

INVESTLETTER



Volume 6 Number 4

Uncovering Patterns

Wall Street:

- DJ 12820
- S&P 500 1386
- NASDAQ 2412

One company acts another reacts. A new more cost effective method for producing solar cells is developed and the ordering of thin metallic film rises from a supplier of the same. The demand for silicon drops and the demand for thin metallic film rises.

Turbulence; markets move in fits and starts. Gencor's price rises almost daily from \$9 to \$30 in 3 months after spending years oscillating over a range from \$7 to \$12. It promptly returns to \$14 over the course of a couple of weeks. This is a series of big gains and equally big losses over relatively short periods of time.

In order to drive a car you don't need to be able to explain the inner working of an internal combustion engine.



Now you see it, now you don't. People often see patterns, even those that don't exist.

Shown an unlabeled graphical representation of thousands of computer generated coin tosses scaled to rise one each time a particular head or tail flip occurs and which generates a new data point each time the opposite side occurs, people believe they can spot patterns. It is your mind playing tricks on you. A coin toss game is completely random. Each event is independent of the one before it. If you flip 5 heads in a row your next flip is equally likely to be a head as a tail. The odds are still 50%. Yet when a series of coin flips is represented graphically, people perceive they can discern some sort of pattern. Humans appear wired to be able to discern patterns. There are thousands of patterns that we recognize, that we adjust for to simplify our lives. Five o'clock comes and rush hour traffic increases. If we were to look at a graph of traffic volumes we could easily spot the difference between a weekend and a weekday. Humans also seem to be able to recognize patterns that do not exist like changes in stock prices or the hot hand in basketball. Players at the NBA level maintain fairly even shooting percentages over their careers. If a player has sunk a high percentage of shots during the course of a game he often is deemed to have a hot hand. It is going to happen from time to time, but will be balanced out by periods when a player makes a lower percentage than his average. In reality it is not much different from flipping 5 heads in a row, you are defying the odds for a short period of time. It is a function of the odds. Shooting 9 out of 10 from the field in a basketball game has nothing to do with a hot hand; it is a normal function of a player who is a skilled basketball player defying the odds for a short period of time, just as it is expected to happen from time to time.

Classical finance theory proposes that stock price changes happen independently of each other. No one price has anything to do with any other for each company and between companies. Price changes are random. We say take a look at the example above, when one company makes a business decision (to produce solar cells using a new more cost effective method) it impacts other companies. It is not a big leap to say stock prices are dependent. (Recent research support

Inside this issue:

- Risk 1
- Amen AMIN 2
- Watch List 3
- Investletter Portfolio 4
- Year to Date 5
- Performance 6

continued

this fact as does common sense.) When IBM started producing PC's it directly affected typewriter manufacturers. They had an impact on the value of the companies involved and a corresponding impact on the price of their shares. Maybe not instantaneously, but eventually.

You don't need to know how complex systems work to take advantage of them.

You don't need to know exactly how markets work to profit from them. Nobody can explain exactly what caused Gencor's price to change so dramatically over such a short time frame after essentially doing nothing for years. Some people can explain exactly how an internal combustion engine works and they make be able to profit from this knowledge. Markets are much too complex with too many dependencies to be able to filter it all down to a simple explanation. We were still able to profit from Gencor's change even though we can't do a very good job explaining how or why it happened.

We can say that businesses don't operate independent of one another. Likewise we can't discern any useful pattern in the movement in a companies share price. Be careful when looking at graphs of price moves because they are not a prologue to future price changes. Often you will see dramatic swings in prices that often occur without warning. It may even be because of events that happened some time ago or an accumulation of events.

All of this brings us back to what we have relied on for years. Picking out arbitrage opportunities where a the value of a company is something different than what Wall Street feels it is. Sometimes we will be able to invest in one of these companies that will be managed by talented individuals who can generate above average growth and above average returns for shareholders. Never can we predict with any certainty what will happen to share prices. While we can consider some of the dependencies that will affect the share price, is it difficult to tell when and in what magnitude.

New Blood

Here are a few of the companies we are investigating as investment opportunities. Mesa Labs produces self-contained, wireless, high precision, data loggers that are used in critical manufacturing, quality control, and transportation applications. They are used to measure temperature, humidity and pressure inside a process or inside a product during manufacturing. Another company they own manufactures Biological Indicators (BI) and Chemical Indicators (CI) used to assess the effectiveness of sterilization processes, including steam, gas (such as ethylene oxide), and radiation. Biological Indicators consist of resistant spores of certain microorganisms which are applied on a convenient substrate. The spores are well characterized in terms of numbers and resistance to sterilization. In use, the BI is exposed to a sterilization process and then tested to determine the presence of surviving organisms. The RAVEN BI include both spore strips, which require post-processing transfer to a growth media and self-contained products which have the growth media already pre-packaged in crushable ampoules. They also make products used in dialysis. Hemodialysis requires the treatment to be conducted on a dialysis machine through the use of a disposable cartridge known as a dialyzer.

