The Commonsense

INVESTLETTER

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Wall Street:

- DJ 13212
- S&P 500 1455
- NASDAQ 2546

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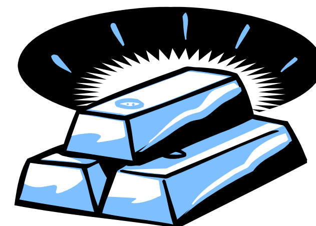
Difference Assets



What a difference the assets make. The majority of companies possess assets that decline in value over time. General motors owns equipment and machinery that gradually becomes worthless. Most businesses own some type of building that will either become worthless or require expenditures over time to maintain it in good order. In other words the assets depreciate. All of this is taken into account when valuing a business. The business will need a certain amount of cash infused on a regular basis to replace worn out equipment, repair or improve facilities, add new equipment or add new facilities. Astronics just made additions to two of their facilities. They are in the process of adding new machines to increase the amount of parts they can produce and thereby increase revenues. This is normal for most businesses.

Some assets are easily valued. Others force you to do a bit of digging.

Companies that own natural resources face a different kind of cost. Chesapeake owns large amounts of natural gas, but not a never ending supply. As they pull gas out of the ground they deplete the amount of gas they have remaining. This is know as, you guessed it, depletion. Resources are subject to depletion and assets are subject to depreciation. Chesapeake has to drill more holes in the land they have to increase the amount of gas they have available to pull out of the ground. When they run out of gas in the land they own or lease, they have to go and buy or lease more land.

But what happens when the assets or resources you own don't deplete or depreciate? Or to a lesser extent, what happens when the company you own uses so few assets to produce their product that replacing assets costs very little? The classic example in our portfolio is Rayonier. A significant portion of their business is the trees they use for lumber sales and to produce their performance fibers, and the land they grow these trees on. The land does not decrease in value nor is it depreciated on a companies books. Many assets do not show any appreciation in the accounting records either, including land. Rayonier has a large portion of their assets tied up in land. The do not have to make any repairs to it, add any additions to it or buy any new machines to make it run better. The trees are similar. Once you plant them they continue to grow and increase in value until you cut them down, at which point you plant more. The large timber companies manage their forests so they always have a similar amount of timber available for harvest. If their trees take 20 years to mature and they cut down one twentieth per year and replant that land with new trees, they will have a continuous supply of lumber. The company records depletion (an expense) which when subtracted from the revenues generated by selling trees reduces their income. The land is never depreciated, it is assumed to always be worth what the company paid for it.

So what, how does this affect our portfolio? The land the company owns never increases in value

Difference Assets

on the books even though the reality may be that the land is worth 10 times or more than the price it is recorded at on the company's books. Rayonier owns 1.9 million acres that is recorded on their books at $1.1 billion, or $580 per acre. Some timberlands have been selling at more than $1,500 per acre in the southeast which is where most of Rayonier's acreage is located. Sale prices in the Northeast and Northwest are somewhat higher. A higher value of more than $10,000 per acre is placed on 200,000 of Rayonier's acreage which amounts to a value of $2 billion. The remaining 1.7 million acres generates a value of $2.5 billion. The total value of the Rayonier's land is something near $4.5 billion. Their accounting records show it to be valued at $1.1 billion. The whole company is valued at $3.2 billion. This figure assumes the timberland is held at a discount and that the performance fiber business is worth zero.

A company with appreciating assets that can be purchased at less than the assets are worth is always welcome in our portfolio.

We have a very easy time sleeping at night with Rayonier in our portfolio. The land they own is not destined to become worthless or require additional infusions of cash as are the equipment and facilities of most other companies. It will become even more valuable over time. Wall Street is making a big error when it values a company with appreciating assets at less than their replacement value. We will be the benefactors of this error.

The combination of Wall Street's missteps and ineffective accounting treatment have caused investors to miss the big picture surrounding Rayonier. Griffin Land and Nurseries to a lesser extent is subject to this phenomena. They don't own as much land as a percentage of their business, but the same valuation error exists.

Our last example involves QEP Corporation (QEPC). QEPC manufactures flooring related products. The kicker is that most of the products they sell are manufactured by contract manufacturers. They have very little manufacturing capacity of their own. They only have about $10 million in capital assets. The company has nearly $220 million in sales and they make capital investments of about $1million per year adding to their $10 million in assets, replacing worn equipment or maintaining their facilities. They have an outlay of $1 million to bring in revenues of $220 million.

