The Turnaround Letter

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FIFTH ANNIVERSARY OF 2008-09 LOW: LOOKING FOR LAGGARDS POISED TO REBOUND

March 9, 2014 is the fifth anniversary of the low point in the 2008-09 stock market meltdown. The S&P 500 stock index closed on that day at 676.53, and since then it has risen by 172% (not including dividends). Of course, some stocks have risen even further than the index, and others have performed less well.

Being contrarians, we aren't inclined to chase the winners. Instead we like to sift through the losers, looking for stocks that have been left behind but still represent good value. In that spirit we combed through the stocks in the S&P 500 that have performed the worst since the market bottomed out on March 9, 2009. The stocks described below represent a diversified group of businesses that we think could have good rebound potential. This month's Purchase Recommendation was also one of those laggards.

Avon Products, the largest global direct seller of beauty products, is in the midst of effecting a turnaround following a number of years of lackluster growth and profitability. A new CEO, Sheri McCoy, was brought in from Johnson & Johnson's pharmaceutical group where she led a major restructuring. The Avon turnaround, however, hit a bump last October when the company reported continuing weak top- and bottom-line results and ongoing legal problems related to bribery allegations in China. We suspect that the bad news is fully priced into the stock, giving it good turnaround appeal.

Best Buy is caught in the battle between bricks-and-mortar and online retailing of consumer electronics. The stock performed well for most of 2013, but it got crushed when the company reported weak holiday sales in January. The jury is still out on how the bricks-and-mortar guys will hold up to the online onslaught, but with its national footprint and strong brand name Best Buy is in as good a position as any traditional electronics retailer to survive and prosper. The company is still generating solid cash flow, which supports an attractive dividend.

Diamond Offshore operates the world's largest fleet of semisubmersible rigs for offshore oil drilling. The stock has never really recovered from the slowdown in offshore drilling following the BP disaster in the Gulf of Mexico in 2010. Nonetheless, the company has been steadily upgrading its fleet, and is well positioned to profit from future increases➔

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Company	**Symbol**	**Recent Price**	**5-Year Range**	**Market Cap. $Mil.**	**% Change From 3/09**	**Div. Yield %**
Avon Products	AVP	15.31	36.39 – 14.16	6,792	-3.83	1.6
Best Buy	BBY	25.82	48.83 – 11.20	8,934	1.13	2.8
Diamond Offshore	DO	47.51	108.78 – 45.24	6,606	-15.37	7.3
First Solar	FSLR	52.74	207.51 – 11.43	5,244	-47.59	NA
FirstEnergy	FE	31.05	50.92 – 30.10	12,986	-15.77	4.5
Frontier Communications	FTR	4.94	9.84 – 3.06	4,938	-19.97	8.6
Newmont Mining	NEM	23.56	72.42 – 20.78	11,790	-37.76	2.6
Peabody Energy	BTU	16.94	73.95 – 14.34	4,596	-23.86	2.0
People's United Financial	PBCT	14.14	18.54 – 10.50	4,226	-16.00	4.6

in drilling activity. Diamond has been regularly paying a "special" dividend since 2008, which gives the stock an impressive 7.3% yield. There is no guarantee that the company will continue paying the "special" portion of the dividend, but it's been pretty regular.

First Solar's revenues have grown fairly steadily from $3 million in 2003 to $3 billion today, but the movement of the stock price has been anything but steady. Following a meteoric rise above 300 by early 2008, the stock fell sharply, particularly in 2011 and 2012, almost reaching single digits in mid-2012. Earnings remain difficult to predict, but First Solar looks like it will continue to be a leading player in what is becoming an increasingly important industry. The balance sheet is rock solid, and cash flow is strong.

FirstEnergy is an electric utility serving Ohio, Pennsylvania, New Jersey, West Virginia, Maryland and New York. Many of the utility stocks underperformed in 2013, and FirstEnergy was particularly weak, having dropped about a third of its value since last May. A recent dividend cut didn't help the stock. Nonetheless, FirstEnergy is a solid company, and its stock should perform better when the sector comes back into favor. Even with the cut, the dividend yield is above the utility industry average.