They make several other products including flow meters used in fluid measurement and other products used in dialysis. The attractiveness is that many of their products involve disposable components. Repeat business based on consumables used for a proprietary prod-

Watch List

uct is a formula we are very comfortable with. Think Gillette and razors or Hewlett Packard and printer ink. Once you get the product out in the marketplace you get a continuing revenue stream from customers ordering replacement materials to keep the machinery running.

The company sports a solid balance sheet with no long term debt. They have sales growth and huge profit margins. The company does not come cheap, but is a worthy company to take a look at.

Park Ohio Holdings operates through three segments: Supply Technologies, Aluminum Products, and Manufactured Products. The Supply Technologies segment provides supply chain management services and also engineers and manufactures precision cold formed and cold extruded products, including locknuts, SPAC nuts, and wheel hardware. It serves heavy-duty truck, automotive and vehicle parts, electrical distribution and controls, consumer electronics, power sports/fitness equipment, HVAC, semiconductor equipment, plumbing, aerospace and defense, and appliance industries. The Aluminum Products segment casts and machines aluminum engine, transmission, brake, suspension, and other components for automotive, agricultural equipment, construction equipment, and marine equipment original equipment manufacturers (OEMs). It offers pump housings, clutch retainers and pistons, control arms, knuckles, master cylinders, pinion housings, brake calipers, oil pans, and flywheel spacers, as well as design engineering, machining, and part assembly services. The Manufactured Products segment provides various engineered products, including induction heating and melting systems, pipe threading systems, rubber products, and forged and machined products.

Wow, what a laundry list. Many of these lines of business are going to be performing poorly with high gas prices and slowing auto sales. The one thing holding back our early enthusiasm is a large amount of debt. The company is nicely profitable and the price is down about 50%, enough to attract our attention.

Company	April price	March price	Change from March	P/E	52 Week High	52 Week Low	Estimated '08 EPS	Dividend Yield
Alico/ALCO	\$39.94	\$44.15	-9.54%	n/a	\$65.00	\$35.35	n/a	2.80%
Alliant Techsystems Inc./ATK	\$109.98	\$103.53	6.23%	17.2	\$120.90	\$92.20	\$6.39	n/a
Arch Coal/ACI	\$57.36	\$43.50	31.86%	21.9	\$62.99	\$27.76	\$2.62	0.60%
Culp/CFI	\$7.03	\$7.52	-6.52%	13.3	\$12.30	\$6.12	\$0.53	n/a
Gencor/GENC	\$26.33	\$17.21	52.99%	8.4	\$30.00	\$8.50	n/a	n/a
Graham Corp./GHM	\$57.18	\$35.61	60.57%	18.7	\$60.96	\$13.45	\$3.17	0.20%
St. Joe Company/JOE	\$40.67	\$42.93	-5.26%	79.0	\$60.85	\$26.70	\$0.64	1.50%
Landauer, Inc./LDR	\$53.25	\$50.34	5.78%	24.8	\$55.34	\$45.50	n/a	3.80%
Mesa Labs/MLAB	\$21.80	\$21.93	-0.59%	14.7	\$27.00	\$17.90	n/a	1.80%
National Technical System/NTSC	\$5.77	\$5.95	-3.03%	21.2	\$7.48	\$5.44	n/a	n/a
Park Ohio Holdings Corp/PKOH	\$16.68	\$15.71	6.17%	9.2	\$32.00	\$13.70	\$2.17	n/a
Schuff International/SHFK	\$26.25	\$27.00	-2.78%	3.9	\$35.00	\$20.00	n/a	n/a
Servotronics Inc./SVT	\$17.50	\$20.17	-13.24%	18.9	\$22.48	\$8.42	n/a	n/a
Span America Medial Sys/SPAN	\$11.50	\$11.79	-2.46%	10.8	\$30.95	\$9.88	n/a	2.80%
Tejon Ranch Co./TRC	\$42.26	\$37.32	13.24%	n/a	\$50.89	\$33.71	\$0.42	n/a
Torm/TRMD	\$32.95	\$29.74	10.79%	2.9	\$47.10	\$26.52	\$4.51	15.80%

The Investletter Portfolio

Even though many of our holdings have performed poorly so far this year we have plenty to be excited about. Companies operate on one time schedule and Wall Street operates on its own separate measure of time. To this point in 2008 the two haven't been closely matched. Our holding Amtech Systems (ASYS) recently reported their second quarter financials. On one level the results were outstanding and on another, the results were somewhat lackluster.

