

# INVESTLETTER



Volume 4 Number 7

## Reading Between The Lines

### Wall Street

- DJ 11381
- S&P 500 1304
- NASDAQ 2184

Each spring many of you find your mailboxes stuffed with annual reports from the companies you own. One of the most important sections is the annual Chairman's Letter. Each year the Chairman of the Board of Directors is required to report on the progress the company has made, reflect on the past years performance and the future direction. Usually a couple of pages, this letter often sheds a great deal of information on how confident management (many times the Chairman of the Board is also the CEO) is about the future and how well they are stewarding the owner's investment. Some companies also have the CEO (when the CEO is not also the Chairman) present a separate letter representing managements view of how well that company is doing.



**How they say it is often as important as what they say, when it comes to Chairman's Letters.**

Some of the letters have a reputation that borders on legendary. Warren Buffett's annual letter in the Berkshire Hathaway's annual report usually numbers more than twenty pages sprinkled with his witty homespun humor. Some Chairman have earned reputations with their brutal honesty like Overstock's Dr. Patrick Byrne. Others over promise and under deliver like Dr. Stephen Sherwin of our own Cell Genesys. He has routinely announced timelines and failed to even come close to meeting them. Sometimes even announcing timelines for the same event in successive years and failing more than once to meet the same objective. In our weak defense, a pattern like this takes several years to become apparent.

Sometimes what is most important is not what is said, but how it is said. The number of definite references compared to the more general could, should and maybes can often be a predictor of future trouble or a defined path to success.

We also are cognizant of the overall quality of the report that the letter appears in. If the annual report is printed on extremely expensive paper and loaded with fancy pictures especially ones of management and the Board it can serve as a warning signal to the aptitude of management towards spending shareholder's money. Don't expect a CEO who spares no expense on the production of the annual report to suddenly get religion and have a spartan office, fly coach and drive a ford sedan for a company car.

With the people who are overseeing our investment in their company also playing a role in how the company's funds are spent and deciding which strategic direction to head in, it is important to read the annual letter and look to pick up as many clues as you can. Our investment in Culp is a good example. The CEO Robert Culp III is brutally honest about the problems the company is struggling with. He also clearly lays out the steps that have been taken to return the company to profitability. We also take great comfort in the fact that the report is rather plain and almost devoid of any pictures. This is a guy who is a careful steward of the shareholders money.

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## Watch List

It seems every time we get close to the point where we can pull the trigger on a company we like, the share price moves back up and soothes our itchy trigger finger. August was a bit of help, but not much. Rayonier is near a price we find agreeable. Maybe in the near future we will get our chance.

We are also waiting for some information from the company to update our valuation. We find it much more comfortable pouring over the information using paper copies than trying to digest it in front of a computer screen. It gets too messy trying to flip back and forth using digital documents. From there, using Excel spreadsheets greatly aids us in manipulating the data we find useful in valuing companies.

In the past few months we have looked at companies that mine coal, manufacture uranium, make truck bodies and manufacture booster engines for the space shuttle. Several candidates are solid well managed companies that should produce good operating results going forward. A characteristic we find very important and is also closely associated with what would be termed growth stocks.

It always comes back to the price and we are reluctant to pay too much. That bears a close resemblance to value investing. So which is it, are we value investors or growth investors? As Warren Buffett has stated, the two cannot be separated. Ultimately, we have no concern whatsoever how our investment style is classified. We are only rewarded based on the success of our picks. It matters not what cutesy name is applied; it does not change how we operate. There is no reason to be pigeonholed into any particular style or character of company we own. We have no preference for stocks that bear any particular label; our bottom line is performance.

To get great performance you have to be willing to change your approach based on what you are given to work with. Some companies catch our eye because of the strength of the assets they own like Chesapeake. Others thrill us with the prospects of solid growth like Astronics. Still others are found by sifting through the gutter for companies that others have discarded like Culp. The companies you see below are a mix of all of the above and then some. It doesn't pay to be choosy. A good idea and a company that proves to be mis-priced is a bargain no matter what label it wears. In the end we have no style (in more ways than one) and it matters not. In order to find a way into our portfolio we need a company with solid prospects of generating good returns for us, it just has to be at a price we feel comfortable with.

