 20/80 deals, or where the home buyer would pay 20% of the purchase price with cash and borrow the remaining 80% may not be as common as before, as banks clamp down on leverage, which implies risk. But we foresee a comeback of leveraged deals once the economy is able to stand on its own, maybe near 2014/2015. Single-family residential properties typically account for the largest share of an individual's wealth and it's purchased with the help of the mortgage providers. Commercial banks normally have a mortgage division and they receive deposits from retail depositors, who are paid 1% interest, or almost nothing in today's interest rate environment, and the bank in return lends out the money to house buyers, via mortgage, thereby capturing the spread, similar to the REIT we just described above. The bank will be the owner of the property until the homebuyer pays back the principal, when the ownership will transfer to the homebuyer.

A typical homebuyer could go through a mortgage broker, who shops around at different commercial banks for the best rates and promotions. For the brokers' services, they are paid a commission fee, typically a point, or 1% of the entire mortgage balance. So, if a buyer borrows $200,000, then the mortgage broker would receive 1% of 200,000, or $2000. So, essentially, the commission fee would be rolled into the mortgage, and the borrower could receive financing with zero cash up front, and receive $198,000 to be applied against the purchase price.

What are the steps and considerations for purchasing a house? We will go through these items, step by step, in this piece.

1) Find the property. Run due diligence by talking with a real estate agent, broker and visiting the properties that fit your check list. 2 Bed, 3 Bed? Granite countertop? Large lawn?

2) Financing. Interest rates are cheap lately. 3-5% in the States for 30 year fixed loans. There may be upfront costs, but at the current environment, they may be forgiving in rolling those costs into the loan. This is possible if the Loan to Value ratio, or Loan amount/market price of the property, is not in the high range (over 70%).

   A. Monthly payments. Many potential buyers are current renters. The benefits of renting is zero insurance and tax concerns, and related home ownership costs. Of course, there are tax benefits derived from the mortgage payments, but those who are strapped for cash are better off making minimal payments, so sticking with renting. Home owners need to pay for PITI, or principal, interest on mortgage and tax and insurance. Also, if the LTV is above 80%, mortgage banks will require mortgage insurance, which is an additional item. Also, maintenance costs, renovation expenses, and monthly utility bills will make monthly expenses too expensive for some.

   B. For those who are looking for an investment property and have the cash to make the down payment, it may be economical to do so in today's market. Low purchase price, low cost of financing, upside potential with the market recovery are favorable for a longer term investor (2-3 years hold). Also, higher rent will service a larger percentage of the mortgage payment cost, thereby less out of pocket cost while waiting for the property price appreciation.

3) After locking the financing, it is a matter of working with the title agent, mortgage broker, real estate broker. Most likely, the real estate broker will be in communication with the related parties and notify the buyer of pertinent matters, but the purchaser should be on top of things as well. It is a relatively simple process, but will require a lot of attention to detail to get the ball rolling.

We have provided a mortgage calculator in our Real Estate tab. http://www.snvaluation.com/real-estate.php

Now a days, a house doesn't represent home; it is more so an opportunity to capture appreciation gain, than anything else. So, the mortgage calculator will provide insight to cost/benefit analysis to renting vs. buying.

One thing is certain – single family residential pricing is climbing up in different metropolitan pockets in the US. Going back to the NYU Professor Damadoran's blog posts, value and pricing is different. The intrinsic value of houses, is roughly 10x annual rent income. So if a house can rent at $2,000/mo, or annually $24,000, then the house could sell for $250,000. This would be similar to a P/E multiple of 10x, a 10 handle, or a 10% yield on the investment, which is close to the 7-8% cap rate, on larger, commercial properties. Yet, we know that these properties are selling for 20 handles, which is where we can see the divergence between value, as stated above, and pricing, which is driven by supply/demand. Value is somewhat fixed, whereas pricing can sway into the fringe.

We are picking up more news related to pricing recovery in Los Angeles, Phoenix, Vegas in the West. These areas have large population growth and the demand is present for another recovery. We knew in our hearts that they would recover from the floor pricing, but it was a matter of time. We don't believe housing **prices** will return to the heydays, and if it does, it is not justified. Of course, flippers will ride the wave all the way to the top, before the poor investor at the top crashes with the market. And we know what happened to the global economy, when the market unraveled. We believe this could happen again in the future, seeing how 1) mortgages are still being securitized, albeit certain regulatory legislation is putting stricter controls on the underwriting process (robo mortgages), so the transfer of ownership, thus risk, is continuing to be spread to investors globally, but with less risky subcomponents 2) banks like Wells Fargo are ramping up their mortgage units, and we know greed begets greed, and we will soon see banks making risky, zero docs, or a differently named mortgage, available to the borrowers, with banks absorbing large non-provision losses on their books, and the list goes on.

