Upside

Best buys in small and midcap stocks

www.UpsideStocks.com

READER Q&A

Q *Several of your stocks have jumped sharply since your initial recommendation — why should I buy them now?*

A The best way to use *Upside* is to buy on our initial recommendation, then hold until we say sell. However, we sell as soon as a stock no longer ranks among our favorites for new buying, so every stock on our Buy List is suitable for purchase. In our view, all stocks on our Buy List have upside potential of at least 10% over the next six months or 20% over the next year.

Q *How could you be so wrong on* ***Axcan Pharma*** *(NASDAQ: AXCA)? After touting the stock as a Best Buy for months, you abruptly downgraded to Sell.*

A When the news changes, so will we. Axcan posted discouraging 2005 sales and earnings guidance. In light of the new guidance, we reexamined our rationale for recommending Axcan — and concluded the stock no longer ranked among our top picks for new buying. While some Wall Street analysts reacted by downgrading Axcan to a "hold," we see no reason to hold a stock no longer among our best ideas.

Q *Your Buy List sometimes beats your Best Buy List. What gives?*

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Using this newsletter

As the Q&A on the left makes clear, things don't always go our way. We take our recommendations seriously, and our goal is to limit our Buy List to only the best year-ahead performers. But the truth is there will be more losers, more stocks sold at a loss so that money can be redeployed in better names.

As the chart below makes clear, our Best Buy List and Buy List have delivered attractive returns. While we do not get every stock right, our disciplined and quantitative approach can deliver superior returns without much additional risk — if some basic principles are followed:

➤ **Stay disciplined.** Since your editor took charge of this newsletter in 1999, *Upside's* approach has not varied: *(1)* use our Quadrix® stock-rating system to screen for high-potential stocks; *(2)* investigate companies rigorously; *(3)* examine company and industry prospects; *(4)* reconsider valuations; *(5)* look for a catalyst; and *(6)* sell stocks no longer among our top picks. This straightforward approach has done well, and we see no reason to mess with success.

➤ **Spread your bets.** The truth is we don't know which of our recommendations will do best, nor do we pretend to know the precise fair value for each of our stocks. We do know that all stocks on our Buy List have superior

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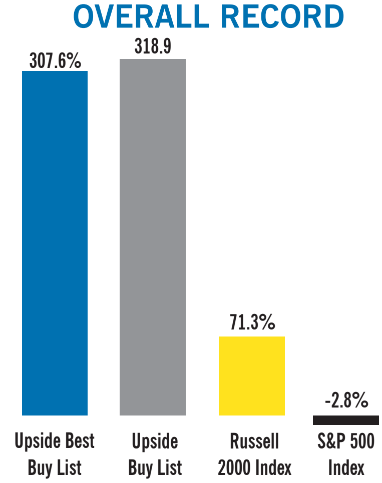
UPSIDE'S BUY LISTS VERSUS THE MARKET

YEARLY RETURNS

	Upside Best Buy List	Upside Buy List	Russell 2000 Index	S&P 500 Index
2011 *	-6.7%	-8.0%	-4.1%	0.6%
2010	21.5	24.0	25.3	12.8
2009	27.5	32.7	25.2	23.5
2008	-44.7	-47.5	-34.8	-38.5
2007	0.5	4.5	-2.8	3.5
2006	18.6	18.2	17.0	13.6
2005	5.4	9.1	3.3	3.0
2004	38.3	46.8	17.0	9.0
2003	90.0	76.0	45.4	26.4
2002	-6.7	-0.5	-21.5	-23.4
2001	1.2	-0.8	1.0	-13.0
2000	14.1	27.1	-4.2	-10.1
1999 †	43.4	20.8	15.1	12.9

*Through Dec. 27. † May 28, 1999, to Dec. 31, 1999.

OVERALL RECORD



Upside's Best Buy List has gained 307.6% since its May 1999 inception, excluding dividends and transaction costs. Over the same period, *Upside's* Buy List has gained 318.9%, the Russell 2000 Index has gained 71.3%, and the S&P 500 Index has declined 2.8%. The Best Buy List's annualized gain since inception is 11.8%, versus 4.4% for the Russell 2000.

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Using this newsletter

year-ahead potential — and that by diversifying among our recommendations you can put the odds in your favor. Spreading your bets is especially crucial in the small-company sector, where more stocks are required to take full advantage of the free lunch provided by diversification.