The company is experiencing meteoric growth. Revenues rose 67% over the same quarter in 2007. Sequentially revenues were up 50% over last quarter. More importantly their orders for equipment that is expected to ship in the next twelve months have absolutely exploded up 296%. Orders for their solar equipment have jumped 600% compared to the same quarter in 2007. This type of growth is extremely exciting for owners as much as it often is trying for managers. Fortunately the company added manufacturing space last year or the growth would be unmanageable.

It is not too hard to imagine the problems that can occur when a business grows this fast. Imagine a pizza place one hour before kick-off on Super Bowl Sunday. Everything from training new employees to ordering and coordinating inventory purchases becomes more complex and time consuming. This is going on while one of the company's business lines has been experiencing a slowdown that will lead to layoffs and the company taking a restructuring charge in the second quarter. All of this leads up to the fact that the company isn't making much money yet, even with all of the added revenues. We are betting this all changes as the company gains operating leverage with the continued rapid sales growth. Sometimes it is tough waiting out the growing pains, but it is not unexpected. Wall Street is looking for results now. We have the luxury of jumping in on a company with a few growing pains that is likely to be hitting on all cylinders once they get a handle on their rapidly expanding size. Eventually, a larger percentage of the marginal revenues will drop to the bottom line. Our plan is to be there waiting.

One other note, the company has almost half of their manufacturing operations in the US, yet only generates 17% of their revenue in North America. Asia is responsible for 59% of revenues (34% from China alone) and Europe is the other 24%. These are some of the new jobs that are helping drive the US economy. What makes this whole situation ironic is the company's CEO is of Chinese heritage. This is a little different than the familiar equation of a US company utilizing low cost Chinese labor to produce cheap goods for export to the US.