In our capitalistic society, it is impossible to segregate greed and growth. Although we don't necessarily believe Greed is good, it does fuel the booms and catalyzes the bust, so greed will resurface from its' 5 year slumber. Has anything really changed? We believe patches have been placed, but no material overhaul.

Soon, real estate frenzy will take its place as excess liquidity from QE shifts from fixed income, to equity, to real estate. Banks are well capitalized and mortgage lending is becoming more lucrative. They will gradually lower requirements and sub-prime mortgages will pick up, opening up opportunities for new home owners to purchase homes, pushing up prices, and current homeowners getting out of negative waters. This will create more transactions, more

headlines on the news, and a full blown real estate recovery will lead to job creation.

One thing is for sure: had the government not intervened 5 years ago with the bailouts, stimulus, and monetary policies, the market would have crashed and the economy would have collapsed. Today, the same follows suit.

Business Startup

Until one starts a business from scratch, it is difficult to understand the nuance of business operations, financing and strategizing. So far, SN Valuation has ventured into 1) financial content writing and 2) tutoring services, with plans to go into 3) manufacturing, 4) import/export. We have minimal capital at the moment and believe this to be for the benefit for the readers. We want to show to the readers that business building may require capital from the start, but there are ways to work around this major obstacle.

1) We must **finalize the business plan before obtaining capital**. The notion of obtaining capital before starting a business, will set the co. back years before launching out. It is never an issue of financing, as it is with the issue of the business idea. So many people don't even start a business plan, simply because they don't have money. A business plan fleshes out the day to day task and important relationships into words. Who are the customers? Who are the suppliers? What function does the business perform? What capital is required? For what purposes? What return can an investor expect? How is the risk of default?

2) **Realize the barebones operations** and focus on completing the system before investing in amenities. Does the business require an office? Separate telephone number? Website? Additional employees? Are these vital in carrying out the barebones task, or are they luxuries, which can wait? **It is like a reiteration**. Once the barebones system is finalized the process can be fine tuned over time, as the system is reiterated over and over again. Car manufacturers design the engine before putting on the body with leather seat, and fancy rims. The barebones operations, or the engine of the co, must be completed before the fancy office is furnished and business cards printed.

3) **What is the core proficiency** the business carries out? Let's look at a website content provider. The co. could invest in a website designer to make a fancy website which would drive traffic and encourage repeat visitors. The revenue would come mainly from advertisements on the website. However, the **core proficiency is writing articles, commentary and etc.** A fancy website with zero content is ludicrous. It doesn't serve its purpose, and the purpose is writing insightful, breaking news articles.

4) **Write out the co.'s vision, goals, philosophy on a routine basis**, to clarify the co's priorities and tasks. We write an annual shareholder letter, which provides a high overview of what we performed in 365 days. So much work can be conducted in 1 day, let alone 365 days. But, was the work productive? Was the work geared toward 1) fulfilling the business plan goals, 2) carrying out the core proficiency, 3) fine-tuning the system? If we just do a lot of busy work, and never hitting our target, then it was a lot of sweat, but no fruit. Changes must be made and the

operations must be reoriented to hitting the goals.

5) **Don't rely on support from family, friends, or colleagues. Nobody will believe in your venture.** They will only pat you on the back, once they see the finished product. Therefore, one must be bull-headed and stick with the plan secretly. Should one's progress hinge on the acknowledgement from others, the project will not materialize. So, focus on the goal, not other people's opinions.

6) **Take a long term approach, say 15 year timeline,** rather than a 6 month or 1 year timeline. It takes time for processes and specialty niches to develop during the 1st year. The real engine is fully constructed around the 3rd year, at least in our experience. Then, the core proficiency can be fully displayed at that time. Building a business is not a rickety operation. It takes much time, energy, experience, knowledge and invested capital, to construct a stable base to fully perform the initial envisioned business.

7) **Get daily inspiration and insight from other people's finished work.** Anyone can start a business, but only those who persevere will be successful. So, one needs constant uplifting messages and inspiration, and dream, to take away from the bombardment of distractions, which will affect one's thoughts, morale, energy, purpose in life. If one runs on empty for a stretch of time, then soon, one will want to give up. It is crucial during these lull period, to find motivation to kickstart the engine. Ours is found in the Bible, the message of life, which feeds us when we are distressed or need an external source of energy, not inherent in ourselves.