Company	August price	July price	Change from July	P/E	52 Week High	52 Week Low	Estimated '06 EPS	Dividend Yield
Alliant Techsystems Inc./ATK	\$76.49	\$80.14	-4.55%	15.2	\$84.90	\$67.20	\$5.05	n/a
Altria Group, Inc./MO	\$83.53	\$79.97	4.45%	15.7	\$85.00	\$68.36	\$5.32	3.80%
Bioanalytical Systems, Inc./BASI	\$5.56	\$6.29	-11.61%	n/a	\$7.80	\$4.75	n/a	n/a
Canadian Natural Res./CNQ	\$52.59	\$53.24	-1.22%	17.4	\$64.38	\$36.64	\$3.03	0.50%
CSP Inc./CSPI	\$8.08	\$7.08	14.12%	n/a	\$8.38	\$5.59	n/a	n/a
Kensley Nash/KNSY	\$27.08	\$28.26	-4.18%	28.8	\$33.33	\$19.32	\$0.94	n/a
Landauer, Inc./LDR	\$47.92	\$46.77	2.46%	21.8	\$53.95	\$43.11	\$2.20	3.70%
Markel	\$363.33	\$340.65	6.66%	13.9	\$371.00	\$307.41	\$26.24	
ModPac/MPAC	\$10.78	\$9.57	12.64%	n/a	\$13.68	\$8.00	n/a	n/a
QLT Inc./QLTI	\$7.71	\$7.07	9.05%	20.8	\$9.00	\$5.93	\$0.37	n/a
Rayonier/RYN	\$39.50	\$39.81	-0.78%	22.4	\$47.50	\$34.00	\$1.76	4.80%
Servotronics Inc./SVT	\$6.80	\$7.11	-4.36%	8.6	\$10.30	\$3.85	n/a	n/a
Tejon Ranch Co./TRC	\$43.39	4081%	6.32%	n/a	\$52.83	\$37.55	n/a	n/a

## The Investletter Portfolio

The chart below shows our investments and the proportion of our portfolio they represent. As you can see, we are heavily weighted towards two stocks. This is considered extremely risky by the popular investment community. We feel perfectly comfortable with it. To achieve the same returns we will receive, you can buy all of the stocks we own in roughly the same proportion. After some time considering how best to invest in the Investletter Portfolio, we have decided that it is best to just invest in all of the stocks we recommend immediately without picking and choosing. The buy price can serve as a target to guide you as to how we feel the shares are currently priced. This can be compared to what the company is currently selling for and be used in making short term purchasing decisions.

Astronics (ATRO) saw another VLJ (Very Light Jet), the Cessna Mustang gain FAA approval. Just as with the Eclipse 500, Astronics has content on this plane. Cessna has orders for 250 of the Mustangs and is sold out until 2009. This is a great deal fewer planes than Eclipse is planning to sell, but a nice piece of business nonetheless. Astronics also has content on several Boeing planes. Boeing has been booking orders this year at their fastest rate since before 9/11. All of this activity adds up to some nice revenue for Astronics, especially in 2007.

Astronics was not the only company in our portfolio to receive a healthy dose of good news. Headwaters, who was in need of some good news, announced several customers restarted their synfuel operations. This will generate a great deal of high profit margin revenue for HW. The drop in the share price that was brought on by the shuttering of these operations due to the elevated oil prices has already started to reverse. If oil prices stay near the current levels next year it will mean a great deal of revenue and income for HW. Without this revenue, we will be forced to wait for several of their promising projects to take off before profits return to pre 2006 levels.

Lastly, we have news on our "Old Reliable" OMI. OMI has been doing what they do best, generating large cash flows, buying back shares and rewarding shareholders. They recently announced a \$70mm increase in their ongoing share buy-back program. With the remaining amount from the previous buyback, the company now has \$113 authorized which is enough to purchase more than 3 million shares. The company ended the second quarter with 66.8 million shares. To top it off they also increased the quarterly dividend by 25% to 12.5 cents. When we purchased shares in the company in 2002 at a price of \$2.90 the company paid no dividend. Now, with 50 cents in yearly dividends, we have a 17% dividend yield on the original purchase price of those early shares. Small dividend yields on a fast growing company can quickly surpass the value of large dividend yields from a slower growing company. Dividend yield can be thought of a lot like a bond coupon. It can be found by dividing the yearly dividend by the share price. Only a bond coupon never changes, while dividends are likely to increase over time.