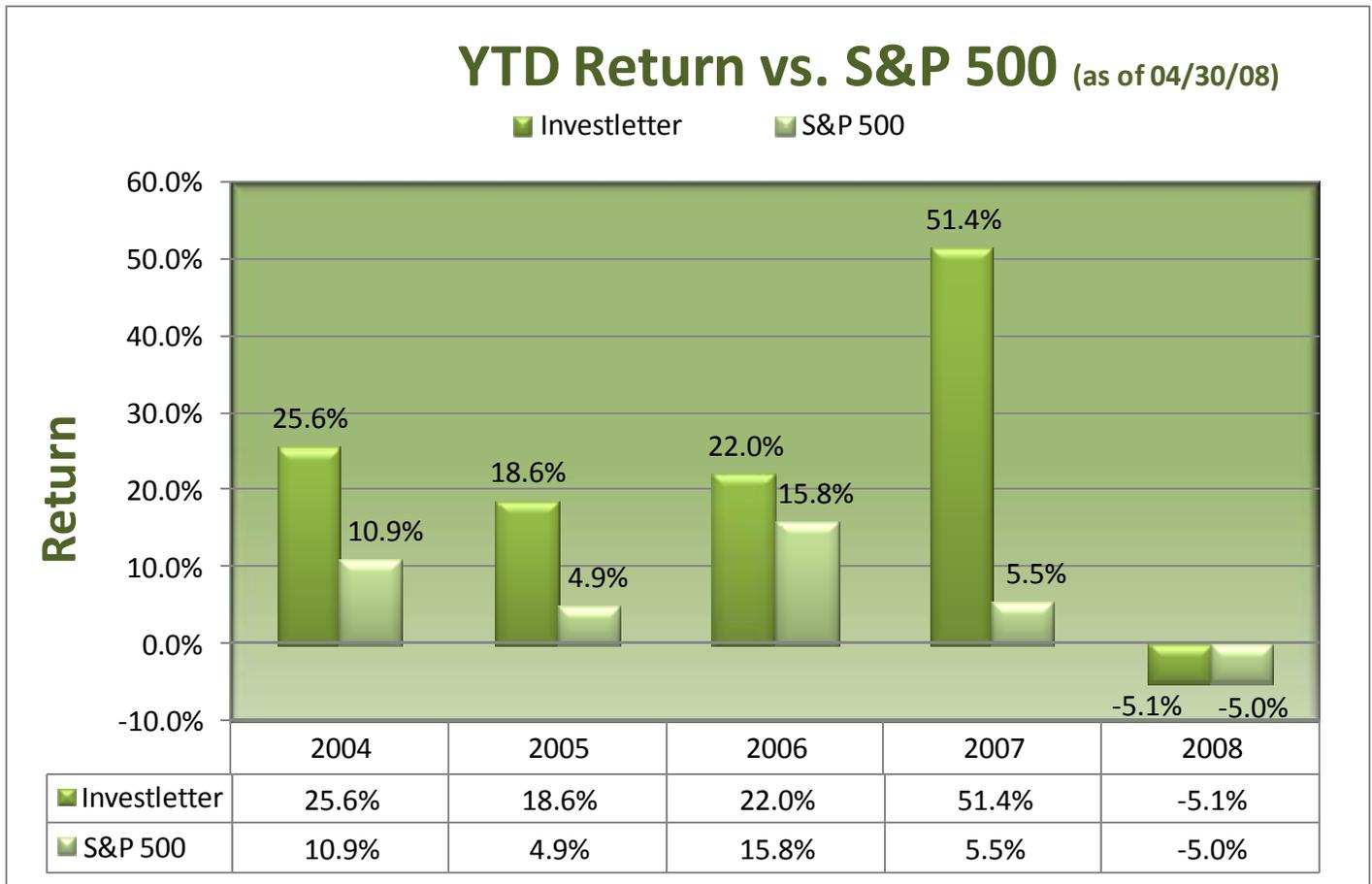
Company	Portfolio Percentage	April price	March Price	Percentage Change	Buy Price (less than)	P/E	Dividend Yield
American International/AMIN	5.60%	\$4.50	\$4.09	10.02%	\$4.95	n/a	n/a
Amtech Systems/ASYS	7.40%	\$12.44	\$12.04	3.32%	\$11.15	31.4	n/a
Astronics Corporation/ATRO	8.60%	\$17.80	\$19.32	-7.87%	\$20.00	13.1	n/a
Atrion/ATRI	6.30%	\$111.90	\$99.99	11.91%	\$93.00	15.9	0.90%
Berkshire Hathaway B/BRK.B	7.10%	\$4,457.00	\$4,473.00	-0.36%	\$4,000.00	15.6	n/a
Cash	18.90%	\$1.00	\$1.00	n/a	n/a	n/a	n/a
Chesapeake/CHK	7.30%	\$51.70	\$46.15	12.03%	\$33.00	14.2	0.50%
CSP Inc./CSPI	7.00%	\$5.93	\$6.03	-1.66%	\$7.00	8.5	n/a
Griffin Land & Nurseries/GRIF	4.40%	\$33.16	\$34.50	-3.88%	\$35.00	22.1	n/a
Headwaters/HW	0.80%	\$11.43	\$13.19	-13.34%	\$14.00	14.3	n/a
K-Tron International/KTII	10.30%	\$137.00	\$120.11	14.06%	\$90.00	18.4	n/a
Protein Design Labs/PDLI	0.30%	\$13.26	\$10.59	25.21%	\$15.00	n/a	n/a
QEP Corporation/QEPC	7.70%	\$7.17	\$7.70	-6.88%	\$12.00	11.6	n/a
Rayonier/RYN	8.30%	\$42.03	\$43.44	-3.25%	\$41.00	18.7	4.60%

Year to Date

In April we stunk out the joint again. We have fallen behind the S&P 500's return year to date. Many of our undervalued small companies have remained undervalued small companies. It is good news that the economy is still growing; it is bad news that it is at a very slow pace. Small companies tend to be the first to struggle when economic growth slows. Even though all small companies don't fare the same in economic slowdowns, it is often hard to tell from their share prices. Often the good are tossed out with the bad in the stock market.

In the near future the economic stimulus payments will hit in full force and this should provide a healthy boost for the retailers and then spread through the economy. How lasting the effect remains to be seen.

