The Commonsense

# INVESTLETTER

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**Wall Street**

- DJ 10993
- S&P 500 1281
- NASDAQ 2281

## How Much is Tomorrow Worth Today?

Last month we talked about how inflation has an impact on how much your money is worth in the future. We used that as an introduction to the time value of money. In the future your money is worth less. Not only does inflation reduce its value but you also have to take into account what else you could do with your money. For example you might invest some money in a CD. If your CD did not pay as much as inflation you would be losing purchasing power over time. If junk bonds are paying 10%, you would be out-pacing the governments current measure of inflation and increase your purchasing power, as long as the value of your bonds did not drop.

***Filtering out time's effect can help us value a business today.***

How about stocks? How can you place a value on them using future results? We do it in a similar fashion as for a CD. Often it is not necessary to be real exact to get a number that is still extremely useful. Bonds pay interest at a steady coupon rate. If you buy a bond for $1000 paying semi annual interest payment at a 5% yearly rate you will make $50 per year. With a stock you get no regular interest payments, although, some stocks pay dividends that are a lot like interest payments. You get them usually four times a year, they are a fixed amount (mostly) over the course of a year and they reward you for investing in the company. But many companies that don't pay dividends generate cash that could be used to make dividend payments if the company was not using the cash to reinvest in the business. If you are able to predict the cash generating ability of a company within a reasonable range, you can treat this cash as a de facto dividend. The next part is where it gets fun.

Lets say that with a reasonable degree of certainty you can predict that a company will earn $50 this year and 10% more each year for the next ten years. Now we have most of the information to calculate what a company is worth today. All of this is leading to how I made the glaring error I did regarding Asta Funding (ASFI). Sometimes a small assumption can lead to a huge miscalculation.

First we are going to walk through some quick calculations. These are real similar to what we talked about regarding inflation. If a company earns $50 this year it is worth $50 to them. If they earn $55 next year it is not worth $55 today. The question we need to ask is how much do you need to invest today to have $55 next year if you the investor could get 10% in another investment? The answer can be found by dividing $55 by one plus the 10% rate of return. We take $55 and divide it by 1.10 and this yields us $50. This is discounting future earnings back to present value. The reverse says how much money do we need today to have $55 in one year if we can earn 10%. Fifty dollars is what $55 at the end of the year is worth to you today. Discount rate is sort of what kind of return do you require to invest in a company. Say the company's earnings rise 15% in the second year ($55 plus 15%) to $63.25, what would that be worth today? It would be

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## How Much?

worth $52.27.  If you add up the present value of all of these cash payments that a company can generate in the future, it gives you an idea of how much a company is worth today.  Obviously the more cash a company can generate, the more it is worth.  Some more assumptions are made but this is generally how it is done.

The critical assumptions you need to make are, what kind of return could you easily get from an investment and how will a company grow its earnings over time? The hard part is being able to accurately judge how a company will perform over an extended period of time.  I can't tell you what Google will look like in 10 years.  I can give a pretty reasonable prediction of what Coke or Wal Mart will look like (unfortunately so can several hundred other people).  Sometimes you may have better insight into a company than almost everyone else and be able to pin a more accurate value on them.  This gives you a big advantage.

With AFSI I made a simplifying assumption that just did not turn out to be true.  I assumed that the cash flow this year was understated because of a large purchase of assets they made.  I goosed up their cash flow numbers a bit to compensate for what I saw as a one time difference in what normal cash flow numbers would look like for the company.  I have examined these numbers hundreds, if not more than a thousand times with other companies.  ASFI happens to be a rare case where adjusting these numbers for what I saw as a temporary condition was not only foolish, but dangerous to our collective wealth.  With other companies this can be done with no problem at all.  ASFI is the first time I have ever been exposed to the sensitivity of the cash flow numbers in this fashion.  This small adjustment that would have made the figure more accurate for many companies led to a gross overstatement in the current value of ASFI.  I had pegged their value at close to $60.  After I was tipped off to the error in my ways, my calculations showed a value that was something less than $30.  The company is currently trading at more than the company is probably worth.  The illusion is so complete that there is a good chance that the share price may actually trade higher before it goes lower.  The problem is that the company uses up its assets so rapidly and needs to spend so much to replace them, that they hardly throw off much cash at all to their investors.  It is not surprising considering the business they are in, collections.  That should have served as a cautionary tip off .  Collections is a tough business with low profit margins.  I thought that I had found a diamond in the rough when I really had found fools gold.