➤ **If a stock is not a buy, it is a sell.** Many subscribers have a hard time with this principle, believing it is somehow wrong to sell a quality company. But one strength of our system is that we are always looking for the best year-ahead performers — and your portfolio can't be in our best ideas unless you sell those that no longer qualify as top picks.

➤ **Make a commitment to small and midcap stocks.** According to Ibbotson Associates, small-capitalization U.S. stocks provided an annualized return of 10.9% from 1926 to 2008, versus 10.5% for midcaps and 9.6% for large stocks. Microcaps returned 11.6% annually. Over the long term, an extra 1% to 3% of annualized return has huge implications for your wealth.

➤ **Look for opportunities in all corners of the market.** More important than the historical returns of small stocks are their abundance. With more than 70% of U.S. stocks considered small-caps, it stands to reason that most of today's best opportunities will not be household names. Because Quadrix is not influenced by the greed, fear, and biases that impact all investors, it is a great tool for highlighting potential buys.

➤ **Be prepared for daily volatility.** Small-company stocks can move 5% in a day on no news. When news breaks, 10% to 15% moves are not uncommon. Diversification is the best way to prepare your portfolio for such moves, but you also need to prepare your psyche. While sustained underperformance from a stock is a yellow flag, don't panic because of a sharp one- or two-day decline.

➤ **Don't worry about your portfolio's correlation with the market averages.** Whether your portfolio tracks the market is irrelevant. What matters is whether returns are attractive — and how much risk you are taking. Our Buy List and Best Buy List are diversified by sector to limit risk. But they are not designed to mimic the S&P 500 or any other index.

3 EASY STEPS

Using this newsletter is easy.

First, make sure you have a discount broker; nowadays there is little reason to pay more than $15 per trade.

Second, decide how much money you are going to commit to *Upside* stocks. If you're investing $30,000 to $60,000, mimic our Best Buy List by buying equal-dollar positions in each stock. You may want to mimic our broader Buy List if you're committing more than $60,000. With less than $30,000, get a low-cost broker and/or consider buying the 10 to 15 Best Buys that best diversify your existing portfolio.

Third, buy all the stocks listed as Best Buys (or Buys), then sell when we downgrade to Sell. On rank changes, strive to get your portfolio back to a roughly equal-weighted position, with the same number of dollars in each stock. But don't make minor trades if a stock is only slightly overweighted or underweighted. If we sell a stock between issues on our twice-weekly hotlines, you may want to hold the cash in reserve until we make new recommendations.

BEST BUY LIST

*** Based on hypothetical $50,000 portfolio, with roughly $2,600 in each stock. Trading commissions not considered.**

		Quadrix Scores							
Company *(Ticker)*	Rec'd Share Position *	Momentum	Value	Quality	Financial Strength	Earnings Estimates	Performance	Overall	Sector
AMERCO *(UHAL)*	30	70	86	75	61	77	71	96	Industrials
Buckeye Technologies *(BKI)*	79	82	62	87	75	65	96	95	Materials
Cash America International *(CSH)*	56	77	85	86	60	85	37	96	Financials
Churchill Downs *(CHDN)*	50	90	68	77	55	70	95	96	Consumer Discretionary
Curtiss-Wright *(CW)*	74	81	69	62	47	31	87	83	Industrials
CVR Energy *(CVI)*	141	92	97	88	50	33	30	97	Energy
Darling International *(DAR)*	198	92	91	96	70	95	34	99	Consumer Staples
Digital Generation *(DGIT)*	221	44	99	87	67	47	2	88	Consumer Discretionary
Ensign *(ENSG)*	107	91	76	90	40	97	51	97	Health Care
EZCORP *(EZPW)*	100	80	82	97	91	24	27	95	Financials
Iconix Brand *(ICON)*	162	45	89	90	87	88	21	93	Consumer Discretionary
Metropolitan Health Networks *(MDF)*	352	78	58	95	59	60	98	94	Health Care
Mitcham Industries *(MIND)*	120	96	61	89	98	99	98	99	Energy
MTS Systems *(MTSC)*	65	99	71	86	85	64	82	98	Technology
Neustar *(NSR)*	77	81	39	93	91	90	96	93	Technology
Primoris Services *(PRIM)*	176	93	70	83	47	73	96	97	Industrials
RPC *(RES)*	144	98	84	99	95	38	40	99	Energy
WellCare Health Plans *(WCG)*	50	96	84	90	46	53	91	99	Health Care
World Acceptance *(WRLD)*	36	78	62	95	70	89	93	97	Financials