The company can easily adjust their manufacturing capacity by increasing or decreasing their orders depending on business conditions. They don't have to add or dispose of assets to adjust to changing business conditions. As a result they have a very little need to make expenditures for new equipment or facility additions. Generating $220 million in sales with a $1 million dollar yearly investment is the kind of leverage we like. What happens to all of the cash they don't have to expend on capital expenditures. It most likely will be used to reduce debt. At some point it can be used to pay a dividend or buy back shares. That is, if the company is not bought out first.

If you can't get a company with assets that appreciate in value like land, the next best thing is a company that needs very little by way of assets that ultimately become worthless.

When considering companies for investment we analyze what competitive advantages they offer. Assets that appreciate act as a floor that prevents share prices from dropping. Having little need for capital assets makes for a business that is very likely to remain profitable. These aren't the only advantages we look for, but advantages of this type sure are easy to understand. We find it amazing so many participants in the market miss them.

Watch List

Everything in it's due time. We have not investigated many new leads as of late. Our research efforts are notoriously cyclical. The ideas seems to pile up and we launch into a frenzy of digging up and trying to uncover successful investments. At other times we have what amounts to a drought. Right now we are in the drought phase. So we go with the flow and wait to spot ideas that look interesting. Right now we see few that pique our interest. As much as reading regulatory report keeps us entertained a steady diet wears on you. A nice drought allows us to refocus and whet our appetite for the next onslaught.

Several companies on the list below have had recent developments that at some point we will investigate further. Altria (formerly known as Philip Morris) has recently spun off their remaining interest in Kraft Foods and now plans on spinning off their international tobacco division. The Kraft spin-off transferred $48 billion in shares to Altria's shareholders and the company, now valued at $144 billion, is poised to get smaller again. Historically the international division has had much better growth than US cigarette sales. Both divisions are large cash generators. Our previous adventures with Altria ended when we could no longer take all of the excitement surrounding the never-ending lawsuits. Much of the advantage we saw in owning the company is now gone with their sharp rise in price. Kraft may end up being the most interesting of the three companies. Kraft has seven brands with sales of more than $1 billion and $34 billion is sales overall.

The primary difficulty we find with companies this size is that it is hard to keep them a secret. When everyone knows about them it is difficult to buy them at bargain prices. Occasionally investors get so irrational that herd mentality takes over and the price gets out of whack, but this is rare in companies this size. When we bought Altria it was just after the master tobacco settlement with the States and they were thought to be a bankruptcy risk. How anyone could think a company with such captive customers could have trouble passing along the settlement costs was beyond us. Barring some similar event we don't see the same dynamics in play with Kraft. It won't stop us from looking.

Company	August price	July price	Change from July	P/E	52 Week High	52 Week Low	Estimated '07 EPS	Dividend Yield
Alico/ALCO	$51.15	$48.03	6.50%	n/a	$65.00	$45.86	n/a	2.20%
Alliant Techsystems Inc./ATK	$105.31	$99.11	6.26%	16.6	$115.95	$75.50	$6.35	n/a
Altria Group, Inc./MO	$69.41	$66.47	4.42%	16.2	$90.50	$63.13	$4.29	4.30%
Arch Coal/ACI	$29.49	$29.89	-1.34%	25.6	$42.59	$25.85	$1.15	1.00%
Bioanalytical Systems, Inc./BASI	$6.78	$6.76	0.30%	n/a	$7.82	$4.75	n/a	n/a
Canadian Natural Res./CNQ	$68.31	$68.41	-0.15%	19.7	$74.57	$40.29	$3.46	0.50%
Culp/CFI	$10.20	$11.90	-14.29%	18.9	$4.37	$12.30	$0.54	n/a
Graham Corp./GHM	$36.30	$35.90	1.11%	17.5	$38.64	$12.55	2.08%	0.30%
Kensey Nash/KNSY	$23.83	$24.41	-2.38%	29.8	$33.69	$22.26	$0.80	n/a
Landauer, Inc./LDR	$50.69	$47.60	6.49%	22.8	$57.29	$45.50	$222.00	3.70%
Markel/MKL	$475.66	$465.50	2.18%	14.0	$521.90	$368.50	$33.83	n/a
ModPac/MPAC	$9.83	$10.16	-3.25%	n/a	$12.50	$9.24	n/a	n/a
QLT Inc./QLTI	$5.87	$6.57	-10.65%	22.6	$9.92	$5.23	$0.26	n/a
Servotronics Inc./SVT	$14.87	$10.76	38.20%	29.2	$12.00	$6.05	n/a	n/a
Specialized Health Products/SHPI	$0.74	$0.76	-2.63%	34.8	$0.99	$0.59	n/a	n/a
Tejon Ranch Co./TRC	$41.38	$39.67	4.31%	n/a	$57.09	$37.70	n/a	n/a
Torm/TRMD	$39.62	$40.20	-1.44%	3.1	$43.13	$24.41	$2.30	13.10%
Universal Forest Products/UFPI	$37.29	$39.54	-5.69%	18.9	$54.61	$33.40	$2.05	0.30%