Frontier Communications has been accumulating wireline (copper and fiber optic) assets that major telephone service providers are divesting. Management has a good reputation for assimilating acquired assets. While the wireline business may not have the growth potential of cellular, it can still be profitable. Frontier has a least two ways of boosting profitability: reducing costs and selling more broadband services to existing customers. The dividend looks sustainable for at least the time being.

Newmont Mining has the distinction of not only being one of the worst performers since the market lows in 2009, but also was one of the worst stocks of 2013 as gold prices collapsed. A new CEO came aboard last March to spark a turnaround. The company is focusing on reducing costs, divesting non-core assets and developing profitable new projects, such as one it's working on now in Indonesia. Given Newmont's size and solid capital structure, it could be a very good way to play a possible rebound in gold prices.

Peabody Energy is another stock with the dubious distinction of being among the worst performers both from the March 2009 lows and for 2013. The combination of competition from increasingly abundant natural gas and environmental concerns has hammered the entire coal sector. But coal remains the number one energy source worldwide. As the strongest domestic producer, which also has a good export customer base, Peabody is well-positioned to gain when coal stocks come back into favor.

People's United Financial offers a range of financial services in the Northeast. Interestingly, the stock held up substantially better than most financials during the 2008-09 crisis, but it has gone essentially nowhere since then. However, People's has made a number of acquisitions that could add to the bottom line in the not-too-distant future. Also, increasing interest rates should boost lending margins and help the stock.

TURNAROUND MUTUAL FUNDS: THE FEW, THE BRAVE AND THE PROFITABLE

While we normally focus on individual stocks, from time to time we like to look at mutual funds that focus on turnarounds. Mutual funds can be attractive because a single fund can provide fairly broad diversification.

Unfortunately, there are very few mutual funds that really focus on turnaround investing. Out of the thousands of mutual funds out there, we could only find the dozen described below to include in this article. Even in the funds mentioned below, turnaround investing is usually not their principal objective – in most cases it is just one of several strategies that the fund manager pursues.

In some ways the scarcity of turnaround-oriented funds just proves our assertion that turnarounds represent an inefficient – and therefore potentially very profitable – niche in the securities markets. Even professional investors tend to shy away from turnarounds because they require a somewhat different analytical approach from more mainstream stocks.

Another reason why there are very few turnaround mutual funds today is that there is no index of turnarounds. Today most mutual funds (and the people who sell the funds) want to compare their returns to a certain benchmark, usually a well-known index like the S&P 500. As a result, most fund managers tend to hug their benchmarks fairly closely. These fund managers are risk averse – they want to keep their jobs, after all – and they give up the opportunity to outperform their benchmark in exchange for reducing the risk of underperforming. Since turnaround stocks are underrepresented in the major benchmarks, fund managers are hesitant to buy them.

The managers of the funds discussed below are brave enough to put at least a portion of their portfolios in turnaround situations, and many of them have posted strong returns over the years because of that.

Columbia Value & Restructuring seeks stocks that are generally out of favor but it is also willing to look at special situations such as restructurings and management changes. Roughly 37% of its holdings are in the Technology and Financial Services sectors with two *Turnaround Letter* holdings (GE and JNJ) among its top ten holdings.

Fairholme Fund is led by Bruce Berkowitz, a well known value manager willing to take concentrated positions. Berkowitz is not afraid to pile into turnaround situations in a big way. For example, American International Group (AIG), one of the poster children for the 2008 financial collapse, accounts for roughly 40% of the fund's holdings. Troubled government-sponsored mortgage lender Fannie Mae (FNMA) is another big holding.

Fidelity Capital and Income invests in high yield bonds, distressed bonds and even a few equities. As a result of its emphasis on bonds, the fund's performance has been steadier in ➔

