The Commonsense

INVESTLETTER

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Wall Street:

- DJ 13595
- S&P 500 1510
- NASDAQ 2810

Big Things Are Often Hidden

The next financial storm is brewing, when will it hit?

The captain of the Titanic chose to travel at an unsafe speed in an area with icebergs all around. Only one third of an iceberg is visible above the water. An iceberg that appears a bit in the distance may already be close enough to strike the hull of a ship. Several years ago Enron and others were the capital market equivalents of the Titanic. I examined the regulatory filings of Enron and couldn't make sense of their financial reports. They seemed to welcome an excessive amount of complexity. Some more sophisticated investors were more apt than myself to act as dragon slayers and conquer the financial reports of Enron and proudly take their place as investors. I chose to look someplace where there were fewer places to hide mischievous activity amongst complex accounting. The damage was done not by what you could see, but by what was under the surface. You could see that there was a likelihood of trouble, you just couldn't discern what the trouble was.

The current sub prime mortgage meltdown is another glaring example of investors seeing big warning signs and than charging full steam ahead right into the mess.

As much as we aim to uncover excellent investment opportunities we also look to avoid companies that look like they have plenty of room for creative accounting. Too often this turns out to be cover for activity that more closely borders criminal than creative.

Over the past month the most compelling example of flawed thinking in the financial community was contained in an item I spotted in a Wikipedia entry for the term tranche. A tranche describes the process by which many of the sub-prime mortgages are pooled together and then sliced up into a variety of investments with different risk characteristics. I understand the concept but am not too interested in the particulars. The whole process adds a layer of complexity that can easily play out in unimaginable ways. New securities are created that have no history, which makes it difficult to predict how they will perform in a variety of economic scenarios. There is a class of investors that considers themselves more sophisticated than average investors and a statement contained in this entry is the type of statement that I have seen repeated over and over.

> "With increased complexity, less sophisticated investors have a harder time understanding them and thus are less able to make informed investment decisions. One must be very careful investing in structured products."

Less sophisticated investors need to be wary? Is that why Merrill Lynch wrote down $4.5 billion and may have another $10 billion to go, Citicorp has written down $10 billion and may have another $10 billion to go, Morgan Stanley has written down over $4 billion with more to come and the Bank of America has written down $3 billion? The total that the large "sophisticated inves-

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Big and Hidden

tors" have written off is over $60 billion so far. Sophisticated and write downs of $60 billion don't seem to belong in the same paragraph.

It was common knowledge that mortgages providers were offering loans to borrowers with questionable credit histories and requiring very little by way of down payment or even the ultimate ability to repay. Yet these large institutional investors chose to ignore the warning signs and focus on the prestige that they perceive comes with investing in these types of complex products. After all, they created many of these structured products.

Often the risks involved in what you can't see are much greater than the risks in what can be seen. You need to consider what could be hiding in the shadows where your vision is less clear.

So who were the "sophisticated investors" in this situation? Was it the prestigious investment bankers that flushed billions down the toilet or was it the small investor who avoided these products to a large extent. Part of being sophisticated is sticking to what you know or even to that which can be known. With a product that is very difficult to understand how it will work in a variety of situations, it is not sophistication when you invest in it, it is stupidity. There is no reward for complexity in investing. The companies we invest in all have very simplistic, straight forward accounting and business models. We sold Freddie Mac a few years ago when their accounting became too complex to understand. If complexity was the key to reward, our portfolio would have much lower returns and these large, "sophisticated investors" would have monstrous returns instead of writing off an amount equivalent to the gross national product of New Zealand.

Investing in trees (Rayonier), tile grout (QEP Company), coal crushers (K-Tron), asphalt plants (Gencor) and extension cords (American International) will not help you appear as a sophisticated investor at approaching Christmas parties. To some, what they invest in is a statement of how sophisticated they are. The investors who piled into World Com, Enron and more recently into the structured collateralized mortgage obligations definitely have bragging rights at cocktail parties. What they don't have is excellent investment returns.

Our advice is much more valuable to your net worth than your social standing. We would have it no other way. The large investment bankers make money on investors and companies using their services. They don't have a great track record of making money using their investing acumen. It will take years just to recoup the money that has been frittered away in the past few months.

Things shouldn't be any more complex than they need to be. This axiom is violated daily, especially in the finance community. (The tax code is another prime example.) When you are contacted by your insurance agent, someone trying to sell you investment products or someone trying to sell you a new car, always consider what's in it for them. Next you need to be wary of what they could possibly hide in the transaction they are trying to make you party to.