The Investletter Portfolio

Today the Federal Reserve cut interest rates and the market responded with the its largest jump in over five years. The Dow Jones average jumped 335 points. Lower interest rates mean higher asset values. Every asset is worth more when interest rates fall. Houses rise in value, bonds become worth more, the Barry Bonds record homerun baseball and yes, stocks. The case for stocks rising in value is easy to understand. The cut in interest rates means lower rates of return on bonds and certificates of deposit. The higher returns that stocks offer become more attractive when fixed rate investments offer lower returns. A second reason is that lower interest rates translate into lower borrowing costs for companies. Lower borrowing costs lead to lower interest expense and lower expenses lead to higher profits. Companies that produce higher profits are worth more. QEP Corporation, Rayonier, Chesapeake and K-Tron all will benefit from lower interest expense.

The rate cut was valued most from a psychological standpoint. Investors were looking for some sign that the fed was sympathetic to lessening the burden on those homeowners with adjustable rate mortgages and to help stem the credit crunch associated with the sub prime lending that had spread to more traditional lending activities. This sign of confidence will add to lenders confidence when making loans that are so important in keeping the economy chugging along. The added liquidity may also lead to inflationary pressures at some point and cause the need to reverse course and push rates higher. This effect is too far out to discern with any type of certainty.

Long term it is difficult to see how this rate cut will affect the economy. In the short term it will help drive solid performance in the stock market through the end of the year. The prices of the companies in our portfolio have crept higher over the past several weeks patiently awaiting what was perceived to be an inevitable rate cut by the Fed. This fuels what we see as the culmination of a solid second half of the year. Holding as many undervalued companies as we do leaves plenty of room on the upside.

Below you can see that for as many strong performers in August, they seemed to be matched by stocks whose performance was the opposite. The result was that the value of our portfolio ended up practically unchanged. The first few weeks of September have been marked by a steady march higher. This leaves us on pace for a record year. The pressure is already starting to build regarding next years performance. It is hard to imagine next years results being anywhere near as strong as this year has been for our portfolio. After the recent slide over the summer it is hard to believe we are already back to posting warnings about enjoying it while it lasts, but we will nonetheless…enjoy this amazing performance while it lasts.

