The Commonsense

INVESTLETTER

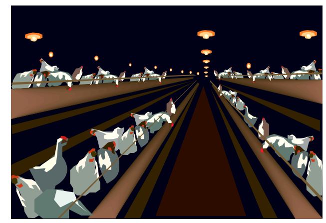
Volume 6 Number 8

Whose Minding The Chickens

Wall Street:

- DJ 10851
- S&P 500 1165
- NASDAQ 2091

Its not even a fox, its more like Godzilla. And...you don't have to worry about guarding...the henhouse has been handed right over to him. You don't even have to worry about the chickens getting stolen a couple at a time, they have just been stomped out of existence with one mighty crash. The same can be said of the current mortgage /credit crisis.



Deregulation itself is not the problem, it is the deregulation of commonsense that is killing us.

Congress and the executive branch caved into lobbying from groups like the Mortgage Banking Association, the prime brokerages, other groups in the financial industry and the banking industry. The regulatory framework has been following the less is more principle over the past several decades and it has finally come home to roost (keeping with the chicken theme) in the form of a transfer of wealth from Main Street to such dubious characters as hedge fund managers, the persistently incompetent bankers, the prime brokers (who promptly squandered it), individuals who took mortgages they had no hope of repaying and such nefarious groups as the mafia and even terrorist organizations. This newsletter (primarily the article in the November 2005 issue) and many others in the finance, educational and citizenry/media fields warned several years ago (and continuously ever since) of the naked short selling scandal that was brewing in the financial markets.

In a huge ironic twist several prime brokers , most notable Bear Stearns and Lehman Brothers, have been forced into bankruptcy or near bankruptcy via the tool (illegal Naked Short Selling) they used to make many ill gotten gains. How does that go? Live by the sword, die by the sword. Unbeknownst to us, naked short selling in credit markets also led to much of the debacle we are currently mired in.

Selling things you don't own, not following the rules to do it, all for the purpose of driving companies into ruin and profiting from it, is not the basis for an economic system that breeds confidence. Now we have arrived at the point were there is a crisis in confidence to the point that nobody trusts the assets, notably mortgage securities, and the decline in the value of these assets has left the credit markets gummed up and sticking to the point of grinding to a halt.

Banks must maintain certain capital levels in order to be considered solvent. Banks that own many of the mortgage securities that have dropped in value have seen a corresponding drop in their capital. When capital levels drop, banks have less money they can loan and this means fewer loans are made. Businesses and homeowners lose access to borrowing. Business innovation and investment drops and fewer people buy homes and new cars. Lower demand for housing and home sales drop. Home sales drop and more homebuyers are inclined to walk away from mortgages. The more mortgages that default, the more the value of the mortgage backed

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securities drop, the less capital banks, who hold many of these securities, have to lend. As you can see this is a downward spiraling vicious circle. The government is attempting to step in a break this cycle by buying up some of this debt from the banks to help re-capitalize them so lending can return to more normal levels.

Losing it all could happen, but it would mark a first in US equity markets. With the financial markets on the verge of collapse, how people react determines what happens next.

The rescue package is less of a bailout and more of a sin tax to fix a system where there is plenty of blame for a multitude of groups. The system is so fragile that a large solution is needed to help mend the loss of confidence. The characterization that this fix is to bailout Wall Street is much less than accurate. The fix is to bail out homeowners taking a free ride on easy money to temporarily achieve a more prestigious zip code. It is to atone for an excess of bankers and other mortgage originators who relaxed the lending standards to the point of giving mortgages to just about anyone who asked, in amounts more than the value of the home they were buying. The fix is to right the wrongs of the President in his quest to increase home ownership by encouraging the Department of Housing and Urban Development to push for relaxed lending standards in the loans that Freddie Mac and Fannie Mae were able to purchase. The bailout is to right the wrongs of lobbyists whose firms benefited by relaxing lending standards which ultimately increased the supply of money available to those with questionable credit. It is also to fix the head in the sand approach of the Securities and Exchange Commission (SEC) who bowed to pressure from powerful Congressmen and equally powerful business interest groups (Chamber of Commerce, etc.).

There is no one group you can pin the blame on, the problem is that this crisis has been caused by systemic problems in the securities and credit markets. Many groups had their hands in the till and now it is time to pay the piper.

