The Commonsense
INVESTLETTER
Volume 3 Number 8

Capital Gains

We have talked many times about capital gains in the past. Capital gains occur when capital assets are disposed or sold. A capital assets include stocks, bonds, rental property held as an investment and includes most assets used for personal use purposes (home, furniture, clothing, personal use vehicles, etc.) by individuals. Most of these items are taxed at a long term rate of 5% or 15% and a short term rate of a taxpayers marginal rate.

Capital gains and losses will effect our decisions regarding the timing of transactions.

Capital gains many times receive favorable tax treatment. We are most interested in the tax treatment of capital gains from the sale of stocks. When a stock holding is sold it generates a gain or a loss. If the shares have been held one year or longer, the gain or loss is long term. If the shares have been held for less than one year the gain or loss is short term. What determines whether a gain or loss is generated? If the sales proceeds of the sold shares are greater than the basis of those shares, a gain is generated. When the reverse is true it results in a loss.

If we bought 500 shares of ModPac for $9 per share in August 2004 and sold all 500 shares for $13 in March 2005, this would result in a short term capital gain of $2,000. The gain would be the product of the $4 increase in share price multiplied by the 500 shares. Short term capital gains are taxed the same as ordinary income. The U.S. tax code has six marginal tax rates (10%, 15%, 25%, 28%, 33%, 35%). You are taxed based on your filing status and the level of your taxable income. If you are in the 28% marginal rate tax bracket you will owe tax of $560 on your gain.

Now, assume the shares were held until September 2005 and sold for the same $13 (unlikely seeing the share now trade for a little over $10) you would pay only ($2,000 x 15%) $300 in tax. This would be a savings of $260. (IF you were in the 10% or the 15% tax bracket you would only have paid a 5% tax which would have only amounted to $100.)

Capital losses can be used to reduce your capital gains or offset up to $3,000 in ordinary income. In the example above, if we would have bought for $13 and sold when the shares were worth $9, we would have had losses. Wages are a good example of ordinary income. If you made $50,000 and had losses (after matching against gains) of $4,000, you could use $3,000 of the losses to reduce your income to $47,000. The other $1000 in losses could be carried forward to the next tax year in which it could be used to reduce your gains or reduce your income, provided you had no other gains to match against it.

Long term capital gains can help us minimize our tax bills. When a opportunity presents itself that will result in short term capital gains, we will have a higher tax bill, but still be better off from the increase in our wealth. If we make no sales we don't have any of this to deal with. Note to self; sit on hands whenever possible.

Wall Street

- DJ 10481
- S&P 500 1221
- NASDAQ 2131

Inside this issue:

Watch List

After further analysis we are going to pass on a investment in Hurco (HURC) at this time. Machine tools are a volatile business. At this point in the business cycle, the industry is in the midst of a strong upturn. That means the share price has also been in a strong upturn. We find businesses like this much more appealing when they are near the bottom of a downturn and their price is more accommodating.

An update on ModPac is also warranted. The company's share price has continued to slide. Their near term prospects are poor at best. The company will show a profit on an accepted accounting basis but will lose money on a recurring operations basis. While the price has plummeted into the mid $10 range, we still see it going lower. If the price gets cheap enough we may add shares again. If we do it will probably not be until late October or early November.

We have added ModPac, Hurco, and Headwaters to our watch list. Headwaters and Rayonier both stand to benefit from the fallout from hurricane Katrina. Rayonier will benefit from timber sales and Headwaters from its foray into ethanol production, diesel from coal projects and nano-catalyst research. Alternative energy will receive a boost from the high gas prices. The recently signed energy bill also has some nice benefits for ethanol production and the diesel from coal operations in the form of excise tax credits. The tax credits will go a long way towards making those two products very profitable. Headwaters currently benefits from section 29 tax credits, which will begin to phase out if the NYMEX crude oil price averages over $62 dollars this year and $63 next year.

Headwaters is has taken us quite some time to analyze. Last year they made two large acquisitions. They still don't have a full year of operations post acquisition, so it has been a bit difficult to get a handle on how the new company will perform. We are very close to finishing and coming to some sort of conclusion. By the time we send out this newsletter we may have made a decision to add them to our portfolio. They will help give us exposure to the energy sector.

