Inside ALPHA Investment Club

Weekly Alert

Message sent on August 26, 2008 after market close

Trades to be executed at tomorrow Wednesday's open

WE ARE CLOSING THE ISSI TRADE AND STARTING A NEW POSITION IN CODI

Inside ALPHA Conservative model portfolio

- Sell all Integrated Silicon Solution Incorporated (ISSI) shares at the open
- Buy 700 shares of Compass Diversified Holdings (CODI) at the open, or the equivalent of 1/26th of today's closing account balance (rounding down)

Inside ALPHA Leveraged model portfolio

- Sell all Integrated Silicon Solution Incorporated (ISSI) shares at the open
- Buy 1,500 shares of Compass Diversified Holdings (CODI) at the open, or the equivalent of 1/13th of today's closing account balance (rounding down)

"Mental Stop" for CODI: $9.00

***Weekly Commentary**: If you’re a CC shareholder, you might need a solid sense of humor*

INTRODUCTION

As TheStreet.com staff reported this month, the good folks at Circuit City (New York Stock Exchange: CC) have gone MAD. Instead of focusing on a sinking stock (down 85% from its 52 week high), or a survival strategy to ward off nemesis Best Buy (NYSE: BBY), Circuit City’s management is spending its time battling another enemy: MAD magazine.

As Alfred E. Neuman, the longtime face of the humor magazine, would say: Yes, CC shareholders. You worry. Circuit City temporarily banished MAD from its stores’ shelves for poking fun at the retailer in a spoof entitled “Sucker City”.

The spoof features hilarious ads, including:

- no interest until 2010* on HDTV with picture-in-picture-in-picture-in-picture technology (*which will be six months after the warranty’s expired and you’ve hosted a Super Bowl party at which your drunken cousin threw a bottle of Rolling Rock at the screen when his team lost and you’ve given up all hope of “the beer drying out” and the set ever working again)
- a Hibachi 50” plasma HDTV set with 1280x1080 resolution that produces 33% sharper detail than the previous generation…which incidentally was featured in last week’s flyer for four hundred bucks more. Pity the suckers who bought it then!
- the Nintendo Wii™ “Guaranteed In Stock... if you’re friends with an employee who hid it in the back for you. Otherwise, ooh, sorry, all sold out.”
- and an Epilepsy Victim™ Bundle for Wii™ by Craptivision, including an optical disc & a bitestick controller

GET IT?

MAD also asks readers to visit its new Sucker City store “directly across the street from Best Buy” or “any of our other 600 stores directly across the street from 600 other Best Buys!” As TSC staff notes, apparently the only way CC can move products off the shelves is to have them removed. Circuit City eventually got the joke and apologized for the “knee-jerk reaction” and put the magazines back on sale.

Spokesman Jim Babb said, in an email response, that “the parody of our newspaper ad in the August MAD was very clever. Most of us at Circuit City share a rich sense of humor and irony... but there are occasional temporary lapses”.

Babb added: “As a gesture of our apology and deep respect for the folks at MAD Magazine, we are creating a cross-departmental task force to study the importance of humor in the corporate workplace and expect the resulting PowerPoint presentation to top out at least 300 pages, chock full of charts, graphs and company action plans. In addition, I have offered to send the MAD Magazine editor a $20 Circuit City gift card toward the purchase of a Nintendo Wii....if he can find one!”

ONLY AN OPENING OFFER

Speaking from the magazine’s “international headquarters”, MAD Editor John Ficarra replied, “We at MAD were shocked and confused by this entire incident - mainly because we had no idea that Circuit City even sells magazines. Nonetheless, we accept their apology but hold out hope that their gesture of a $20 gift card is only an opening offer”.

On MAD Mag's message board, a poster warns Ficarra: "Good luck getting the $20 gift card. I'm still waiting on the $75 card they promised me after taking 5 1/2 weeks to replace my laptop. Oh, BTW, they promised it would be taken care of in one week".

On The Consumerist web site, a reader named Michael tells his story: "I was looking for cheap televisions online and was happy to come across an 8% off coupon for Circuit City through my AAA membership. I figured I'd have a fat chance of being able to use it on a cheap Vizio TV, but I was still surprised to find so many exceptions on the coupon". Michael refers to the fine print, reproduced below.

CONCLUSION

"Restrictions: This offer is good for 8% off $199 or more. This coupon is good for one (1) use only and applies to total qualifying purchase on a single sales receipt dated between 05/01/2008 and 12/31/2008. Not valid on previous purchases.