So just how big is the problem and what is the fix designed to do. The value of all U.S. housing stock is $19.4 trillion dollars and currently there is mortgages on $10.6 trillion of it, as found in the September Z.1 statistical release from the Federal Reserve Board. Much of the $700 billion rescue package to get the credit markets moving again can be directly tied to mortgage debts. This means that if the $700 billion figure were to represent an estimate of the amount of distressed mortgage securities, that almost 7% of the mortgages have dropped seriously in value. Banks have default rates on their loans that get worrisome if the rates jump above 1%. This does not imply that 7% of the mortgages are in default. By purchasing $700 million of these distressed mortgage securities, the banks will receive cash they can make loans with and it will decrease the supply of these mortgage securities with the intent on firming up their pricing. If the value of these securities rise the banks capital also rises, again freeing up more money to loan. It gets the credit markets moving again.

The government directly becomes an investor in the mortgages of American homeowners. The cost of the rescue package in the end will be nothing close to $700 billion. Many mortgages will continue to get paid and the government will slowly recoup their outlay. It ties up $700 billion dollars that could be used for other purpose, like not creating the debt that will be the source of this money. It will impact government spending for years to come. It will put pressure to cut spending in other areas to help reduce government debt levels.

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The ultimate fix will come with a greatly increase regulatory framework. Many of these problems were already understood and at the same time routinely ignored. Recent testimony by Christopher Cox, the Commissioner of the SEC highlights how lax the regulatory oversight in the financial and banking industries has been. In a speech given on September 23, 2008, Mr. Cox gives some graphic examples. He mentions the credit default swap (CDS) market and the numerous enforcement action (investigations) that are currently underway because of “the significant opportunities that exist for manipulation in $58 trillion CDS market, which is completely lacking in transparency and completely unregulated.” CDS are like mortgage insurance for banks (or insurance on a bond if that is the underlying asset) and other large lenders. They are derivatives that one party receives payments for guaranteeing that a party is made whole if the value of a mortgage security drops below a certain value. Now this is not a $58 billion market, this is a $58 trillion market with a T and we have one of the primary US financial regulatory heads saying effectively that nobody is minding the store. No agency has responsibility for making sure these markets are policed and remain fair. So as you might imagine, they haven’t been. They have also been used in combination with naked short selling to amplify profits on companies experiencing difficulty, like Bear Stearns. Investors bought CDS on Bear Stearns debt and then proceeded to naked short shares of the company to drive the price down so it would default on their Bonds and profit on their side of the CDS contract. This is not to mention that a CDS buyer is in essence a naked short seller of a mortgage security or corporate debt or whatever underlying asset .

Mr. Cox also admits that the measures used to determine if banks maintain enough liquidity and sufficient capital levels are flawed and need to be revised. “The SEC, working with the Federal Reserve Board, has implemented substantially more rigorous approaches to supervision of liquidity levels and liquidity risk management.” He further states that “They have developed scenarios that are of much shorter duration and that are much more severe ,…” As we have said in the past the math used by modern finance is fundamentally flawed. This statement seems to be a concession to the fact that the use of linear mathematics just cannot explain risk. Hopefully his comment is in reference to a wholesale shift in the idea of risk.

Company	August price	July price	Change from July	P/E	52 Week High	52 Week Low	Estimated '08 EPS	Dividend Yield
Alico/ALCO	$43.15	$42.43	1.70%	n/a	$52.76	$33.14	n/a	2.50%
Alliant Techsystems Inc./ATK	$105.23	$99.69	5.56%	14.2	$120.90	$95.00	$7.39	n/a
American Pacific/APFC	$17.22	$16.12	6.82%	16.1	$19.20	$13.37	$1.16	n/a
Arch Coal/ACI	$54.24	$54.21	0.06%	19.7	$77.40	$29.36	$2.76	0.70%
Culp/CFI	$7.46	$6.15	21.30%	14.4	$11.00	$5.99	$0.51	n/a
Gencor/GENC	$9.54	$11.03	-13.51%	5.8	$32.88	$8.50	n/a	n/a
Graham Corp./GHM	$93.40	$89.00	4.94%	23.1	$109.82	$27.69	$3.53	0.10%
St. Joe Company/JOE	$37.27	$35.15	6.03%	86.7	$46.82	$26.70	$0.82	1.70%
Landauer, Inc./LDR	$65.26	$63.92	2.10%	26.4	$68.83	$47.00	$2.46	3.10%
Mesa Labs/MLAB	$20.50	$21.05	-2.61%	14.6	$27.00	$17.90	n/a	2.00%
Schuff International/SHFK	$27.00	$27.50	-1.82%	3.9	$35.00	$21.00	n/a	n/a
Servotronics Inc./SVT	$12.20	$15.25	-20.00%	9.2	$22.48	$10.12	n/a	1.20%
Span America Medial Sys/SPAN	$12.84	$13.00	-1.23%	12.4	$20.19	$9.88	n/a	2.80%
Tejon Ranch Co./TRC	$34.21	$31.00	10.35%	69.9	$44.51	$29.71	$0.49	n/a
Torm/TRMD	$34.40	$32.32	6.44%	7.2	$47.10	$26.52	n/a	n/a
Twin Disc/TWIN	$18.37	$20.11	-8.65%	9.2	$37.47	$12.07	n/a	1.50%

