The Commonsense

INVESTLETTER

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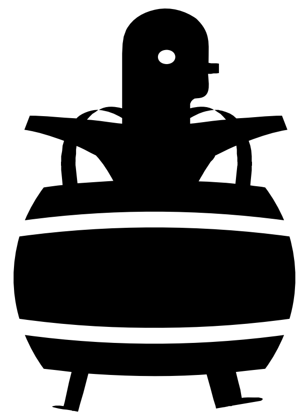
- S&P 500 1265
- NASDAQ 2267

Naked Short Selling

The aim of this article is to bring you up to speed on what could be the next pending financial crises. To start, we need to lay out some basic definitions beginning with short selling. Selling a stock short is simply selling a stock you do not own. The mechanics are a bit more complex. In order to short stocks you first need to have a margin account with your broker. A margin account allows you to borrow money to buy securities. Usually you can borrow up 50% of the assets in your account. Assets include stocks, bonds, cash and other securities. In theory when you sell shares short you are supposed to borrow the shares from another account. All of this takes place in the background without the input of the individuals whose accounts are involved.



The next financial scandal to catch regulators attention.

When would you want to short a stock? You would want to short stock when you have a conviction the share price will fall. You will buy shares after the price drops to cover your trade and replace the shares you borrowed. All of this activity is perfectly legitimate and occurs everyday in the stock market. An example may help clarify things. Suppose you have good reason to believe that Company A's shares will drop. For arguments sake lets assume that Company A's shares are trading at $10 per share. You decide you want to sell short 100 shares of Company A. You place your order to sell 100 shares of Company A even though you don't own any shares. Your order goes through and your broker borrows the shares unbeknownst to another account holder and your trade is settled. Now you have the proceeds of $1,000 dollars in your account and some other investor is the proud owner of 100 shares of Company A. The account that had the shares borrowed essentially has an IOU from you. If this person wanted to sell his shares the 100 shares would just be borrowed from another account holder and the IOU would be transferred to that account.

Just as you had forecast, the price of Company A's shares drops all the way down to $5. This is great news for you. Now you take $500 dollars of the $1,000 you received from selling the shares and you buy back 100 shares at the $5 price. The shares are replaced from the account holder who holds your IOU at that time and everything is back to the way it was before you began, except you now have an extra $500 in your account. Again, all of this is perfectly legitimate and actually serves a useful purpose.

This scenario is not how short trades always work. Selling short can be used to unmercifully manipulate the share price of a company's stock down ridiculously large amounts. In some instance companies may have been driven into bankruptcy. It can be a large problem for a company, its shareholders and any other stakeholders. You may wonder how can this happen in this age of increased oversight and tightened rules. It is a good question without any real good answers. Every-

Inside this issue:

Naked Shorts

Naked short selling is not accidental, it is a deliberate attempt to benefit at the expense of others.

thing from crooked SEC employees to organized crime may be involved. When short sales are used in the manner we will describe next, they are referred to as naked short sales. The naked part refers to the fact that you provide no cover. The shares that are sold short are never borrowed from another account. This is referred to as a fail to deliver or FTD. We will walk you through some of the ramifications of naked short sales and what it means to you.

FTD's are often a deliberate intentional act designed to force a share price down. Going back to our example on the last page assume that when you sold the shares short you exempted yourself from having to borrow the shares that you sold. Now your broker in effect issues an IOU to the person who buys your shares. They are never aware that this has taken place provided they do not take delivery of actual stock certificates. If they do try and obtain a certificate for their shares, they may find that they can't get one because the shares have not yet been delivered. This is in violation of the security laws. Naked short sales are allowed to happen, but the FTD is supposed to be temporary. Crooked hedge funds, often located offshore, make short sales with no intentions of ever delivering the shares they sold. The short seller has in effect created an artificial security. You could call them phantom shares or counterfeit shares. The short seller has sold shares that don't belong to him and that don't even exist. The effects are staggering.

Naked short selling is something akin to selling your house out from under you without your knowledge, while you are living in it.