8) **To succeed in business, you must be in business**. Heard the quote online and recognized the truth behind the quote. Don't think about starting a business, don't only plan it, do it.

1) Make a roadmap - event, causes, outcomes, and resolution

2) Conduct exhaustive research, due diligence

3) ACTION is key. Act, act, act, on the proprietary research

4) Business development

Great organizations such as Bernstein, McKinsey, BCG, Goldman, exists because their research is comprehensive and they execute on their research. Without research, their investments would be much more risky and flawed. Research is the foundation on which any ground breaking organization must build on. From research comes innovation and innovation increases profitability.

We must make the roadmap.

We will focus on developing a business.

1) Assessing current situation

   A. No seed capital

   B. No clear product

2) Where do we want to go?

   A. Make a product business by end of 2014

   B. Make $5000 a month from business

3) What obstacles lay in our way?

   A. No money

   B. No product

   C. No experience

   D. No faith in the possibility

4) Is the goal feasible?

   A. Absolutely

Now that we are aware of the situation, we must dig into the research.

Over the past 4 months, SN Valuation has been researching electronic gadgets and website ideas. I bought electronic kits, spent many hours researching online, visiting stores, asking people about my ideas, reverse engineering actual products. It is a committed passion. Meaning, I have committed myself to this task and solely this task in my free time. It may seem like tinkering at first, but it's a learning process. Researching is as much tinkering as it is reading books.

Warren Buffett once said he reads 1,000 pages of data and information each day. The work for investors is reading and analyzing, but mainly reading a ton of information. He probably has acquired a mental filter which filters out the noise and only picks up the essential information and data. Also, he is probably able to spot trends and bigger picture items, as he has trained his mind to weed out the junk and focus on the pertinent pieces.

So, read a wide breadth of subjects and focus in on the subjects which are appealing. Dig deep, read a ton, write a lot about it, and try to summarize the main points into your own words. Try to explain the topic to a kid and thereby, you can see what is the most important data and what is superfluous.

1) **Idea is not important**
2) **Execution is the most important**

Businesses are tangible products and services. This requires a lot of work and investment to turn a concept into a real, reliable product. We should think 10%, and act 90%.

Case in point has been the development of our Kids' room at church. The place was very drab, and not fit for a kids room. The chairs were taking up 60% of the room, the wall paint was chipped, and there was no "kiddy" design or decoration, except a few year old, yellowing wall paper.

But in a matter of 1 month, with help from 5-6 people, we turned the room around and it looks awesome. It required a lot of work, and we must have invested about $300 buying the supplies and decorations. We had to work together, and it took about 20-30 hours. It was not easy, but our concept went from an intangible idea, into a tangible end product.

The business development is not just conceptualizing and thinking about the product. It requires real work. Roll up your sleeves, get ready for hours of work.

Also, we suggest a Blitzkrieg, or swift action, strategy. From conceptualization to taking the 1st steps, it should all happen within a matter of days. We could physically and mentally drain ourselves of energy and motivation if we drag our feet too long. Men are not inherently patient beings. We must keep the ball rolling and keep the momentum high, or else progress could slow down to a standstill.

There is no such thing as a perfect execution. It is all trial and error. Granted, experts can avoid the major pitfalls through their accumulated knowledge and experience. However, even then, nothing will come out perfectly. This is why we must run multiple iterations. By doing so, we can see what works and also, we can strengthen the overall process. So mentally, be prepared to fail on the first couple attempts, but work hard to see continual improvements until the Beta and Final versions come to fruition.

Why are we so adamant about business development?

1) Office work is essentially indentured servitude. We are servants of the master, who are the senior executives. While they make millions off the labor of the employees, the employees are stuck making just enough to make good on payments while working long hours.

2) Office workers will never make a lot of money working at a company. The salaries are capped annually, no matter how hard one works. Also, when one quits, all the work vanishes into thin air. The work will never be transferrable for one's personal usage.

3) On the flip side, as a business owner, the salary increase is endless. Granted risk abounds, but the positive is uncapped. And it forces one to be innovative, resourceful, strong, leader. It forces character development.

4) I believe it is also an innate part of who we are. We were meant to create, rather than to submit to remedial tasks. Many office workers feel lifeless. I don't believe this is what we were created to do. Machines can do those works now. We must be willing to take risk and start a business. Here lies the adventure.