Reader Q&A

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A We cannot predict with precision which of our recommendations will do best. We do know we have a nice system for putting the odds in our favor — and that all our recommendations hold superior year-ahead potential. While we strive to put our top ideas on the Best Buy List, we're not perfect. As a subscriber, you should take some comfort in the fact that our returns reflect a system, not a few lucky picks that have lifted our relatively concentrated Best Buy List.

Q *I believe in selling any stock that falls more than 7%. Why don't you use this system to avoid big losers?*

A Such an automatic sell mechanism will keep you out of big losers. But it will increase portfolio turnover considerably — and often whipsaw you into selling stocks you should be buying. Small-company stocks can fall 7% to 10% simply because of a lack of buyers, and such trading-related declines can open excellent buying opportunities. Rather than sell automatically, we reexamine the outlook for every recommended stock at least twice a week. If a stock's price action suggests our outlook for a company is flawed, we'll sell.

Q *How are returns on your Buy List and Best Buy List calculated? When I add up the annual returns, they don't match your overall return number.*

A Returns on our Buy List and Best Buy List are calculated in the same way, with dividends and transaction costs excluded. Returns for the lists assume the portfolios are equal-weighted, with positions rebalanced when changes are made. For example, the Best Buy List now has 18 stocks, so 5.6% is in each stock.

This approach is equivalent to putting the same number of dollars in each stock, the methodology we recommend subscribers use. Because each stock has equal weight, the return for a period equals the average return of the stocks on the list. For example, in February 2004, the average change of the 19 stocks then on our Best Buy List was 4.99%. Rank changes were made Feb. 26, and the Best Buy stocks returned an average of 4.22% from Feb. 26 to Apr. 1, when more rank changes were made. So, to calculate the return from Jan. 29 to Apr. 1, we link the returns as follows:

(1 + 4.99%) x (1 + 4.22%) – 1 = 9.42%.

The math may be clearer with a real-money example: A $10,000 investment on Jan. 29 increases by 4.99%, or $499, to $10,499 on Feb. 26. Then that $10,499 increases by 4.22% to $10,942 on Apr. 1. So, a $10,000 initial investment yields an overall return of $942, or 9.42% ($942/$10,000 = 9.42%).

The overall returns of our Buy List and Best Buy List reflect the linked returns of all the periods between rebalancings. Because money gained in the first period can be invested in the second period, you can't simply sum the returns of two periods to calculate an overall return. For example, assume you gained 50% one year and 20% the next year. In year one, your initial $1,000 would grow by $500 to $1,500. In year two, your account would climb another $300 ($1,500 x 20% = $300). So, the cumulative gain is 80% ($800/$1,000 = 80%).

Similarly, you can't simply sum the annual returns of our Best Buy List to calculate the overall return. The Best Buy List's return since May 28, 1999, reflects the cumulative gain for the portfolio, reflecting the compounding effect that occurs when earlier gains are reinvested profitably.

Q *What is meant by annualized compound return?*

A A portfolio's annualized compound return is the yearly return that would deliver the same result as the overall return, assuming the portfolio gains the same amount per year. So, the Best Buy List has delivered an annualized compound return of 14.2% since May 28, 1999, versus 5.5% for the Russell 2000 Index.

Q *In calculating returns for the Buy List and Best Buy List, what prices do you use?*

A *Upside* lists all rank changes on twice-weekly hotlines, posted on Tuesdays after the market's close and Fridays at noon. If a rank change is made on a Tuesday, we calculate returns based on Thursday's close. If a rank change is made on a Friday, we use Tuesday's close. Occasionally, our recommendations impact a stock's price. But, because we wait at least a full trading day after each rank change before recording prices, we're confident subscribers can garner returns similar to what we present in the newsletter.

Q *How do I get the twice-weekly hotlines?*

A Go to **www.UpsideStocks.com**. Or call our toll-free telephone hotline listed on page 6 of the newsletter.