Offer excludes advertised specials, notebook and desktop computers, software, monitors, music, movies, games, game hardware, hard drives, select MP3 players, Olevia, Element, Toshiba televisions, Vizio, Nikon digital cameras, Bose, Apple, select Polk models, Kicker, all Sony DSLR cameras, all Sony camera accessories, all Sony XBR televisions, Verizon, Outlet, firedogSM, Circuit City Advantage Protection Plans, pre-order/backorder products, SON KDSR60XBR1, SON KDSR50XBR1, SYM SC520FDF, SHA LC20B8US, HIT 51F59, SYL 6620LCT, SDK SDMX31024A18, SDK SDMX44096A70, HIT 51F59A, SHA 32SC26B, GMN SP2720, GMN SPC330, GMN SPC340, GMN SPI5, TTM GO300, GMN NUVI780, GMN NUVI5000, GMN NUVI260W, ELA 014633159110, ELA 014633159110, ATV 047875951235 and gift card purchases.

Delivery fees, shipping charges and sales tax not included in total purchase calculation. Not combinable with select Circuit City offers." A commentator suggests: "Why, you can buy $199 worth of Mad Magazines!"

This week’s research: *Is Compass Diversified trading at a discount of 40% to fair value?*

INTRODUCTION

On Wednesday we’ll close the Integrated Silicon Solution trade for a loss. The company missed its second quarter consensus by a single cent, and apparently nobody wants to touch the stock for the time being, so we’re moving on.

Our first Business Development Company (BCD) long trade was with American Capital Strategies (NASDAQ: ACAS) in 2003, for a dividend-adjusted price of $14.54, before the shares roughly tripled.

Heavy buying by twelve insiders, including Directors Philip Harper, Stan Ludine and Molly Baskin, as well as by President & CEO Malon Wilkus, was one of the indicators that the shares had good chances of trading higher.

SUCCESS WITH PAST BDC TRADES

Since then, we’ve had several long trades with ACAS and ALD, with good success. Normally, we would consider the BDC sector as a better investment in a growing economy, or in an “easy money” environment.

However, from July 2007 to July 2008, Compass Diversified Holdings (NASDAQ: CODI) lost 43%, rebounding a bit since. As I write this, the shares have lost more than 25% from their highs of last year.

In July 2007, Compass was generating a bit more than $1.50 of cash flow per share on a trailing twelve months (TTM) basis; now we’re above $1.70 for a 12% gain over a difficult twelve month period; thus the current share price seems to make little sense.

A MAJORITY INTEREST IN SIX ENTITIES

Based in Westport, CT, CODI engages in the acquisition and management of small to middle market businesses which are headquartered in the United States. The group owns majority interests in the following entities:

- CBS Personnel Holdings, a provider of temporary staffing services, employee leasing services, permanent staffing and temporary-to-permanent placement services in the United States
- Advanced Circuits, active in the quick-turn production and prototype printed circuit board (“PCB”) manufacturing
- American Furniture Manufacturing, a promotionally priced upholstered furniture manufacturing company with products including stationary and motion sofas, loveseats, sectionals and recliners
- Anodyne Medical Device, a medical support surfaces company whose product line includes specialty beds, mattress replacements, overlays and patient positioning devices
- Fox Racing Shox, which produces mountain bike and off-road suspension products
- Halo Branded Solutions, a manufacturer of customized promotional products; the offering includes drop-ship and fulfillment services of apparel, writing instruments, calendars, office accessories etc.

Let’s take a quick look at each of the parts before we can sum them all up.

CBS

Based on the TTM pro forma contribution to Compass’ earnings before interest, taxes, depreciation and amortization (EBITDA), CBS is the most important component, having contributed to 38% of CODI’s EBITDA from the third quarter of last year to the second quarter of 2008. Its competitive strengths include:

- Geographic density with regional market dominance
- Strong niche markets, including a large focus on logistics
- Important customer base
- Low customer concentration
- High operating margins relative to industry

As in the 2000 to 2002 period, management believe that it is significantly outperforming its competitors and gaining market share in key markets. While revenues are down 5% compared to last year, EBITDA is up 45%.

ADVANCED CIRCUITS

CBS’s numbers are reasonable taking into account that Manpower had a worse than 8% comparable decline over the period, and Kelly Services’ figures show an attrition superior to 7%.

All this does not take into account the Staffmark acquisition. Compass management recently communicated that CBS is ahead of its $7 to $10 million annualized synergy targets.