Company	August price	July price	Change from July	P/E	52 Week High	52 Week Low	Estimated '05 EPS	Dividend Yield
Altria Group, Inc./MO	**$70.70**	**$66.96**	**5.59%**	**14.3**	**$73.72**	**$44.50**	**$5.11**	**4.10%**
Allergan/AGN	**$92.05**	**$89.37**	**3.00%**	**28.9**	**$95.43**	**$66.78**	**$3.23**	**0.42%**
Bioanalytical Systems, Inc./BASI	**$5.99**	**$5.69**	**5.27%**	**n/a**	**$10.37**	**$4.56**	**n/a**	**n/a**
Fresh Del Monte Produce/FDP	**$25.49**	**$26.31**	**-3.12%**	**11.2**	**$33.94**	**$24.36**	**$2.33**	**2.99%**
Headwaters/HW	**$38.50**	**$42.75**	**-9.94%**	**15.2**	**$45.75**	**$26.31**	**$2.23**	**n/a**
Hurco/HURC	**$14.53**	**$17.36**	**-16.30%**	**15.6**	**$20.00**	**$10.17**	**$0.97**	**n/a**
The St. Joe Co./JOE	**$75.21**	**$81.39**	**-7.59%**	**38.6**	**$85.25**	**$46.40**	**$1.89**	**0.89%**
Landauer, Inc./LDR	**$51.50**	**$49.80**	**3.41%**	**24.0**	**$54.00**	**$42.88**	**$2.10**	**3.30%**
ModPac/MPAC	**$13.68**	**$16.75**	**-18.33%**	**n/a**	**$18.60**	**$9.52**	**n/a**	**n/a**
Paychex, Inc./PAYX	**$34.11**	**$34.91**	**-2.29%**	**28.7**	**$35.37**	**$28.60**	**$1.16**	**1.53%**
QLT Inc./QLTI	**$8.73**	**$8.53**	**2.34%**	**12.5**	**$18.10**	**$8.03**	**$0.67**	**n/a**
Rayonier/RYN	**$54.25**	**$57.04**	**-4.89%**	**23.8**	**$57.98**	**$43.80**	**$2.37**	**3.61%**
Sanderson Farms/SAFM	**$36.93**	**$43.09**	**-14.30%**	**10.4**	**$49.19**	**$30.81**	**$3.54**	**2.45%**
Tejon Ranch Co./TRC	**$51.16**	**$61.37**	**-16.64%**	**n/a**	**$62.72**	**$34.50**	**n/a**	**n/a**
USG Corporation/USG	**$62.85**	**$48.90**	**28.53%**	**7.5**	**$68.60**	**$17.82**	**$8.70**	**n/a**
The Washington Post Co. /WPO	**$832.00**	**$888.00**	**-6.31%**	**24.8**	**$999.50**	**$785.00**	**$33.08**	**0.88%**

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.

In our last update we mentioned we may be looking to exit Gencor. The company did receive a fat $10m payment in August from their partnership interest. This brings the total of the payments to $44m this year. The whole company is valued at $80m. For your $9 per share price, the company will earn something over $3.50 this year. We have a better handle on the payments they will receive from their partnership and are waiting for one of these payments to drive the share price up. The last payment had little effect due to the fact that the company chose not to publicize it. The company is controlled by a father and his two sons. They attempted to take the company private late last year and were rebuffed. We feel that they had some idea these payments were going to resume after last years hiatus due to tax issue uncertainty. They were hoping to gain the benefit of these payments all for themselves. Another attempt may be made to take them private and the less publicity the company has (from their point of view), the better. With widespread publicity the share price probably would have pushed higher already. As soon as we get the chance to exit at an agreeable price, we are liable to take it. It is much more comfortable investing with management who works for the owners, than for themselves. In this case, the appearance is that management is trying to take care of themselves first. Management is too important to invest with poor performing, greedy or a dishonest management team. Many times these trait are found all in the same team.