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The final comment we wish to highlight is where Mr. Cox states that "the failure of the Gramm-Leach Bliley act to give regulatory authority over investment bank holding companies to any agency of government was, based on the experience of the last several months, a costly mistake." Wow! Is that an understatement. Congress has caved in to special interests and pretty much let investment banks (Bear Stearns, Lehman Brothers, Merrill Lynch, etc.) do as they please. Is it any wonder that the leadership of the SEC is often from the prime brokers (investment banks) and the same can be said of the Federal Reserve Board. (Mr. Cox is not a lifelong industry insider, while Mr. Henry Paulson, the Secretary of the Treasury, was the Chairman and CEO of Goldman Sachs before taking over his current position.

Now lets back up a step and consider the actual mortgage securities and how they end up in investors portfolios. We have talked before about mortgages being packaged up and then sliced into securities and sold to investors. Before these securities could find buyers they needed to have a determination as to the quality of the mortgages underlying the investment security. The firms creating these securities needed to get them rated. So they took their business to the bond rating agencies like Fitch Inc., Standard and Poor's and Moody's Corp. Bond ratings agencies investigate the underlying assets and then form an opinion of the overall quality of the bond or debt obligation. Of course, it turned out this was how it was supposed to work in theory. When a company brings you business and wants their bond or other debt instrument rated, they aren't looking to have it rated as junk. They aim to have it rated as high quality investment grade debt so they can easily find buyers. If you are a ratings agency that wants that business you may be inclined to look the other way at some weaknesses or if you are in a real hurry and just want to lock in the business, you may ignore that bothersome step of actually investigating the underlying mortgages and in effect just sell an investment grade rating. When investors go into the market and purchase investments grade bonds for their pension plan or other such endeavor they often rely (why we have no idea) on the ratings agencies to help point them to suitable investments. Investors did invest in investment grade mortgage backed securities that bond rating agencies did not properly investigate and were not anywhere near the investment grade quality that they were passed off as. Now that the value of these securities has become better know, they value has dropped to reflect the new reality. The bond rating agencies still get to keep their fees, although they are facing numerous lawsuits.

How do you make sense of all of this? You don't. The problem is so complex and affects so many parts of the system that it is impossible to allocate blame in any meaningful way. The true solution will be measured in how stringent the regulatory overhaul is and how many convictions we have. Right now let's get this mess cleaned up and get this economy righted.

Company	Portfolio Percentage	August price	July Price	Percentage Change	Buy Price (less than)	P/E	Dividend Yield
American International/AMIN	7.00%	$3.23	$3.33	-3.00%	$3.50	n/a	n/a
Amtech Systems/ASYS	6.00%	$11.23	$9.41	19.34%	n/a	36	n/a
Asta Funding/ASFI	2.40%	$8.28	$8.00	3.50%	$10.00	5.6	2.00%
Astronics Corporation/ATRO	12.70%	$24.29	$14.60	66.37%	$20.00	15.0	n/a
Atrion/ATRI	7.30%	$115.28	$110.42	4.40%	$93.00	15.2	1.00%
Berkshire Hathaway B/BRK.B	6.30%	$3,902.00	$3,829.00	1.91%	$4,000.00	15.6	n/a
Cash	7.70%	$1.00	$1.00	n/a	n/a	n/a	n/a
Chesapeake/CHK	8.20%	$48.40	$50.15	-3.49%	$40.00	12.2	0.60%
Consolidate Tomoka/CTO	2.60%	$41.29	$39.59	4.29%	$39.00	15.4	1.00%
CSP Inc./CSPI	9.20%	$6.06	$5.74	5.57%	$5.70	12.5	n/a
K-Tron International/KTII	11.40%	$148.79	$138.79	7.21%	$120.00	17.7	n/a
Protein Design Labs/PDLI	0.40%	$12.07	$11.22	7.58%	n/a	14.7	n/a
QEP Corporation/QEPC	9.60%	$5.93	$6.38	-7.05%	$5.60	8.2	n/a
Rayonier/RYN	9.20%	$44.99	$46.72	-3.70%	$41.00	22.5	4.40%