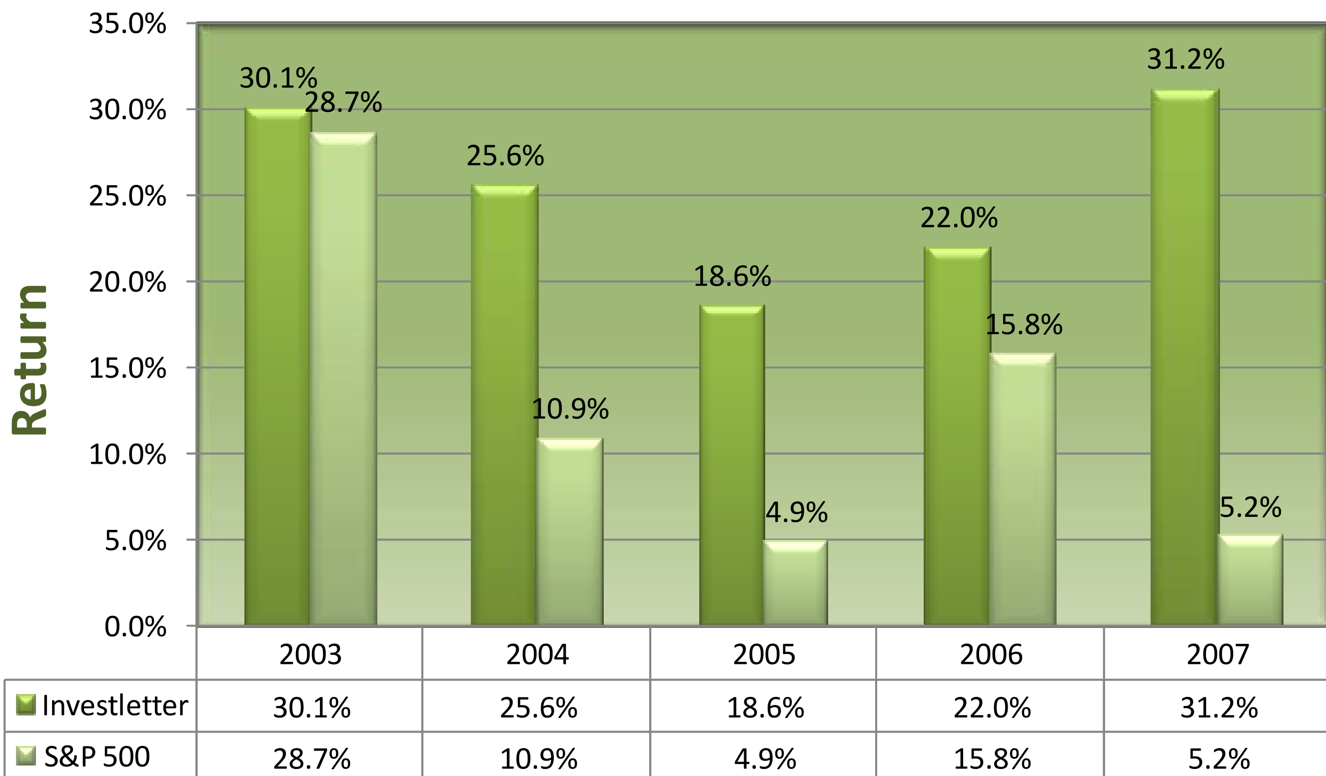
Company	Portfolio Percentage	August price	July Price	Percentage Change	Buy Price (less than)	P/E	Dividend Yield
American International/AMIN	7.30%	$5.45	$4.95	10.10%	$4.95	n/a	n/a
Amtech Systems/ASYS	2.50%	$11.05	$12.13	-8.90%	$11.15	34	
Astronics Corporation/ATRO	22.00%	$31.42	$34.72	-9.50%	$26.00	20.5	n/a
Atrion/ATRI	6.70%	$114.00	$104.42	9.17%	$93.00	18.0	0.80%
Berkshire Hathaway B/BRK.B	7.60%	$3,890.00	$3,604.00	7.94%	$3,300.00	15.3	n/a
Cash	9.60%	$1.00	$1.00	n/a	n/a	n/a	n/a
Chesapeake/CHK	6.30%	$32.26	$34.38	-6.17%	$33.00	9.5	0.80%
Gencor/GNCI	7.20%	$9.98	$9.30	7.31%	$9.70	5.6	n/a
Griffin Land & Nurseries/GRIF	5.50%	$35.07	$37.79	-7.20%	$36.00	30.5	n/a
Headwaters/HW	1.30%	$16.52	$16.13	2.42%	$17.50	6.1	n/a
K-Tron International/KTII	9.40%	$90.01	$98.06	-8.21%	$90.00	15.0	n/a
Protein Design Labs/PDLI	0.80%	$19.51	$23.29	-16.23%	$21.00	n/a	n/a
QEP Corporation/QEPC	7.10%	$11.68	$10.94	6.76%	$12.00	14.4	n/a
Rayonier/RYN	6.70%	$42.74	$42.34	0.94%	$41.00	18.2	4.70%

Year to Date

Last month was a wild ride. At one point our return numbers dropped ten percentage points over the past 6 weeks. We had increased our yearly returns to 35%, promptly dropped ten percentage points to 25% and finished August at 31.2%. This was down a little over one percent from our results at the end of the July. Our results are still very satisfying considering the modest returns from the S&P 500. You have already heard us comment that the sell off last month was unwarranted and the recent activity would tend to back us up. The volume of shares sold in the market has dramatically decreased over the past few weeks. The subprime mortgage crises is concerning, but we still see little impact on the economy as a whole.