The stock market, like most other markets operates on supply and demand. If a greater number of folks than usual decide they are going to sell something, prices are likely to fall. If very few items are available for sale, for example the Mona Lisa, then the price will tend to be higher. When a large volume of a company's stock is sold it will tend to drive the price down. When shares end up getting "manufactured" on a daily basis, the share price can be driven down 50%, 80% or even end up destroying a company and pushing it into bankruptcy. All of this makes the people talking about this problem sound like a bunch of nuts, ourselves included. We were very skeptical until we explored the problem for ourselves.

The problem is very complex and involves multiple players and very technical issues. We have tried to squash it down into a short article that leaves out many of the more subtle details and effects. The companies that are most susceptible are smaller companies whose share price tends to be easier to manipulate to begin with. Lists of companies that may be affected can be found at both the NYSE and the NASAQ web sites. None of the companies we own appear to be targets to the best of our knowledge.

The magnitude of the problem may be much larger than any regulatory agency is willing to admit. Some companies may have double the number of shares they have outstanding trading in the market. It is difficult to comprehend how this mess was allowed to get to the point it is at now. Our part in the solution will begin with writing letters to our elected representatives. This problem needs urgent attention and a rapid response by our lawmakers and regulatory agencies to prevent serious consequences. It should result in criminal convictions firings and lawsuit verdicts to help swing things back around. At a time that is so close to previous scandals that shook the confidence of investors in our financial markets, a rapid and harsh response will help prevent a further erosion of confidence and drop in prices. If you would like more information please feel free to contact us. We will be watching this situation carefully to make sure we stay out of harms way.

For more information go to http://www.ncans.net/

Watch List

The companies on our watch list had a pretty uneventful November with few exceptions. Hurco was one company that defied this trend. The company announced extremely strong earnings and booked a large number of order in the previous few months. We were extremely optimistic about this company's prospects, although not quite as optimistic as Wall Street has become. The share price has skyrocketed. We were concerned with the eventual downturn in the machine tools industry and underestimated the popularity of their new product line with manufacturers. The share price has continued to climb into December and now stands over $29 per share. Our caution has caused us to miss another opportunity for a quick profit. It is not the first time and will not be the last. Often smaller companies have their price adjusted in incredibly violent fits once the true value is recognized. We hope to see our Astronics shares perform in this fashion next year. For those of you that owned Consolidated Tomoka you experienced some of this type of movement. Our article on naked short selling also comes into play in this regard, only the price drops instead of climbs.

Small companies are favorite targets of naked short sellers who aim to manipulate the price downward. An online retailer Overstock.com is a classic example. Their share price has been hammered and at times the company has had more than 125% of the total number of outstanding shares trading. The true number may be over 200% of the available shares trading. This unfortunate circumstance is a blight on our financial system and is desperately in need of reform.

Over the next few weeks we will be looking to update our watch list. We have a large list of companies that we are currently investigating as potential investment candidates. Some of these companies may replace companies currently on our watch list or be deemed worthy candidates of current investment. We are looking to position ourselves for another year of potential out performance.