5) We shouldn't quit our day job while developing the business. Again, this is a side business. One should only quit after the business has proven itself, with years of consistent cashflow, which exceeds the future income from the current full-time

Acquisition

Cash	2,000
Liab	1,000
SE	1,000

Cash	2,050
Goodwill	900
Liab	950
SE	2,000

Purchase Price	2,000

Debt Assumed	50
Contribution to Cash	50
Goodwill	900

I had the hardest time figuring out what it meant when the acquirer (the Co. who is buying the target) would assume the debt in the Target Co. Now, the way I understand it, the buyout structure is centered on the SPV, or the Special Purpose Vehicle, or an empty shell legal entity, specifically created for the acquisition. The entity with legal ownership of the Target Co. through the SPV is the equity investor, the likes of PE firms, hedge funds, wealthy individuals. They create the SPV, they put their money into the SPV, and the SPV uses the funds from the equity and debt investors, to acquire the shares of the Target Co. After consummation, the Target Co. will pay dividends or issue an intercompany loan to the SPV, which will then remit the interest payment to the debt investors. The SPV could send cash to the Target Co. to retire the Target Co's outstanding debt, which is what is meant by assumption of debt.

Economics

When constructing anything, it is important to start from scratch. If one wants to truly understand the mechanics of a thing, it is important to understand the beginning, and then build from there. So, in order to understand the economy, we need to start from scratch. Ray Dalio did a great job explaining the system, which we know as the economy and we wanted to share some of his ideas.

We think the history of money development developed as follows:

1) Self-sustaining
2) Bartering
3) Produce excess for luxuries
4) Golds, gems become standard
5) Paper money becomes more efficient
6) Nominal money in the form of credit is available

Let's assume we live in an island. It's a family of 4 and we can sustain ourselves by scavenging, fishing and using tools made from components collected from mother nature. So, we have a micro economy, without money, without credit. We are producing goods and don't need capital to start production.

Money is only needed when the production is conducted from outside our sphere of control, or ownership.

There is a neighboring island and they have goats, which are not available on our own island. So we first start to barter and trade some fish for some goats. Obviously, goats provide more utility than 1 fish, so they haggle up to 20 fishes for 1 goat. We can always catch more fish, so we call it a deal. We can essentially trade without money. So when does money come into play?

In and of itself, gold, gems have no value – unless it is not available in the counterparties' dominion. If they have a surplus of fish, and have a strong desire for gold, then they will accept gold as payment. So gold is really only accepted, when a bartering country produces enough to trade for luxury items.

But is the value placed in gold, gems a universally accepted perception? What if a neighboring island laughs at the idea of trading useful goods for a shiny rock? Then, between parties A,B, and C, lies arbitrage opportunities, since there is a variance in the value of goods.

Also, using gold as a set standard of value is misleading since a discovery of gold mines

increase the supply, thereby giving one country immense power over night, simply by finding more shiny rocks. On news of the discovery, the counterparty will demand more gold for the same quantity of fish, but the country will oblige since their gold mine will provide more gold. Thereby, the holders of gold before the discovery, will be left holding a devalued asset. This is true for dollar holders, who should see their dollar holdings devalued as the FED prints more dollars.

The idea of the 49'ers is amusing to me. Imagine, people becoming millionaires, by simply digging holes and sorting for shiny rocks? It is like people digging holes and finding dollar bills underground.

Single currencies can only be imposed by a governing government, or power. Who is to say that a dollar is worth anything, unless the government forces the creation of an economy run and operated by it, as well as an army to enforce and guarantee transactions with neighboring countries based on the usage of the currency? Universal currencies are fine, but a telltale sign of trouble is when they start to debase currency by removing precious contents from the coins (less silver, less gold), thereby increasing the number of coins released to the market. Soon, prices run rampant.

It is interesting how people are indoctrinated to trust in the dollar, although it has zero assets backing up the currency. It's a faith in the system, which is constructed by the government. The government, which started by the people, has now great influence over the lives of the people through the dollar. The government has the power to create dollars out of nothing and has much invested to lose control of the monetary power. I believe the US military does more to support the value of the USD, than any economic report. It is all about power, the power to create dollars, power to trade with dollars, and the power to destroy for dollars.

Closing Remarks

Investing is practical, educational, hardwork, exciting, methodical, logical, aggravating, consuming and is a great way to learn about people, values and the world we live in.

It has been a great ride over the past 4 years, documenting my thought on the market outside of a classroom setting, knowing the hurt of a downturn in the market and finding stability in a recovery stage. I have learned so much during the process and it has been bitter sweet.

I hope this piece of writing serves to inform the readers of the underlying valuation principles in a practical manner, while illustrating the interrelated nature of these seemingly different markets.

Don't let the market intimidate you. Always question the market and trust your analysis, as long as it is founded on facts. However, don't be foolhardy and completely ignore the market, for the market is comprised of many individuals and one should lean in on the squawk box when the market jerks.