MUTUAL FUNDS WITH TURNAROUND FOCUS					
FUND	SYMBOL	RECENT NAV	5-YEAR AVG. RETURN %	1-YEAR AVG. RETURN %	TOTAL ASSETS $MIL.
Columbia Value & Restructuring	UMBIX	48.80	23.22	27.26	2,000
Fairholme	FAIRX	39.45	21.91	31.35	8,400
Fidelity Capital & Income	FAGIX	10.08	20.80	10.96	10,000
Fidelity Event Driven	FARNX	10.64	NA	NA	28
Franklin Mutual Recovery	FMRAX	12.23	15.93	22.62	59
GoodHaven	GOODX	28.00	NA	9.43	559
Keeley Small-Mid Cap Value	KSMVX	15.59	31.85	26.93	287
Mutual Shares	TESIX	28.07	18.66	21.42	15,600
Putnam Capital Spectrum	PVSAX	36.80	NA	37.10	6,400
Putnam Equity Spectrum	PYSAX	43.25	NA	45.55	3,100
Skyline Special Equities	SKSEX	39.16	33.46	38.56	1,200
Third Avenue Value Investor	TVFVX	56.16	18.00	12.55	2,500

recent years than most equity funds. The fund's willingness to buy more troubled situations led to a gain of 72% in 2009, as distressed debt securities snapped back from the financial crisis.

Fidelity Event Driven Opportunities Fund is a new fund (launched December 2013) that by its charter targets companies in reorganization, undergoing management change, effecting corporate restructuring, changing capital structure or flirting with the bankruptcy process. The fund is still very small, but we like the strategy.

Franklin Mutual Recovery targets special situations where the manager believes a catalyst exists to unlock the value of mispriced assets. Distressed and post-bankruptcy stocks are included in the fund's mandate. Among the fund's top holding are *Turnaround Letter* recommendations BP and Xerox. The fund also offers a way to play a rebound in Europe as more than 40% of its portfolio comes from across the pond.

GoodHaven managers Larry Pitkowsky and Keith Trauner developed their expertise while working for the Fairholme Fund. Now at GoodHaven, they seek stocks that are out-of-favor because of adverse publicity, industry problems or company specific issues. They also like special situations, including mergers, reorganizations and management changes. While large-cap *Turnaround Letter* recommendations Hewlett-Packard and Microsoft are among the funds' largest holdings, nearly 60% of the portfolio is in mid- and small-cap stocks.

Keeley Small-Mid-Cap Value focuses on the stocks of companies that are going through major changes. Corporate restructurings and post-bankruptcy situations are among its targets. The fund's charter requires 80% of its investments to be in mid- and small-cap stocks, defined as being below $7.5 billion in market capitalization. Currently, Industrials, Consumer Discretionary and Financials are roughly equally weighted and make up about two-thirds of the total portfolio.

Mutual Shares has a long history of seeking out undervalued assets including turnarounds. The fund's first two managers, Max Heine and Michael Price, are legends in the deep value and distressed securities world. The fund focuses on stocks with capitalizations larger than $5 billion, and it can invest up to 35% (currently about 28%) of its assets in foreign securities. Microsoft, a *Turnaround Letter* recommendation, is the fund's second largest holding, and its top two sectors are Financials and Consumer Staples.

Putnam Capital Spectrum and **Equity Spectrum** are both managed by David Glancy, who is an alumnus of the Fidelity Capital and Income Fund. Glancy likes leveraged companies, and he does not shy away from bankruptcies and other special situations. His funds can be quite concentrated. For example, Dish Network is a 10+% position in both funds. Equity Spectrum is principally focused on stocks, while Capital Spectrum can buy debt securities as well.

Skyline Special Equities focuses almost entirely on small-cap stocks — market caps below $2.5 billion. The fund's managers are attracted to companies experiencing problems that have depressed the stock price. For example, the fund's largest holding, Teleflex, experienced a botched acquisition that led to a new CEO.

Third Avenue Value Investor was founded and managed until a couple of years ago by Marty Whitman, who has been a legend in the turnaround/distressed securities arena for many decades. Current lead manager Ian Lapey has worked with Whitman since 2001. The managers' mantra has been "safe and cheap," but the "safe" portion hasn't discouraged an occasional dip into a bankruptcy or restructuring.

<u>**Disclosure Note:**</u> An affiliate of the Publisher owns securities of, and has other business relationships with certain of the funds discussed in this article.