*It is all about the cash flow.  Investors can spend cash.  Earnings are an artificial substitute.*

Fortunately, I learned my lesson before I had caused any real damage.  I have said before that investing is cumulative.  The lesson I have learned I will carry with me for the rest of my life. This is just another tool I can add to my arsenal used to evaluate companies.  Mistakes like this go along way towards puncturing any ego that may become over-inflated.  I was both embarrassed and humbled at my ignorance and stupidity.  However, I would much rather have my ego deflated than my or your brokerage account.

I always like to emphasize that you will make some mistakes when investing.  It is much better when you just fail at predicting the future rather than get too comfortable and get sloppy with your analysis.  The best I can offer is that I have learned from it and will not be repeating this mistake anytime soon.  I still leave plenty of room for other mistakes though.  Nobody is that good.  I am sending a spreadsheet with this edition of the newsletter that will illustrate discounted cash flow analysis much better than it can be explained on paper.  This should help illustrate what I was talking about.

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## Watch List

In the past, over a given months time, it has often occurred that the companies on our watch list have soundly outperformed the companies that make up our portfolio. This past month was not one of them. The companies on this list in aggregate had an abysmal month. This makes several of them much better candidates for investment. Investing is a lot like shopping for bargains. Rarely does the staff at Investletter celebrate an increase in the price of steak or gasoline. On Wall Street it is not uncommon to see many investors pile into companies like Google or eBay after the price has jumped much higher. Just two months ago Google shareholders were gladly paying $475 per share. Now shares are trading hands at $340. There is a whole investment style dedicated to buying stocks with rising prices called momentum investing. To us a company becomes more attractive after the price has fallen. Just like a gallon of milk appears a much better bargain when it is marked $.50 off, interesting companies look more appealing when their price is down 30%.

Many of the popular stocks have attracted folks to them solely because their price has already had a significant move upwards. This alone is a poor reason for investing in a company. Our K-Tron International (KTII) has had a nice move upwards in their price. We are interested in buying more, but would love to see a little dip in the price before we move in. Fortunately, the company is still real modestly valued. Our original purchase was at a real low valuation. This helps explain the nice 50% move so far while still leaving the company at reasonable valuation levels.

In the list below, CNQ, XTO and FDP are much more compelling values this month compared to last month. We take our time investigating many of these companies . Sometimes it takes quite a bit of time and effort before we can get our hands around a topic. Price is one component in determining if we make a purchase and another, as we have stated in the past, is understanding the business. With FDP, if we can't tell you what they future looks like for banana and pineapple sales, we have no confidence in our ability to determine what Fresh Del Monte is worth. Sometimes we take months or years to fully grasp a business. If we never get comfortable understanding the factors that influence a companies business, our best bet is to stay away.

Some of the businesses we invest in can be understood by almost anyone, others require some special expertise. As long as we stay within or limits of expertise we have a good chance of generating above average returns.

| Company | February price | January price | Change from January | P/E | 52 Week High | 52 Week Low | Estimated '06 EPS | Dividend Yield |
|---|---|---|---|---|---|---|---|---|
| **Altria Group, Inc./**MO | $71.90 | $72.34 | -0.61% | 14.5 | $78.68 | $62.70 | $5.28 | 4.50% |
| **Bioanalytical Systems, Inc./**BASI | $6.42 | $6.08 | 5.59% | n/a | $10.37 | $4.75 | n/a | n/a |
| **Canadian Natural Res./**CNQ | $54.56 | $62.00 | -12.00% | 32.4 | $64.38 | $24.48 | 4.16 | 0.40% |
| **Fresh Del Monte Produce/**FDP | $20.14 | $22.99 | -12.40% | 10.5 | $31.99 | $20.02 | $1.65 | 4.15% |
| **The St. Joe Co./**JOE | $59.93 | $63.45 | -5.55% | 34.5 | $85.25 | $58.67 | $1.84 | 1.05% |
| **Kensey Nash/**KNSY | $24.48 | $24.41 | 0.29% | 50.0 | $34.00 | $19.32 | $0.65 | n/a |
| **Landauer, Inc./**LDR | $46.00 | $46.76 | -1.63% | 25.3 | $54.00 | $43.90 | $2.13 | 4.00% |
| **ModPac/**MPAC | $11.04 | $12.05 | -8.38% | n/a | $18.60 | $10.02 | n/a | n/a |
| **Novastar Financial/**NFI | $30.65 | $31.49 | -2.67% | 6.7 | $42.55 | $24.08 | $4.18 | 19.00% |
| **QLT Inc./**QLTI | $7.15 | $6.02 | 18.77% | n/a | $13.37 | $5.93 | $0.59 | n/a |
| **Rayonier/**RYN | $43.10 | $42.75 | 0.82% | 18.2 | $44.07 | $31.70 | $1.72 | 4.40% |
| **Tejon Ranch Co./**TRC | $47.40 | $42.42 | 11.74% | n/a | $62.72 | $39.15 | n/a | n/a |
| **XTO Energy** | $41.89 | $49.08 | -14.65% | 12.9 | $50.01 | $26.00 | $3.15 | 0.70% |