As for our investment approach we try to keep things as simple as possible. Your available pool of investments is not limited. We are not forced to invest in a certain number of sophisticated investments, we can choose all simple ones. And, we will. With no added reward for sophistication, it is much safer for us to invest in the companies that are easier to understand. We are exposed to much less risk when we more fully understand what we are investing in.

Watch List

Out of Many ...One. Harnessing the power of many is occurring more frequently, especially with the advent of the internet. Shared computing resources have allowed complex scientific inquiries to use the power of a de-facto supercomputer made up of computers in businesses and homes around the world. There are multiple projects that allow everyday folks to donate computer resources to help solve very intensive problems that lend themselves to the power offered by supercomputing resources. It involves many individuals combining their resources to accomplish something that not one of them could accomplish on their own.

Other efforts harness individuals to solve other problems. Colgate-Palmolive uses a website where they post business problems that anyone can offer a solution for a cash award. They are not only tapping their employees to solve business problems, but the world at large. They are tapping any smart mind that is willing to submit a solution (and they don’t even have to pay for health insurance). In this instance the solution is being offered by one person or a small group

Another type of problem is solved not by a large pool of resources or by finding one smart person from a pool of many, it is solved by the crowd. The problem of pricing securities. The stock market sets its pricing by combining the opinion of many to set one price. Many times with a great degree of accuracy. A company like Microsoft is followed by hundreds of thousands of investors with thousands buying and selling shares on a particular day. The price of the company’s shares is probably going to pretty closely reflect the value of the company most of the time. However, not all companies are treated equally. Many smaller companies have many fewer participants looking to invest in them. Your odds of being smarter than a few hundred participants is much greater than trying to best thousands. With fewer investors chiming in on the value of a company there is a greater chance that a company is mis-priced. Crowds can also miss the mark a be collectively wrong. Our strategy is to play the easy odds and stick to the situations where we have an advantage. This partly explains why most of our investments are in smaller companies.

Company	September price	August price	Change from August	P/E	52 Week High	52 Week Low	Estimated '07 EPS	Dividend Yield
Alico/ALCO	$47.44	$43.34	9.46%	n/a	$65.00	$43.00	n/a	2.30%
Alliant Techsystems Inc./ATK	$110.39	$109.30	1.00%	17.6	$115.95	$75.50	$6.29	n/a
Altria Group, Inc./MO	$72.93	$69.53	4.89%	16.7	$90.50	$63.13	$4.37	4.10%
Arch Coal/ACI	$41.00	$33.33	23.01%	36.3	$42.59	$27.18	$1.13	0.70%
Bioanalytical Systems, Inc./BASI	$8.80	$6.96	26.44%	n/a	$8.99	$4.98	n/a	n/a
Canadian Natural Res./CNQ	$83.20	$75.75	9.83%	22.4	$82.45	$44.56	$3.72	0.40%
Culp/CFI	$8.80	$10.38	-15.22%	16.3	$12.30	$4.37	$0.54	n/a
Graham Corp./GHM	$66.04	$41.11	60.64%	31.8	$63.65	$12.67	$2.08	0.20%
Kensey Nash/KNSY	$27.36	$26.11	4.79%	30.7	$33.00	$22.26	$0.89	n/a
Landauer, Inc./LDR	$49.27	$50.96	-3.32%	22.2	$56.53	$45.50	$2.22	3.80%
Markel/MKL	$543.22	$484.00	12.24%	15.7	$534.82	$397.25	$34.56	0.20%
ModPac/MPAC	$8.71	$8.60	1.28%	n/a	$12.50	$7.44	n/a	n/a
QLT Inc./QLTI	$4.78	$5.69	-15.99%	28.1	$9.92	$4.20	$0.17	n/a
Servotronics Inc./SVT	$13.70	$16.50	-16.97%	29.2	$17.00	$7.60	n/a	n/a
Specialized Health Products/SHPI	$0.82	$0.72	13.89%	34.8	$0.99	$0.60	n/a	n/a
Tejon Ranch Co./TRC	$40.08	$41.40	-3.19%	n/a	$57.09	$37.70	n/a	n/a
Torm/TRMD	$42.19	$41.10	2.65%	3.5	$47.10	$25.43	$2.30	12.00%
Universal Forest Products/UFPI	$35.81	$29.90	19.77%	19.6	$54.61	$29.51	$1.83	0.40%

The Investletter Portfolio

Our recent addition of St. Joe (JOE) to our portfolio adds a company that we became familiar with in 2003. The company was much more complex back in 2003 with a home construction business, resort operations, commercial real estate rentals among other business lines. They have gradually divested these businesses until now where they pretty much have just the land left. And they have lots of land, 740,000 acres worth. Much of the land is forest land or other lands that have limited value. They have 100,000 acres for sale that they have been realizing between $1,500 and $2,500 an acre over the past few years.