RECOMMENDATIONS:
Purchase Recommendation: Staples

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Framingham, MA 01702
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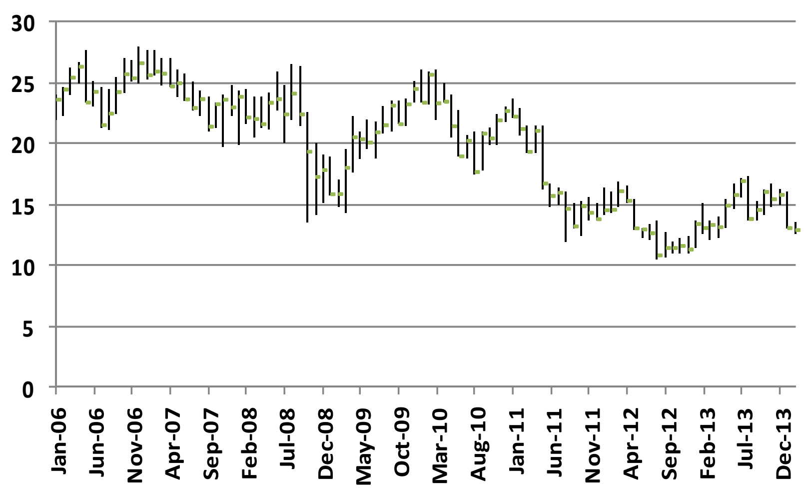
Category: Mid-Cap ($8.8 Bil.)
Symbol: SPLS **Exchange: NASDAQ**
Business: Office Products Retailer
Annual Revenue: $24.4 Bil. (2/2/13)
Earnings: ($211 Mil.)
2/26/14 Price: 13.60
12 Month Range: 17.30-12.08
Max. Rec Price: 18
Est. Dividend Yield: 3.7%



Background: Staples is the world's largest office products company. Founded in 1986, the company was the first of the office products superstores. It grew rapidly, initially through retail locations and later through direct sales and the Internet. The stock performed well through the mid-2000's, but has been weaker since then, first because of the 2008-09 recession, which caused many businesses to cut spending, and more recently because of fierce online competition.

Analysis: If you asked "Who is the second largest online retailer in the world after Amazon?" we suspect that very few people would answer "Staples," but that is indeed the case. Unfortunately for the current stock price, the company also operates more than two ➔

thousand bricks-and-mortar locations across the U.S., Canada and several other countries.

As a result, investors are valuing Staples as a traditional retailer – which are out of favor with investors these days – rather than an online retailer. For example, Staples stock trades at 0.37 times sales and about 10 times next year's expected earnings. By contrast, Amazon stock trades at 2.22 times sales and 85 times next year's earnings.

Sure, Staples is probably not the second coming of Amazon. (Who knows, maybe even Amazon isn't the second coming of Amazon.) Nonetheless, Staples has a lot going for it that could be reflected in the stock price before too long.

The company has reshaped its marketing efforts over the last year or so, and is taking steps to stay at the forefront of online retailing. It recently acquired Runa, a pioneer in the field of personalized e-commerce, and it is partnering with another e-commerce company to assure that it can match competitors' prices on a real-time basis. Given Staples' huge online presence, a small improvement in revenues or margins could be very beneficial for the stock.

Staples should also benefit from some turmoil among its competitors. Its two closest competitors, Office Max and Office Depot, recently merged. This will result in the closing of a number of stores that compete with Staples locations, and any hiccups in the integration of Office Max and Office Depot operations will likely work to Staples' advantage.

Moreover, economic trends could be turning more favorable for the stock. Small business spending in the U.S. has been slow to recover from the 2008-09 downturn, but it is showing some life as the economic recovery continues. Also, Staple's recent results have been hurt by the weakness in Europe, and there are definite signs of recovery in that region.

Despite recent weakness on the bottom line, Staples has been generating very solid cash flow. The company has been using some of that cash flow to repurchase stock and enhance the dividend. During the first nine months of 2013, the company bought back nearly $270 million worth of stock, and it currently sports a 3.7% yield.

We believe that Staples will be able to take advantage of its powerful market position to boost earnings and the stock price. But even if its financial results are held down by competitive pressures for a while longer, the company's stock buybacks and generous dividend will create value for shareholders. <u>We recommend buying Staples up to 18.</u>

Sale Recommendation: Marsh & McLennan

Marsh & McLennan recently posted solid results for 2013. Its restructuring now seems largely complete, and the stock is back in the good graces of mainstream investors. That tells us that it is time to take our profits and move on.