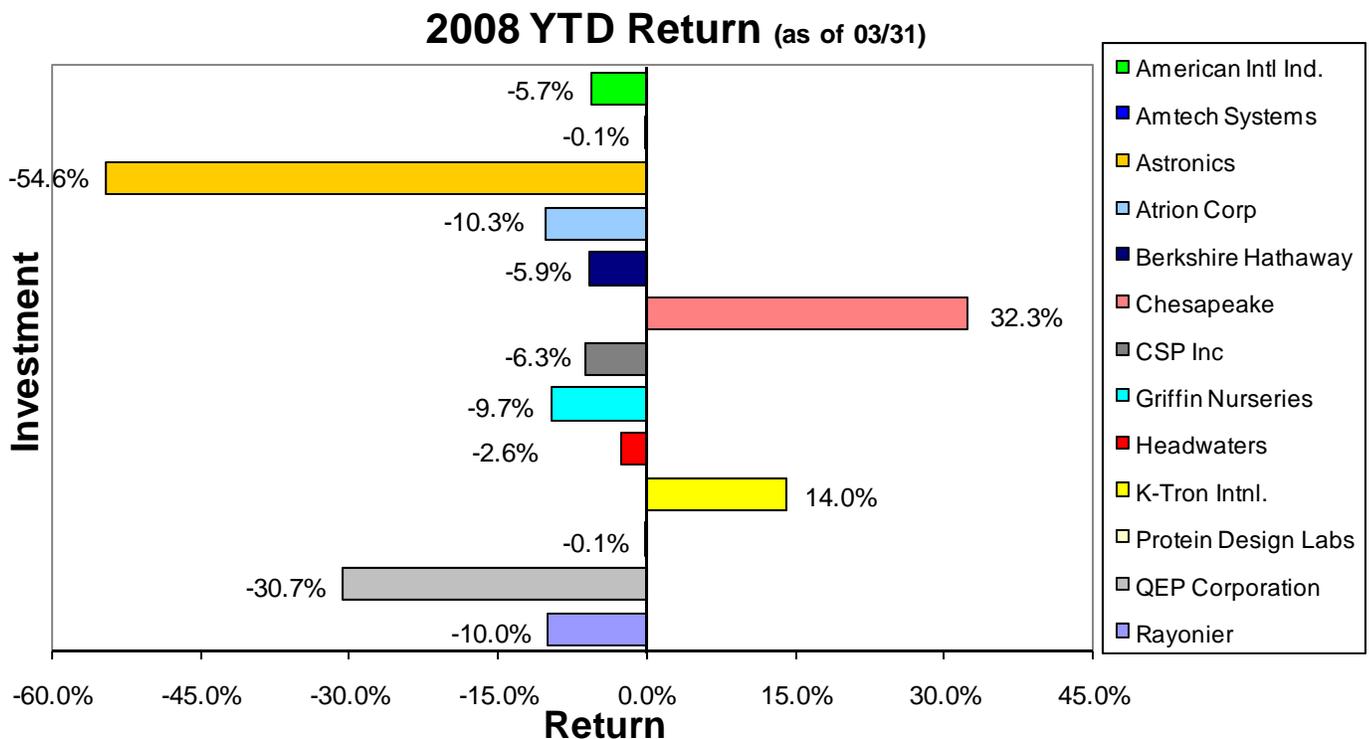
The sharp rise in gasoline and food prices are going to make it difficult for the economy to get back on track. The stimulus checks may even have a negative effect on fuel prices if the extra cash encourages people to do more driving. Another inflationary pressure falls a little closer to home for us. Natural gas prices are up over 40% this year. There was much greater natural gas usage this winter than last year. The storage is below the five year average and production is at lower levels than consumption. Last year we imported more natural gas than we will this year. Foreign countries are paying a premium to the prices that can be had in the U.S. and the shorter shipping distances have made the U.S. that destination of last resort for liquid natural gas. The price of natural gas could be sharply higher next winter when the combined effect of lower production and imports is factored in. Take a look at Chesapeake (CHK) and their change in price year to date on page 6.



Performance

Chesapeake (CHK) operates as our hedge against high gas bills for the subscribers in the northeast. When the price of gas rises you can count on shares of the natural gas producers to rise. When the price of oil rises you can pretty much count on the natural gas producers to rise. When the supply declines, again you can count on the price of the producers to rise. All of these events have happened this year. A warm summer and we could be looking at record natural gas prices next winter. For any of you who have invested in CHK, the rise in natural gas has been accompanied by a much larger increase in the value of your investment into CHK. We originally purchase our shares in CHK in the summer of 2006 at a bit less than \$30. Currently the shares are trading well over \$50.

The rising price of natural gas has helped, but the company has also announced a major new gas find that may double the amount of reserves they have. After announcing they were going to scale back exploration last year to concentrate on generating large cash flows to help increase the value of the company, the company recently did an abrupt about face after announcing the gas find. They are seizing on the supply weakness and strong gas prices to spend lots of money to bring more gas into production. They have been selling off mature producing fields to generate cash to fund a massive drilling program that will show tremendous benefits over the next several years. Our investment accounts can hardly wait.



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