Much of the company's land is worth about $1,500 an acre, but not all of it. Over the past 2 ½ years the company has sold 1,139 home sites (lots) for a total of $210 million dollars. The company's financial reports don't spell out the size of these sites but we conservatively assume them to average one acre. In reality they may be less, meaning multiple sites per acre. The average sale price per home site is $210,000. This year it has trended a bit lower at $170,000 .

One 75,000 acre sector will be anchored by the relocated Panama City Airport whose construction began this week. The mixed use plan is one of the largest comprehensive plans in Florida's history. The company will use business relationships established in the recent past to form strategic relationships to develop this land. The project will take years to complete but should create tremendous value for the shareholders. While we wait for all of this to occur the land values should keep on rising.

To value the company we have assumed the company has another 50,000 acres they can sell at an average of $70,000. The company already has land use entitlements allowing them 45,000 residential units so our assumptions are extremely conservative. Add to this another 690,000 acres worth about $1,650 per acre and the total value of the company's land is somewhere around $4.6 billion. Wall Street has assigned the company a value of $2.5 billion. It is easy to purchase a company that is selling at a minimum of a 45% discount to the companies true worth. In reality the company's land is worth far more than the values we have assigned. Even accounting for taxes the company is still significantly undervalued.

With the company in this transition phase a great deal of uncertainty surrounds the company in the investment community. With a great deal of uncertainty it is not uncommon to find a greatly depressed price. The shares are down from a high of $64 over the past year. It make take some time for the recent transition to work itself out, but when it happens we expect to be the beneficiaries of a significantly higher share price.