NEWS NOTES & UPDATES

We are raising our maximum buying prices on three stocks: **Wendy's** to 13, **Veolia Environnement** to 22 and **Corning** to 24. We believe that all three of these stocks have further to rise.

PERFORMANCE

The tables below and on the next page show the performance of all of our currently active recommendations, plus recently closed out recommendations. The categories are based on market capitalization on the recommendation date, except that recommendations made prior to August 2004 are categorized by their 8/20/04 market cap.

SMALL CAP (under $1 billion) CURRENT RECOMMENDATIONS

RECOMMENDATION	SYMBOL/ EXCHANGE (1)	REC. ISSUE	PRICE AT REC.	2/27/14 PRICE	TOTAL RETURN (3)	CURRENT STATUS (2)
Bristow Group	BRS/NY	Nov 86	0.75	74.96	+10,121	Hold
Electro Scientific Ind.	ESIO/NQ	Feb 07	21.24	9.35	-53	Buy (20)
Wet Seal	WTSL/NQ	Oct 09	3.93	1.77	-55	Buy (6)
ACCO Brands	ACCO/NY	Mar 10	7.17	5.77	-20	Buy (12)
Superior Industries	SUP/NY	Sept 10	14.75	18.08	+36	Buy (30)
Kemet	KEM/NY	Feb 11	14.75	5.69	-61	Buy (11)
Drew Industries	DW/NY	Mar 11	23.13	49.26	+130	Hold
Fairpoint Communications	FRP/NQ	July 11	9.42	13.25	+41	Buy (14)
Builders FirstSource, Inc.	BLDR/NQ	May 12	4.17	8.51	+104	Buy (9)
Felcor Lodging Trust, Inc.	FCH/NY	Nov 12	4.39	8.39	+92	Buy (9)
Chiquita Brands	CQB/NY	Apr 13	7.76	11.70	+51	Buy (15)
Stewart Information Services Corp.	STC/NY	June 13	29.34	36.45	+25	Buy (37)
Accuride Corporation	ACW/NY	Oct 13	5.14	4.36	-15	Buy (8)
Layne Christensen Co.	LAYN/NQ	Nov 13	19.59	17.61	-10	Buy (26)

MID CAP ($1 billion - $10 billion) CURRENT RECOMMENDATIONS

RECOMMENDATION	SYMBOL/ EXCHANGE (1)	REC. ISSUE	PRICE AT REC.	2/27/14 PRICE	TOTAL RETURN (3)	CURRENT STATUS (2)
Newell Rubbermaid	NWL/NY	June 04	23.24	31.49	+59	Buy (33)
Janus Capital Group	JNS/NY	Aug 05	15.27	11.04	-19	Buy (17)
Portland General	POR/NY	Nov 06	25.70	31.55	+51	Buy (33)
Interpublic Group	IPG/NY	Dec 06	11.94	17.01	+48	Buy (18)
Tellabs	TLAB/NQ	Feb 08	6.66	2.44	-60	Hold
Federal-Mogul	FDML/NQ	May 08	21.00	18.42	-12	Buy (23)
Old Republic	ORI/NY	June 08	14.64	15.59	+35	Buy (18)
Boston Scientific	BSX/NY	Aug 10	5.60	13.34	+138	Buy (15)
MGIC	MTG/NY	Jan 11	10.11	9.08	-10	Buy (11)
Wendy's	WEN/NQ	Mar 12	5.18	10.19	+100	Buy (13)
Veolia Environnement S.A.	VE/NY	Oct 12	10.82	17.51	+70	Buy (22)
Cypress Semiconductor	CY/NQ	Jan 13	10.63	10.25	0	Buy (16)
New York Times	NYT/NY	Mar 13	9.64	15.73	+64	Hold
Rite Aid Corporation	RAD/NY	May 13	2.61	6.63	+154	Hold
PennyMac Mortgage Investment Trust	PMT/NY	Sept 13	21.40	24.13	+18	Buy (26)
Allscripts Healthcare Solutions	MDRX/NY	Feb 14	16.43	18.53	+13	Buy (24)

KEY: (1) Exchanges: NY= New York; NQ= NASDAQ; (2) Maximum recommended buy prices in parentheses; (3) Total return includes dividends as well as price changes.