## 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 three 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.

The January swoon is over. In February we came back with a vengeance. At the end of February, our portfolio has increased 3.9% in value this year compared to 2.6% for the S&P 500 market average. You can see from the chart below that Astronics increased in value by 21.4% in February. This is coming off a year when they had a more than 100% increase in value. They had solid 4th quarter results and showed a huge increase in their backlog. This year could be a real solid year as long as several large project they are involved in launch on time. Only Berkshire and OMI showed small drops in value, every other position we had rose.

Towards the end of February Gencor announced that they received a $5.5m payment from their partnership interests. Combine this with the $10m they received in January and Gencor is going to have extremely large earnings this quarter. We expect that earnings will be more than $1 per share. Their cash and investment accounts should swell $15m and be offset by an increase in deferred taxes. At some point the market is going to revalue these shares higher than the current price. This also happens to be the time of year when their asphalt plant business performs well. Customers order their equipment in the off-season so they can have it ready for spring and the beginning of road construction season. They had a large backlog going into this quarter and many of the orders should have shipped and be recorded as revenue. With the company's huge stash of cash and investments, they could use it to reward shareholders. We are doubtful that management has any intentions of sharing. The battle could get intense and we may play a role. Stay tuned for any new development on this front. Sometimes you have to fight for what is rightfully yours.

Another one of our holdings that has done well recently is Culp. They have almost returned to profitability. The next several quarters should be exciting. Now that they have nearly completed their restructuring and dramatically reduced their costs, their quarterly reports should begin to look much better.

| Company | Porfolio Percentage | February price | January Price | Percentage Change | Buy Price (less than) | P/E | Dividend Yield |
|---|---|---|---|---|---|---|---|
| **Alico/**ALCO | 14.70% | $45.23 | $44.60 | 1.41% | $50.00 | 51.1 | 2.30% |
| **Amgen/**AMGN | 4.90% | $75.48 | $72.89 | 3.55% | $60.00 | 25.1 | n/a |
| **Astronics Corporation/**ATRO | 9.90% | $13.28 | $10.94 | 21.39% | $9.90 | 40.0 | n/a |
| **Berkshire Hathaway B/**BRK.B | 17.20% | $2,888.00 | $2,932.00 | -1.50% | $2,900.00 | 14.4 | n/a |
| **Cash** | 16.70% | $1.00 | $1.00 | n/a | n/a | n/a | n/a |
| **Cell Genesys, Inc./**CEGE | 3.10% | $7.04 | $6.26 | 12.46% | $6.50 | n/a | n/a |
| **Culp/**CFI | 2.90% | $4.95 | $4.61 | 7.38% | $4.15 | n/a | n/a |
| **Gencor/**GNCI | 7.50% | $9.05 | $8.85 | 2.26% | $8.50 | 2.7 | n/a |
| **Headwaters/**HW | 4.40% | $37.12 | $34.50 | 7.59% | $34.00 | 12.6 | n/a |
| **K-Tron International/**KTII | 3.60% | $39.90 | $36.80 | 8.42% | $40.00 | 14.8 | n/a |
| **OMI Corporation/**OMM | 12.50% | $17.50 | $17.56 | -0.34% | $18.00 | 5.3 | 2.20% |
| **Protein Design Labs/**PDLI | 1.90% | $31.31 | $29.15 | 7.41% | $24.00 | n/a | n/a |
| **Terra Systems/**TSYI | 0.70% | $0.80 | $0.70 | 14.29% | $0.70 | n/a | n/a |

## Performance

When discussing our performance it is always important to consider where we have been. In the two years and two months we have published this newsletter, we have owned 23 different companies. Of these, we still own 11 of them. Over this time most of our returns have come from just four companies. More than 83% of our gains have come from Astronics, Consolidated Tomoka, Mod Pac and OMI. Consolidated Tomoka and OMI are both large holdings that generated large returns. Astronics is a smaller holding that has had tremendous returns over the past 14 months. Mod Pac was just a short term opportunity that took advantage of investors misperceptions. Eighteen of our positions were profitable and 5 lost some of our capital. It shows what you can expect when investing. A few companies will do much better than you expect, several will do alright and some will perform much worse than you expect. Overall the results are not far from what one would expect.