Q *Your advertising touts* Upside's *performance in* The Hulbert Financial Digest*, but I don't see you listed among* Hulbert's *leaders. What gives?*

A *Upside*, formerly *Low Priced Stock Survey*, has been published continually since 1980. Your editor, Richard Moroney, took charge of the newsletter in March 1999. From June 2001 to May 2003, *Upside* was included as part of a subscription to *Dow Theory Forecasts*. *The Hulbert Financial Digest* considers *Upside's* performance from June 2001 to May 2003 part of the *Forecasts'* track record, so *Upside* does not yet have a five-year track record in *Hulbert*. *Hulbert* has tracked *Upside's* Best Buy List without interruption, though reported returns are impacted by the cash position the *Forecasts* recommended from June 2001 to May 2003.

Q *If I use* Upside*, how much buying and selling can I expect?*

A Opportunities will dictate trading activity, but we tend to add two to four new stocks in each monthly issue. We also sell two to four names per month, sometimes on the twice-weekly hotlines. On average, stocks have been held on the Best Buy List for nearly eight months and the Buy List for about nine months.

Q *Why don't you show initial recommendation prices in the newsletter?*

A We think there is more important information to present, and a list of all current and closed-out recommendations is available on request. Just call or write, and we'll mail you the *Upside* Performance History.

Q *I'm looking for current income. Why do so few Upside recommendations pay dividends?*

A Your editors strive to recommend only the best small and midcap stocks for 12-months returns. Many exceptions exist, but finding high-quality dividend plays among small and midcap companies is relatively hard at this time — and we will not recommend a second-tier stock simply because it pays a good yield. Income investors who like *Upside's* approach should consider *Dow Theory Forecasts*, which recommends many quality dividend plays. Published since 1946, *Dow Theory Forecasts* uses the Quadrix stock-rating system and has the same editor as *Upside*.

Q *I bought XYZ Corp. on your recommendation — five days later you said to sell the shares. What gives?*

A Every Tuesday and Friday, your editors review each stock on the Buy List with one question in mind: Given today's valuation and the company's prospects, does the stock rank among our top picks for 12-month gains? If the answer is no, we'll downgrade to Sell. In general, rank changes on our Tuesday and Friday hotlines are downgrades to Sell. But most rank changes, and nearly all new recommendations, are made in the monthly publication.

Q *Your Quadrix scores are presented as percentile ranks. What is a percentile rank?*

A Percentile ranks range from 0 to 100. If a stock earns an Overall score of 97, it ranks better than roughly 97% of the some 4,000 U.S. companies in our Quadrix universe. Similarly, if a stock earns a score of 97 for trailing price/earnings ratio, its P/E ratio is lower than roughly 97% of the nearly 4,000 companies.

Q *What Quadrix score is most important?*

A The Quadrix Overall score is most important. In real-time use since 2000 and back-testing to 1990, Overall scores have done a good job of identifying likely winners and losers. A stock's Overall score depends on its scores for Momentum (recent operating results), Value (price/earnings, price/cash flow, and other valuation ratios), Quality (long-term growth records and returns on assets, equity, and investment), Financial Strength (debt levels, interest coverage, and profit margins), Earnings Estimates (trends in analyst estimates), and Performance (stock returns in different periods over the past 12 months).

Q *If Overall score is most important, why do you show the others?*

A By looking at all the category scores, you can quickly determine why a stock is earning a good or bad Overall score. For example, if a top-ranked stock earns a score of 25 for Value, 80 for Quality, and 80 for Momentum, you know it is scoring well because strong operating results are countering a relatively expensive valuation.

Also, we've found it generally pays to avoid stocks with very low scores for Value, Performance, and Earnings Estimates. We sometimes make exceptions if we feel a company has suffered a one-time hit to its earnings estimates and share price. But, in general, we avoid stocks with Value, Performance, or Earnings Estimates scores below 20.

Finally, the category scores allow you to pick stocks that suit your investment style. If you're a dyed-in-the-wool value investor, stick to stocks with good Value scores. If you're a momentum-oriented investor, emphasize Momentum, Performance, and Earnings Estimates.

Q *Insiders have been selling XYZ Corp. Don't you consider that in your recommendation?*

A In general, we view insider buying as more significant than insider selling, though unusually heavy selling is a yellow flag. With so much of today's executive compensation paid in stock or stock options, limiting our Buy List to stocks without insider selling would severely restrict our choices.

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