Company	November price	October price	Change from October	P/E	52 Week High	52 Week Low	Estimated '05 EPS	Dividend Yield
Altria Group, Inc./MO	$72.79	$75.50	-3.59%	15.3	$78.68	$48.40	$5.11	3.90%
Allergan/AGN	$100.00	$89.30	11.98%	37.7	$110.50	$69.01	$3.27	0.37%
Bioanalytical Systems, Inc./BASI	$5.27	$5.60	-5.89%	n/a	$10.37	$4.70	n/a	n/a
Fresh Del Monte Produce/FDP	$25.97	$26.07	-0.38%	10.0	$33.94	$21.90	$2.02	3.32%
Hurco/HURC	$22.67	$17.83	27.15%	11.4	$30.75	$10.25	$2.57	n/a
The St. Joe Co./JOE	$66.40	$65.95	0.68%	45.2	$85.25	$57.69	$1.76	0.88%
Kensey Nash/KNSY	$22.89	$22.93	-0.17%	28.1	$35.54	$19.32	$0.77	n/a
Landauer, Inc./LDR	$48.90	$50.00	-2.20%	23.5	$54.00	$42.88	$2.09	3.90%
ModPac/MPAC	$11.50	$10.35	11.11%	n/a	$18.60	$10.02	n/a	n/a
Paychex, Inc./PAYX	$42.41	$38.76	9.42%	39.5	$42.41	$28.60	$1.21	1.42%
QLT Inc./QLTI	$6.51	$7.07	-7.92%	n/a	$17.30	$6.02	$0.64	n/a
Rayonier/RYN	$39.74	$38.23	3.95%	22.0	$41.68	$29.20	$1.61	4.28%
Sanderson Farms/SAFM	$35.62	$34.51	3.22%	8.9	$49.19	$31.97	$3.61	1.33%
Tejon Ranch Co./TRC	$41.35	$44.40	-6.87%	n/a	$62.72	$35.55	n/a	n/a
USG Corporation/USG	$61.20	$59.12	3.52%	6.4	$71.25	$26.80	$9.82	n/a
The Washington Post Co. /WPO	$737.00	$745.00	-1.07%	33.0	$999.50	$737.50	$29.62	0.99%

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 one year of 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 priced compared to what the company is worth and be used in making short term purchasing decisions. Some of the stocks that have traded below our buy price for the past year have been some of our worst performers. So much for being able to predict short term price actions. Long term our accuracy is much better.

Another month of little activity regarding our holdings. Some of you may be past the 30 day mark from the point that we sold Kensey Nash. We are waiting for a nice price to re-enter at.

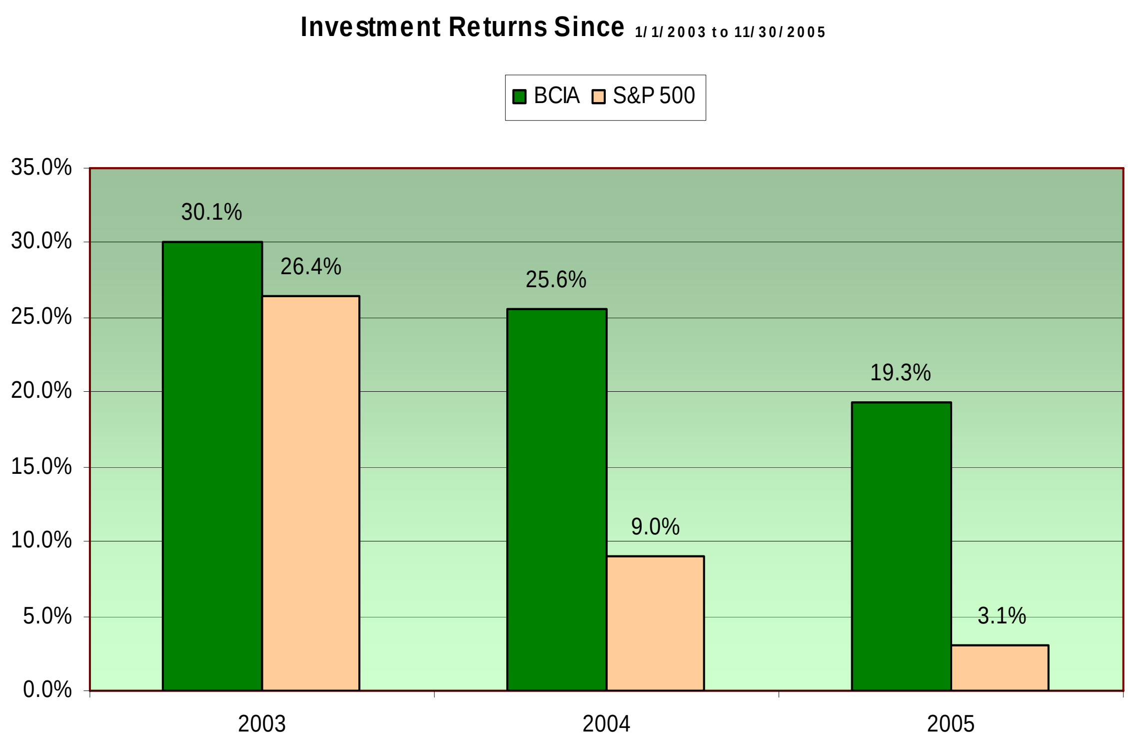
One extremely upbeat event that will be occurring in the next few months is extremely strong earnings from OMI will be announced. OMI now announces the rates their ships are commanding on a monthly basis. It makes it real easy for us to calculate what revenues and earnings will look like for the fourth quarter. From the looks of it we are going to see some real impressive numbers. The company has been buying back their own shares at a rapid rate this year. They had something near 85 million shares to begin the year and will finish 2005 with something close to 70 million. Spreading their earnings over many fewer shares means that each share gets a bigger piece of the pie. If a company had 100 shares and earned $100, the company would earn $1 per share. If the company bought 25 of its own shares and left 75 outstanding and still earned $100, now the company would earn $1.33 per share. This is an increase of 33% on a per share basis. Each share is now worth more. OMI will exhibit the same type of relationship. It all works because they are generating huge cash flows that provides the cash to buy back the shares. This is good for the value of our investment in OMI.