The Investletter Portfolio

Our letter to the Directors of CSP, Inc. (CSPI) has been received and is on the agenda for the November Board of Directors meeting. We have spoken with the CFO twice in the past few weeks and have expressed our views related to the company's level of cash and investments. He was quick to reiterate that the company currently has a stock buy back program in place. This is true, but the amount of money they have allocated to this activity is minimal. We have voiced our opinion that the buyback is insufficient and we would like to see it greatly increased.

The conversation has been cordial to this point, but this does not give us any indication of how serious they are taking our efforts to increase shareholder value. The call to increase the buyback or make large special dividend payments is not an attempt to cause a few to benefit at the expense of others, it is an attempt to see all shareholders benefit.

Even though the company does offer their executive management stock options, they sell their shares acquired as quickly as they obtain them. With a large ownership stake management may be more inclined to support actions to boost the share price. There is an inherent conflict of interest between management and the Board of Directors. Management may prefer to maintain a large cash balance. The interest income on investments adds a considerable amount to the bottom line for CSPI. The Board of Directors is supposed to look out for the best interest of the shareholders and therein lies the conflict. When management is also large shareholders they tend to be more closely aligned with all shareholders. In this case management does not share a large ownership stake.

At least one Director is a large shareholder, potentially putting his interests in conflict with management's. The relationship between the Board and management becomes muddled when the CEO is also the Chairman of the Board as is the case with CSPI. The CEO most likely played a strong role in determining who would be invited to join the Board of Directors and probably plays a strong role in determining their pay package.

While we don't hold out strong hope that the Board will enact a more shareholder friendly stance, we do think that the recent plunge in the share price makes a compelling case to buy back shares more aggressively. The SEC has also waived regulation limiting buybacks to encourage companies to more aggressively buy shares in this malfunctioning market.

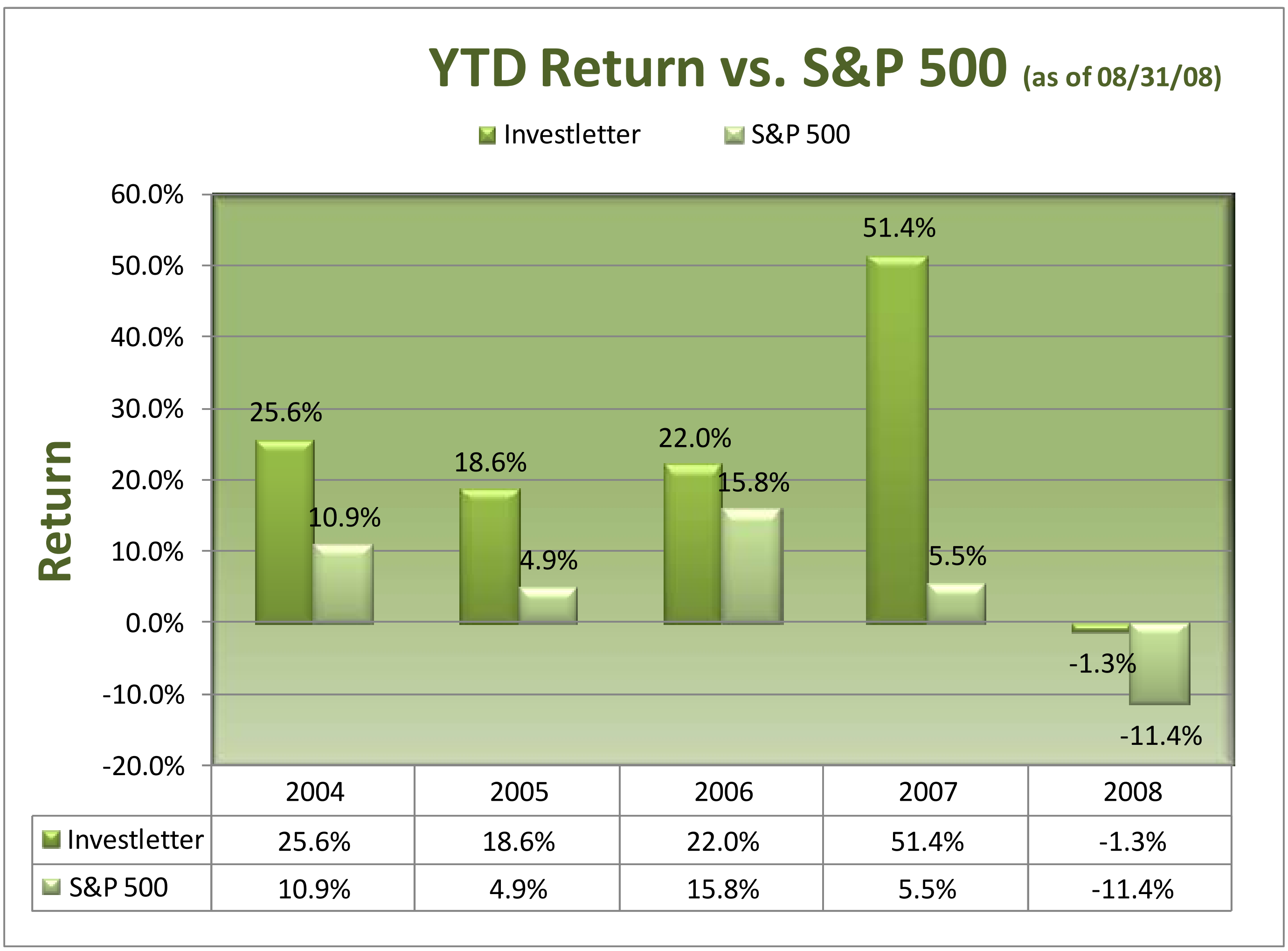
I have asked the CFO to respond with the results of the meeting and at this point I will be able to determine my response. One possible scenario is to put forth a shareholder resolution to be included on the next proxy statement. It is a route we have taken before and would be more than willing to follow again. Even though the resolutions are non binding, they serve to send a strong message. New shareholder communication regulation make the idea of launching a proxy battle for seats on the Board of Directors more appealing. Unfortunately it does not make it any cheaper.