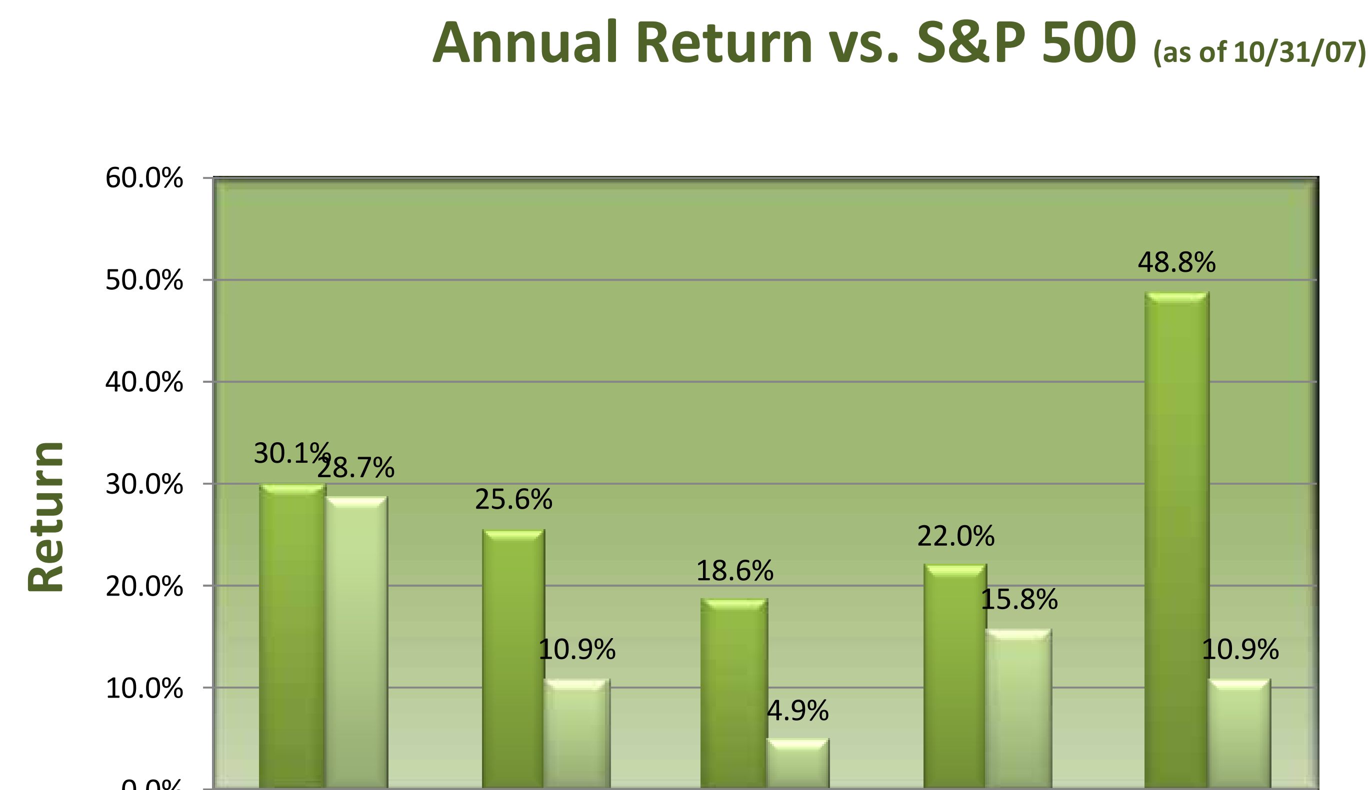
Company	Porfolio Percentage	October price	September Price	Percentage Change	Buy Price (less than)	P/E	Dividend Yield
American International/AMIN	6.50%	$5.20	$5.10	1.96%	$4.95	n/a	n/a
Amtech Systems/ASYS	3.80%	$17.44	$12.82	36.04%	$11.15	46.4	n/a
Astronics Corporation/ATRO	20.60%	$44.50	$43.57	2.13%	$36.00	27.3	n/a
Atrion/ATRI	6.40%	$124.24	$125.00	-0.61%	$93.00	20.0	0.80%
Berkshire Hathaway B/BRK.B	7.60%	$4,414.00	$3,952.00	11.69%	$3,800.00	15.5	n/a
Cash	8.40%	$1.00	$1.00	n/a	n/a	n/a	n/a
Chesapeake/CHK	6.80%	$39.48	$35.26	11.97%	$33.00	11.1	0.70%
Gencor/GNCI	6.00%	$9.35	$9.90	-5.56%	$9.70	5.5	n/a
Griffin Land & Nurseries/GRIF	5.10%	$37.00	$37.00	0.00%	$36.00	32.8	n/a
Headwaters/HW	1.00%	$14.35	$14.88	-3.56%	$14.00	5.4	n/a
K-Tron International/KTII	9.90%	$106.01	$95.00	11.59%	$90.00	17.7	n/a
Protein Design Labs/PDLI	0.70%	$21.20	$21.61	-1.90%	$21.00	n/a	n/a
QEP Corporation/QEPC	10.50%	$10.67	$12.82	-16.77%	$12.00	10.9	n/a
Rayonier/RYN	6.70%	$48.29	$48.04	0.52%	$41.00	18.5	4.20%

Year to Date

Our lead over the S&P 500 index was extended again in October. The Investletter Portfolio is now up a whopping 48.8% so far this year. This dramatically outpaces the solid 10.9% that the S&P 500 index has generated. We are now up 170% since we began publishing the newsletter compared to the 49.4% that the S&P 500 has returned.

Currently we are holding the lowest percentage of cash in our portfolio going back at least over the past five years. At the same time many of our positions have had tremendous increases this year. Stock valuations are not at stratospheric levels, but many of the undervalued companies we purchased even a few months ago are no longer deeply undervalued. Some of them are pretty fairly valued. The companies that we bought as strictly value plays are reaching what may be the end of the line. Others that were undervalued and also have a solid business can be offered a bit more leeway. The decisions don't have to be made in any rush and we would much prefer to defer these decisions until 2008 when the new capital gains rates kick in. At the same time it is difficult to let taxes guide your decision making. Too often in the past we have found that using taxes as a guide has allowed share price to drop to a level that we no longer find it compelling to sell a position.

The point we are getting to is don't be surprised if we raise cash at some point by liquidating one or more positions.