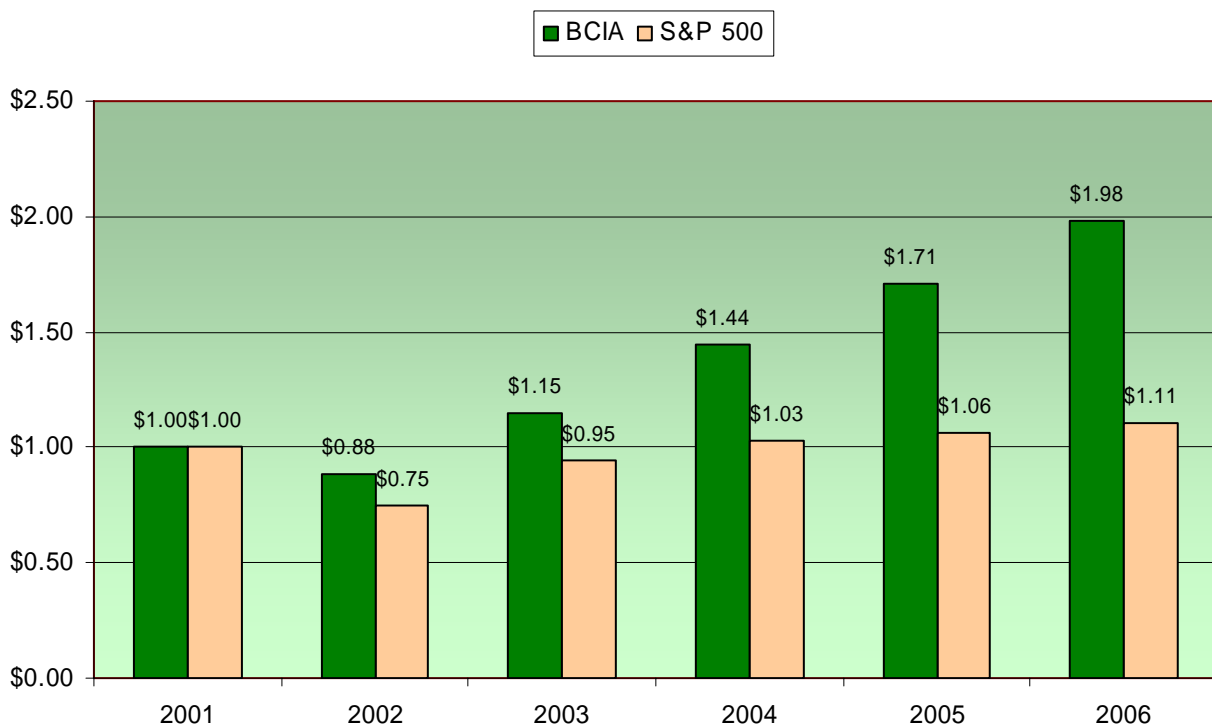
Company	Porfolio Percentage	August price	July Price	Percentage Change	Buy Price (less than)	P/E	Dividend Yield
Alico/ALCO	6.30%	\$58.78	\$54.50	7.85%	\$50.00	48.0	1.90%
Astronics Corporation/ATRO	15.20%	\$15.95	\$13.16	17.80%	\$13.00	23.2	n/a
Berkshire Hathaway B/BRK.B	8.50%	\$3,203.00	\$3,047.00	5.12%	\$2,900.00	14.5	n/a
Cash	22.80%	\$1.00	\$1.00	n/a	n/a	n/a	n/a
Cell Genesys, Inc./CEGE	2.20%	\$4.99	\$4.91	1.63%	\$5.00	n/a	n/a
Chesapeake/CHK	3.90%	\$31.57	\$32.95	-4.19%	\$30.00	7.2	0.80%
Culp/CFI	2.90%	\$5.09	\$5.19	-1.93%	\$4.40	19.6	n/a
Gencor/GNCI	7.00%	\$9.25	\$9.20	0.54%	\$8.50	5.4	n/a
Headwaters/HW	2.50%	\$22.12	\$23.14	-4.41%	\$25.00	9.2	n/a
K-Tron International/KTII	5.10%	\$58.12	\$51.00	13.96%	\$42.00	18.1	n/a
OMI Corporation/OMM	20.40%	\$22.52	\$22.00	2.36%	\$18.00	7.7	1.70%
Protein Design Labs/PDLI	1.00%	\$19.70	\$18.01	9.38%	\$24.00	n/a	92
Specialized Health Products/SHPI	1.30%	\$0.67	\$0.40	67.50%	\$0.40	n/a	n/a
Terra Systems/TSYI	0.90%	\$0.50	\$0.65	-23.08%	\$0.60	n/a	n/a

## Performance

The good news just keeps on coming. August was very kind to the S&P 500 market average, and even kinder to our portfolio. Our portfolio rose 6.8 percentage points in August compared to 2.7 percentage point rise for the S&P 500 average. For the year we are up 15.8% versus the S&P's 4.5% increase. A dollar invested at the end of 2001 using our portfolio picks would have grown to \$1.98 at the end of August. An investment in the S&P 500 average would have turned your dollar into \$1.11.

A five year period is probably the minimum timeframe that you can use to form any concrete opinion about the success of any investment strategy. Even with our very fortunate performance over that timeframe, it still is not very awe inspiring. We are proud of our accomplishments, but very wary of letting it prevent us from focusing on the only true timeframe that matters for all of us; the next five years and beyond. Right now we feel like a clean up hitter in a slump. The pitches have been looking blurry and we have been watching a lot of balls pass without a swing. Fortunately in our game there are no called strikes. Lets hope a fat pitch comes sailing down the pipe soon.

**Value of One Dollar Invested at The End of 2001 as of 8/31/2006**



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