Company	Portfolio Percentage	September price	August Price	Percentage Change	Buy Price (less than)	P/E	Dividend Yield
American International/AMIN	5.70%	$2.74	$3.23	-15.17%	$3.50	n/a	n/a
Amtech Systems/ASYS	5.90%	$9.31	$11.23	-17.10%	n/a	31	n/a
Asta Funding/ASFI	3.10%	$7.01	$8.28	-15.34%	$10.00	4.5	2.30%
Astronics Corporation/ATRO	19.80%	$22.84	$24.29	-5.97%	$20.00	14.1	n/a
Atrion/ATRI	6.70%	$103.07	$115.28	-10.59%	$93.00	13.7	1.00%
Berkshire Hathaway B/BRK.B	7.20%	$4,395.00	$3,902.00	12.63%	$4,000.00	17.9	n/a
Cash	15.10%	$1.00	$1.00	n/a	n/a	n/a	n/a
Chesapeake/CHK	5.90%	$35.86	$48.40	-25.91%	$28.00	7.7	0.80%
CSP Inc./CSPI	8.80%	$5.27	$6.06	-13.04%	$5.70	11.0	n/a
Gencor/GENC	2.60%	$8.08	$9.54	-15.30%	$8.00	3.0	n/a
K-Tron International/KTII	10.50%	$128.83	$148.79	-13.41%	$120.00	15.4	n/a
Protein Design Labs/PDLI	0.30%	$9.31	$12.07	-22.87%	n/a	7.9	n/a
QEP Corporation/QEPC	8.40%	$5.33	$5.93	-10.12%	$5.60	7.4	n/a

Year to Date

As we mentioned in the last update we have finally put some distance between our performance and that of the S&P 500 market average. The rest of the year looks like tough sledding. While earlier this year we fully expected that the economy may skirt along the edges of a recession, we now see a recession as inevitable. The recent changes in the financial markets and the stunning depth of the problem in the mortgage securities market has fundamentally changed the economic landscape going forward. The massive rescue package necessary to get the credit markets moving again will alter the economy in ways that can't be fully anticipated today.