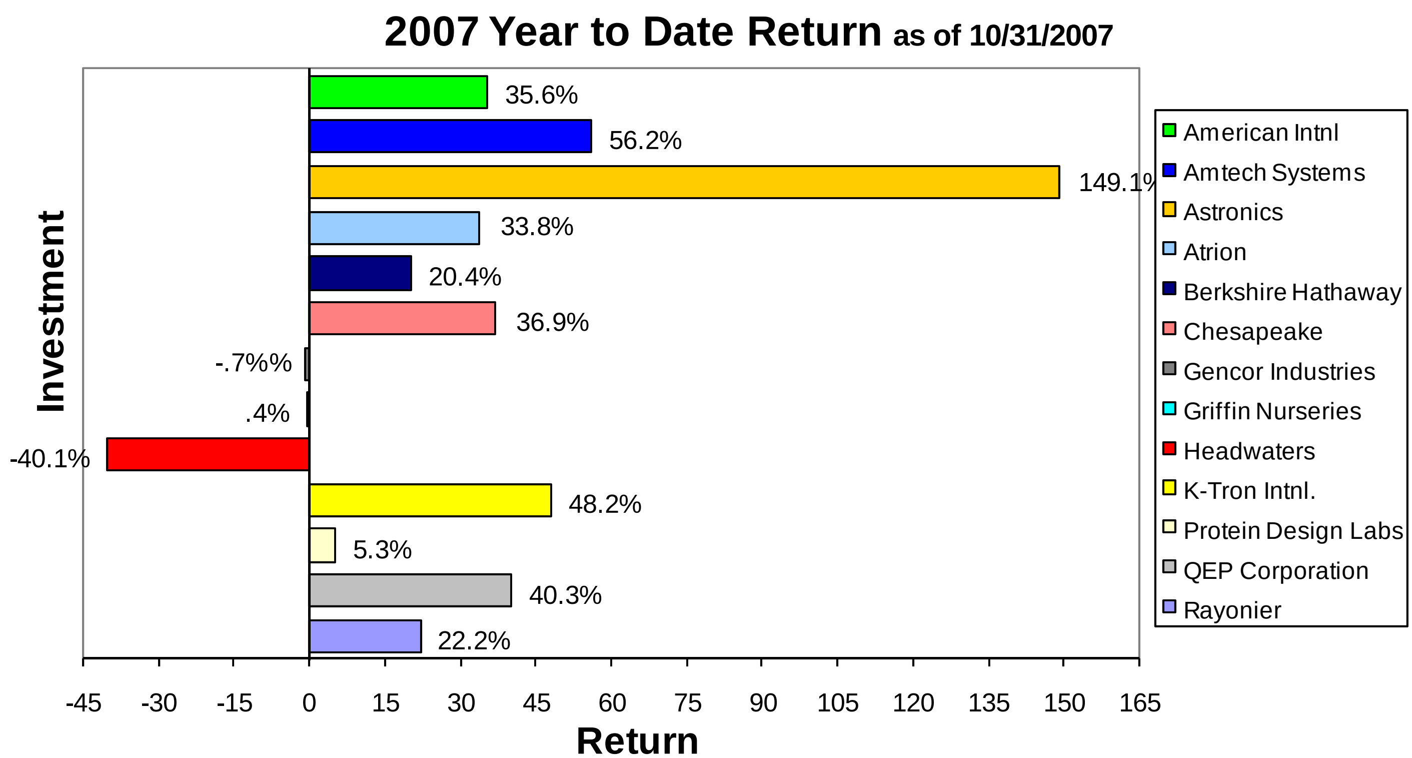


	2003	2004	2005	2006	2007
Investletter	30.1%	25.6%	18.6%	22.0%	48.8%
S&P 500	28.7%	10.9%	4.9%	15.8%	10.9%

Performance

Our performance this year has received a nice boost from our investment in Astronics. With our year to date results approaching 50%, it is easy to see the boost Astronics has provided us. It is also plain to see that our returns would be solid even if we did not own Astronics. Eight of our other current holdings have returns of greater than 20%. The other four positions we have are a bit below breakeven.

Our biggest gainer in the past month has been Amtech Systems. As oil prices have risen higher, expectations are that orders for solar panels will increase. Solar panels become that much more cost competitive when oil prices rise. When orders for solar panels rise, so do the orders for equipment to produce those panels and Amtech makes that equipment. Orders for their solar panel manufacturing equipment increased from $8.1 in fiscal 2006 to $21.4 million in fiscal 2007, which ended September 30. That is a year over year increase of 164%. In October the company announced $15 million in orders that will ship in 2008. With $15 million in orders in the first month of 2008, the orders for the full year should easily beat the $21.4mm in 2007. The stock is already trading at very rich levels and with such rapid growth occurring it is difficult to get a handle on what their earnings will look like. Nonetheless, revenues should continue to grow rapidly. If earnings don't ramp up as quickly, they should follow along a short time later.



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