November was a very generous month for us. We now maintain an almost insurmountable lead on the S&P 500 average for the year. All of our large positions performed well during the month. All of this has been accomplished while holding approximately a 15% plus, cash cushion throughout the year.

Company	Porfolio Percentage	November price	October Price	Percentage Change	Buy Price (less than)	P/E	Dividend Yield
Alico/ALCO	15.40%	$46.00	$44.03	4.47%	$50.00	54.8	2.20%
Amgen/AMGN	4.90%	$81.64	$75.62	7.96%	$60.00	27.9	n/a
Astronics Corporation/ATRO	6.80%	$10.37	$9.25	12.11%	$7.00	n/a	n/a
Berkshire Hathaway B/BRK.B	18.40%	$3,007.00	$2,815.00	6.82%	$3,050.00	20.3	n/a
Cash	17.40%	$1.00	$1.00	n/a	n/a	n/a	n/a
Cell Genesys, Inc./CEGE	2.90%	$5.76	$5.93	-2.87%	$9.00	n/a	n/a
CSP Inc/CSPI	4.30%	$7.26	$6.35	14.33%	n/a	16	n/a
Culp/CFI	3.00%	$4.98	$5.16	-3.49%	$4.15	n/a	n/a
Gencor/GNCI	4.40%	$7.35	$7.10	3.52%	$7.20	2.6	n/a
Headwaters/HW	4.40%	$36.76	$31.84	15.45%	$33.00	12.6	n/a
K-Tron International/KTII	3.50%	$37.74	$34.82	8.39%	$33.00	12.8	n/a
OMI Corporation/OMM	12.80%	$19.72	$18.04	9.31%	$17.00	5.9	1.70%
Protein Design Labs/PDLI	1.80%	$27.75	$28.02	-0.96%	$18.75	n/a	n/a

If the year ended at the end of November we would have outperformed the S&P market average by a whopping 16.2 percentage points. This would be just slightly less than last years 16.6 point margin. It will be extremely difficult to generate this large a margin of out performance three years in a row. It is in our best interest to temper your expectations because of the relatively small odds. We will however, be working as hard as ever to uncover the best possible investments for our portfolio going forward.

The past year has seen quite a change in our portfolio and we are very pleased with where we stand at present. Our 15% to 20% cash cushion gives us an extra layer of protection that will give us some added buoyancy in any market downturn. We have no idea what to expect from the market next year which is no different from any other year. Fortunately, our strategy does not rely on the market in general. We are solely concerned with the performance of our investments. They are often not representative of the market as our recent results have proven. The companies that we own are positioned very well going forward. We would like to wish all of our subscribers a very Merry Christmas and a very safe and healthy New Year. And, one final word. There is no *Christ*mas without *Christ*. Bless each one of you and your families.



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