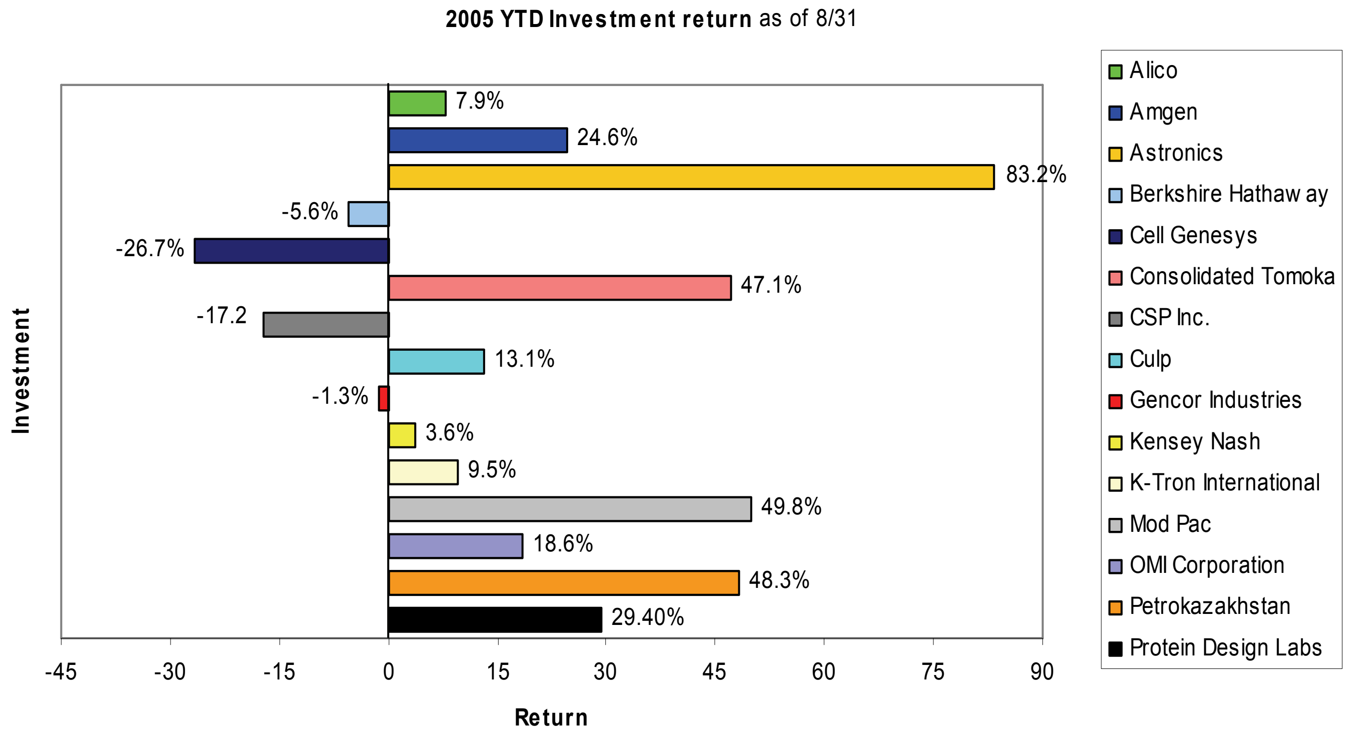
We will be looking to replace the exposure PetroKazakhstan gave us in the oil production industry. Oil prices may drop from the levels they are at currently, but supply is tight enough that prices should stay strong for some time. The oil companies are cash producing machines. All we need to do is find one cheap enough. Our nice gains in PKZ will give us more funds to invest in this area.

Company	Porfolio Percentage	August price	July Price	Percentage Change	Buy Price (less than)	P/E	Dividend Yield
Alico/ALCO	17.30%	$49.70	$54.67	-9.09%	$50.00	57.8	2.00%
Amgen/AMGN	4.90%	$79.90	$84.00	-4.88%	$60.00	26.6	n/a
Astronics Corporation/ATRO	6.30%	$9.38	$10.10	-7.13%	$7.00	n/a	n/a
Berkshire Hathaway B/BRK.B	16.90%	$2,776.00	$2,778.00	-0.07%	$3,050.00	17.2	n/a
Cash	15.80%	$1.00	$1.00	n/a	n/a	n/a	n/a
Cell Genesys, Inc./CEGE	2.60%	$5.94	$6.39	-7.04%	$9.00	n/a	n/a
CSP Inc/CSPI	4.40%	$7.12	$10.66	-33.21%	$7.00	16.4	n/a
Culp/CFI	2.80%	$4.60	$4.41	4.31%	$4.15	n/a	n/a
Gencor/GNCI	4.00%	$8.73	$9.00	-3.00%	$8.40	3.3	n/a
Kensey Nash/KNSY	5.60%	$30.30	$32.63	-7.14%	$26.50	28.5	n/a
K-Tron International/KTII	2.90%	$32.13	$33.67	-4.57%	$33.00	12.5	n/a
OMI Corporation/OMM	9.90%	$19.13	$17.23	11.03%	$17.00	5.6	1.80%
PetroKazakhstan/PKZ	5.00%	$54.30	$42.57	27.55%	n/a	7.1	1.20%
Protein Design Labs/PDLI	1.60%	$26.74	$26.24	1.91%	$18.75	n/a	n/a

Newsletter Performance

As well as we performed in July, August was its equal, but in the opposite direction. By then end of the month we were only down a little over 2%. One of our big let downs was disappointing earnings at CSP International. Their performance is best described as lumpy. Their earnings are not like the smooth and predictable earnings many large companies exhibit. This past quarter they had lower earnings than the previous year which triggered a large one day drop.

Most of our companies are showing nice gains through the first eight months of this year. All of our holdings we sold this year exhibited nice gains; Consolidated Tomoka 47%, ModPac 50%, and PetroKazakhstan 48%. OMI and Astronics have both performed well among our larger percentage holdings, which has helped balance out the laggard Berkshire Hathaway. With the market up a few percentage points this year we are very pleased with our double digit returns. With more than a quarter to go, we have built up a nice margin over the S&P 500 average and hope to outperform the market for our sixth straight year. We may make a few tweaks before the end of the year. Namely CSP Inc., and Gencor. We also may add one or more new companies to our portfolio. We will keep you posted.



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