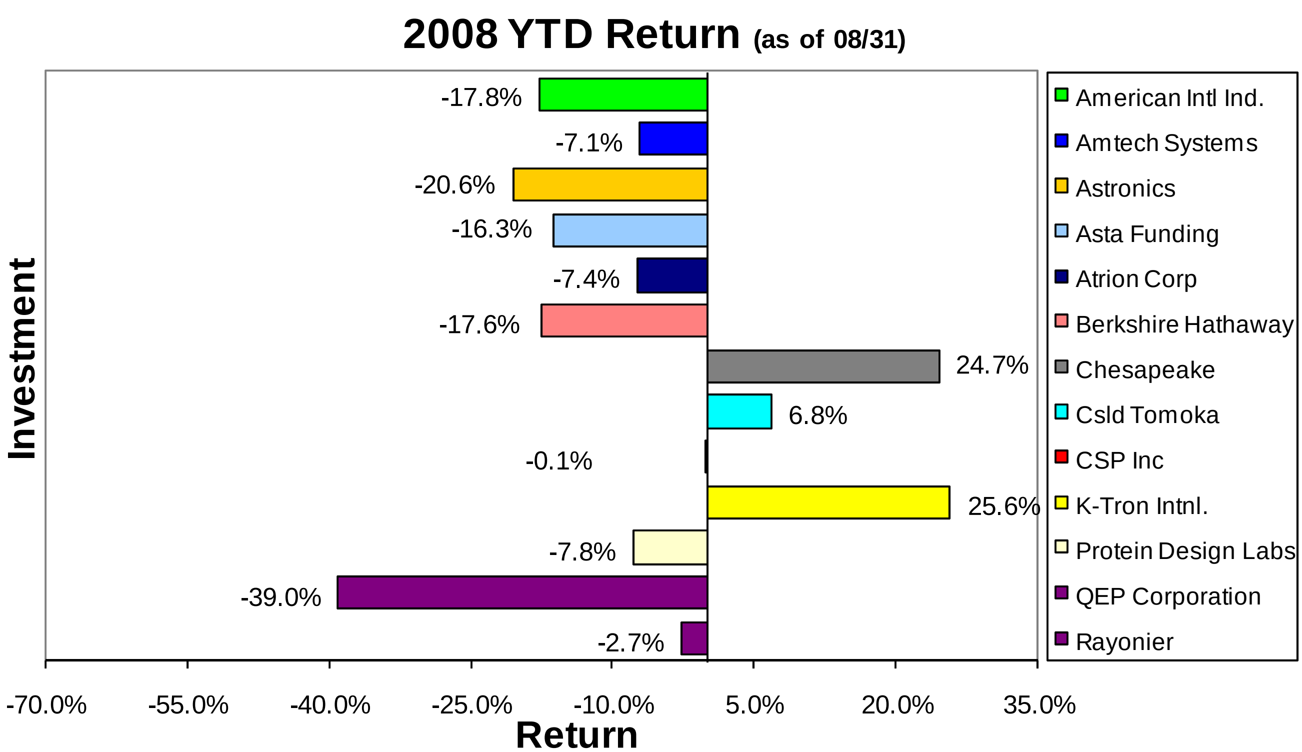
Earlier this year it appeared to us that the economy may turn the corner in the second half of this year. Our abilities at economic forecasting aren't any better than anyone else. While we have performed better than the S&P 500 average so far this year, it is little consolation in a year with such poor market returns. If the economy does indeed continue to slow, the likely performance in the stock market will be lackluster. Just as people have slowed in their appetite for buying new cars, the appetite for buying companies slows down; no matter whether it is the whole company or in pieces via the purchase of shares of stock. The drop in demand for goods and services leads to lower earnings and share prices. The only bright spot we can see is that recessions do not last forever. At some point this disruption will pass and the economy will again improve.



Performance

Strong performance in a few of our positions this year are still responsible for our lead over the S&P average. Perennial top performer K-Tron has again had strong performance this year. They do a large amount of business with customers outside of the U.S. that will benefit from the weak dollar. Stronger foreign currencies make U.S. goods cheaper abroad boosting sales of exporting companies like K-Tron. With over 50% of sales outside the U.S., much of K-Tron's success in the short term will be determined by how widely the U.S. financial malaise spreads to the rest of the world.

Recently we added back shares of Gencor that has been our most successful investment this year. Shares we sold at much higher prices have dipped back below $9 per share. The company has $68 million in cash and at the current price the company is valued at $80 million. Is it worth paying a $12 million premium investing in a company with $80 million in sales? We certainly feel it is, especially in one that still may receive a substantial payment from their partnership interests that are winding up operations. Gencor's cash and investments total a bit over $7 per share. This helps provide a solid bottom to the share price. We own the operations for prices that can't be found in similar situated companies without cash hoards. It is just another example of the pricing anomalies found in the financial markets that aren't as efficient as finance community believes.



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