LARGE CAP (over $10 billion) CURRENT RECOMMENDATIONS

RECOMMENDATION	SYMBOL/ EXCHANGE (1)	REC. ISSUE	PRICE AT REC.	2/27/14 PRICE	TOTAL RETURN (3)	CURRENT STATUS (2)
Carnival Corporation	CCL/NY	Jan 01	30.50	40.22	+65	Buy (45)
AT&T Inc.	T/NY	May 03	23.05	32.00	+110	Buy (44)
Ford	F/NY	Dec 03	13.00	15.26	+29	Buy (20)
Microsoft	MSFT/NQ	Oct 06	27.94	37.47	+51	Buy (40)
Pfizer	PFE/NY	Mar 07	25.84	31.99	+47	Buy (35)
General Electric	GE/NY	July 07	38.12	25.30	-20	Buy (30)
Motorola Solutions	MSI/NY	Aug 07	68.52	65.45	0	Buy (70)
DuPont	DD/NY	Jan 08	45.07	65.51	+67	Buy (70)
Bank of America	BAC/NY	Oct 08	35.00	16.33	-52	Buy (20)
Marsh & McLennan	MMC/NY	Feb 10	21.71	47.59	+136	Sell
Applied Materials	AMAT/NQ	Apr 10	13.45	19.10	+53	Buy (20)
Fifth Third	FITB/NQ	Nov 10	12.56	21.66	+79	Hold
Coca-Cola	KO/NY	Apr 11	32.86	37.87	+27	Buy (45)
General Motors	GM/NY	May 11	32.09	36.83	+15	Buy (45)
Xerox	XRX/NY	Aug 11	9.58	10.75	+16	Buy (14)
Sony	SNE/NY	Sept 11	22.01	17.38	-21	Buy (32)
Johnson & Johnson	JNJ/NY	Jan 12	65.45	91.11	+47	Buy (95)
Corning, Inc.	GLW/NY	Feb 12	12.61	19.27	+56	Buy (24)
Weyerhaeuser Co.	WY/NY	Apr 12	21.89	29.85	+39	Buy (35)
Hewlett-Packard	HPQ/NY	June 12	22.74	29.90	+36	Buy (30)
Cisco Systems, Inc.	CSCO/NY	Sept 12	19.18	21.93	+19	Buy (26)
MetLife	MET/NY	Feb 13	37.20	49.97	+38	Buy (60)
BP plc	BP/NY	July 13	41.78	50.42	+25	Buy (55)
Freeport-McMoRan Copper & Gold	FCX/NY	Aug 13	28.21	33.41	+21	Buy (40)
EMC Corporation	EMC/NY	Dec 13	23.72	26.35	+12	Buy (34)
Dow Chemical Company	DOW/NY	Jan 14	44.60	47.83	+7	Buy (55)

RECENTLY CLOSED OUT RECOMMENDATIONS (ALL CATEGORIES)

RECOMMENDATION	SYMBOL/ EXCHANGE (1)	REC. CAT.	BUY ISSUE	PRICE AT BUY	SELL ISSUE	PRICE AT SELL	TOTAL % RETURN (3)
MetroPCS	PCS/NY	Mid	Dec 11	8.38	June 13	14.55	+74
Kadant Inc.	KAI/NY	Small	Apr 02	14.28	July 13	30.55	+115
Tenet Healthcare	THC/NY	Mid	Sept 04	41.08	Aug 13	44.40	+8
Time Warner	TWX/NY	Large	Dec 04	53.46	Aug 13	62.07	+40
Goodyear Tire	GT/NY	Mid	July 04	9.14	Sept 13	20.31	+122
CTS Corporation	CTS/NY	Small	Nov 07	12.54	Oct 13	15.77	+31
Delta	DAL/NY	Mid	Oct 11	8.11	Nov 13	26.48	+227
Schwab	SCHW/NY	Large	Mar 04	12.20	Dec 13	24.83	+127
E*Trade Financial	ETFC/NQ	Mid	Aug 12	7.53	Dec 13	17.92	+138
Sprint	S/NY	Large	Mar 08	8.09	Jan 14	10.58	+31
Sysco	SYY/NY	Large	Nov 09	27.01	Jan 14	36.28	+50
United Continental	UAL/NY	Mid	Dec 12	20.22	Feb 14	45.43	+125

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