Many of the companies we own are still trading at cheap prices. Not what we normally see when markets are overpriced. We expect solid returns over the remainder of the year.

Over the first 44 months of publication the Investletter portfolio is up over 138% versus the 42% of the S&P 500 average. If we are able to tack on another six percentage points of return this year, we can finish our first four years up 150%. Another six points is definitely achievable. Whether it happens is another story.

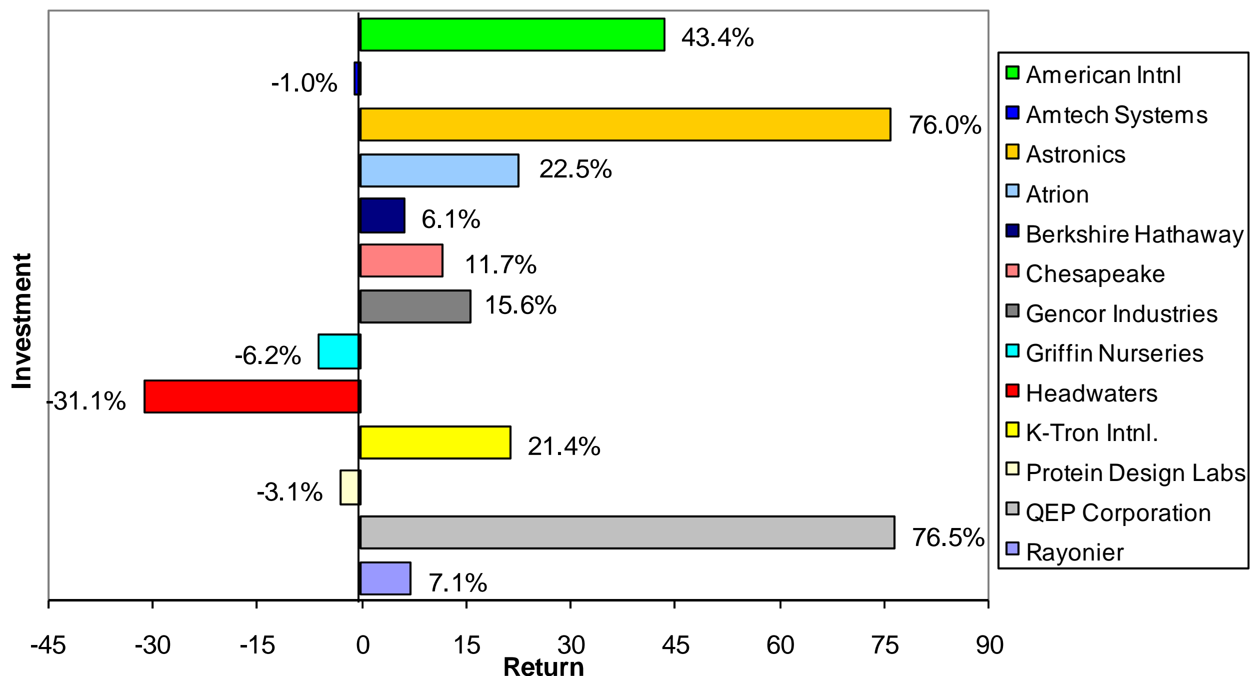


	2003	2004	2005	2006	2007
Investletter	30.1%	25.6%	18.6%	22.0%	31.2%
S&P 500	28.7%	10.9%	4.9%	15.8%	5.2%

Performance

Substantial gains from several of our recent purchases have provided a nice boost to our portfolio. Atrion is up a solid 22.5% since our initial purchase. They have also announced a 20% increase in the small dividend they pay. The dividend is now $.96 per year and this is over a 1% yield on our original purchase price of $91 in early May.

Our foray into QEP Corporation has an interesting little tidbit. When we initially analyzed the company we knew relatively quickly that the company was selling at rock bottom prices. We spent a bit more time looking for anything that might change our mind and found nothing. We sent out our initial email to purchase shares on July 8. On July 16th the company announced their quarterly earnings and the price promptly rose about 70%. We were so wound up in checking out their story we had no idea QEPC was so close to their earnings announcement. Initially we had planned on adding shares over a few weeks to build our position. We still added shares, but it was not until the shares dropped back to around $9. With the shares currently trading over $11, even the shares purchased at $9 are looking pretty good. Another strong quarter and even todays $11 shares will look like a bargain.



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