With a 21% contribution to TTM EBITDA, Advanced Circuits is the second most important part to look at. As of June 30, 2008 EBITDA growth is 13% as margins stand at 40%.

FOX RACING SHOX

In a difficult market, Advanced Circuits has been insulated from Asian manufacturing competition thanks to its small, customized order size and customer requirements for rapid turnaround.

It’s now the largest quick turn manufacturer in the United States, with more than 300 unique daily orders received; AC’s customer base is diverse with more than eight thousand different entities.

Over the last twelve months, Fox Racing Shox provided 14% of CODI’s EBITDA, up 102%; the bike parts specialist enjoys a leading market position in the premium mountain bike segment and significant market share in other segments.

THE AMERICAN FURNITURE FIRE

American Furniture is number four on the list, with a 12% contribution to the group’s earnings before interest, taxes, depreciation and amortization; the company is insulated from foreign imports due to transportation economics and customer demands.

Due to a fire at the facility in February 2008, this year’s financials are somewhat uncertain; sufficient insurance coverage was in place, but so far the EBITDA growth was a negative 28% mostly due to that (hopefully) one time event.

Halo Branded Solutions has a diverse customer base characterized by long-standing relationships, extensive supplier relationships, industry leading back-office infrastructure leading to operating efficiencies and is an attractive acquirer/recruiter of smaller distributors; EBITDA growth is a nice 68% over the last twelve months and future gains are expected thanks to sourcing most of the business directly from Asia.

INSIDERS OWN 30%

Finally, Anodyne has grown EBTITDA at an annualized rate of 69% up to last June; its competitive strengths are cost savings through scale purchasing and operational improvements, and Food & Drug Administration (FDA) approvals.

As of this month, the Compass management believes that the sum of all these parts translates conservatively into $17.55 per share, i.e. more than 40% above the current share price.

CODI's management, board and affiliated parties (the managers of the various entities) own more than 30% of Compass's stock, and have bought hundreds of thousands of shares (costing several million dollars) over the last three months.

OVERVALUED PORTFOLIO?

Obviously, the main concern is the valuation of the companies composing the CODI portfolio; however, since May 2006, Compass has surpassed the $100 million mark in realized gains for its shareholders, in a less than rosy environment.

For the second quarter of this year, cash flow was $14 million versus $9 million in Q2 of 2007, an increase of 48% during a tough period; the current dividend translates into an annualized $1.30, an 11% yield on the current stock price. So far, distributions have increased by 24% in just over 2 years.

In the current debt market turmoil, Compass management believes that it will be a major beneficiary, with $200 million more current assets than current liabilities, and an additional $300 million available on demand.

EASY FINANCING

In other words, while competitors might face non-economical lending terms, CODI's absence of financing contingencies should improve its ability to dictate prices and terms.

Just like Warren Buffett, the company is never forced to invest or exit any of its businesses if it doesn't want to, and it isn't dependent on anybody else. Current net debt is less than one year's worth of EBITDA, and the group faces no material maturities until late 2011.

With an existing $400 million financial capacity for additional acquisitions (leaving $100 million in net liquid assets just in case), management is not assuming that capital markets will improve any time soon.

ANALYST WITH $19 TARGET UNTIL DECEMBER

One consequence might be the consideration of stock buybacks; another goal and plan is to grow dividend distributions, just to show the market that it's wrong in assessing the business for anything less than $20 per share.

BB&T's Vernon Plack has a $19 per share price target on the stock by next December. After announcing a 75 cent profit for the first half of the year (25% better than analyst forecast), Compass is now expected to deliver a 95 cent profit for the second half. If the company continues to surpass consensus by the same margin, we might see annualized profits in excess of $2 per share in the coming two quarters.

Even if the stock market were to prove difficult until next March, I fully expect CODI to overperform the S&P 500 index by a wide margin; however, should the market conditions get better, I still believe that the BDC sector would massively profit, which could translate into a positive readjustment of multiples.

CONCLUSION

While anything is possible in an irrational environment, I'll wager that we won't see new lows for the stock in the coming seven months; thus, risk should be limited to approximately 25% on this trade, barring exceptional circumstances.

If the fair value is judged to be around $18 per share with the group's management spending millions to acquire additional shares in the open market, despite owning already one third of the company, then the stock should be trading North of $20, taking into account its future potential for profits.

Whatever happens, I doubt that we will let go of the shares for less than $19 to $20 until the fourth quarter numbers are out; that should allow for a minimum profit of 50% in a time span of seven months or less.

Thanks for reading!

Warm regards,

Marc