The Commonsense

INVESTLETTER

Volume 4 Number 11

Wall Street

- DJ 12463
- S&P 500 1418
- NASDAQ 2415

Inside this issue:

New Year Prognosticators

At the end of the year all of the talking heads stand back and reflect on how the stock market did in the just finished year. Then they gather up their courage and make fearless predictions about what is to come. This game is an exercise in futility and while it generates a great deal of attention, it does not do the damage to the reputation of the erroneous prognosticator that one might think. A recent local newspaper article highlights this paradox

Rolling dice gives you better odds than predicting the market.

The title of the article is "Stock Pickers see Normal Gains in 2007". Each investment professional had the task of predicting the level that the Dow Jones Industrial Average would end 2006 at. In 2006 Dow average ended the year up 15.2% at 12,343. The closest prediction was 93 points away, less than one percent off. The other six missed by between 200 and 1,000 points. That is about two to nine percentage points off. Even from an entertainment standpoint we don't get much satisfaction from seeing the worst predictor of the "pros" mess up by having their prediction fall about 35% short of the mark.

The hilarity continues. If this wasn't enough, the same group of professionals also picked five or six individual stocks they thought would do well in 2006. As we said last month, this is an awfully short time frame to get it right regarding the performance of stocks. This group of investment professionals will help me drive my point home. Now, a reasonable person would venture a guess that maybe three or four of the seven pros would have outperformed the stock market with their picks.   Only one of the seven managed to beat the market. Three of them actually managed to lose money with their small portfolios. How could this be and what kind of peril awaits these pros in the running of their investment advisory businesses? Our guess is that these folks really don't have much skill in picking individual stocks (or the level of the stock market one year in advance) and it probably will have no impact whatsoever on their advisory business. Why is it that they do so poorly? This question may be easier to answer than it might appear.

Our Pro's function is to be a salesman first and then worry about their clients returns. When you have a whole list of clients and your livelihood depends on getting more clients, you first go out and get clients. This is a time consuming process. Then you need to set these clients up on some type of investment program, but they don't have a particularly large amount of time to allocate to this task. That is why you will see so many of them fall back on the comfort of modern finance theory. It tells them that you need to worry about asset allocation so you can reduce the swings from high to low in a portfolio. They will spout the party line that mere mortals cannot beat the market because each stock is price at exactly what it is worth and that the only way to earn higher returns is to take on higher risk. The beauty of saying that it is too difficult to beat the markets and you are better off not trying is they have a built in excuse for poor performance. So it becomes

New Year Prognosticators

easy to justify doling out generic investment options to their clients. This option will allow them to perform similarly to what the market does without generating too many ups and downs. Because this they justify, is the best that can be done. How amazing, the most convenient strategy from a time standpoint also happens to dovetail nicely with modern finance theory and is proclaimed as the gospel truth in the professional community. This fact remains that even though modern finance theory has been to a large part been rendered intellectually obsolete. The professional practitioner has no motivation to see a change in the status quo for it would upset his/her comfortable means of eking out a six figure salary.

Some things are better off left to the professionals, stock picking is not one of them. While some registered investment advisors undoubtedly generate excellent performance for their clients, statistics show that as a whole they perform worse than the market.

If it was determined that with the right temperament and training that some were capable of outperforming the market and a professional could not meet that objective then what future would they have? This would wreck the careers of a great number of investment professional who couldn't meet the new standard. It would probably make it tougher for everyone to beat the market if the unequipped (investment advisors) were kept from participating.

So why does modern finance theory persist even when it has been proven to be a poor model of explaining markets? Because it has a lot of inertia behind it. There are large sums of money involved and too many people don't want to lose their cut. How does this affect the Investletter and our subscribers. Thank your lucky stars the status quo has sticking power. We are huge beneficiaries of the inefficiencies this creates.

Who better to have to match wits against, a bunch of salesmen that have to capture and service clients or seasoned investment analysts that are skilled in effectively valuing companies. We are much more comfortable competing against the professional investment (salesmen/saleswoman) advisor every time. This is a group that we have a decided advantage over. Especially when they conveniently believe that you can't beat the market anyways. Certainly a self fulfilling prophecy for many of them.

As individual investors always make sure you understand what motivation someone has for wanting to invest your money for you. Ask yourself whose interest is it that they are putting first. Frequently it is not yours.

You may ask yourself is our publisher biased. The answer is of course he is. But, he also trusts you can sort out the facts on your own and reach an intelligent conclusion. Using a professional investment advisor or financial planner or whatever other title they give themselves will cost you about one percent of your assets yearly as a management fee. For the privilege you will get about average returns. At Investletter we are not interested in skimming one percent off the top. Everyone deserves good advice and even the little guy should be able to afford it. (As long as too many don't look to get it from us. Please don't let this stop you from recommending us to friends and relatives, we are nowhere near that number yet.) Hopefully our low cost advice can be just as valuable in this coming year as it has the last few. Just don't expect us to predict where the stock market will end the year, that is better left to the pros.

Watch List

We have two companies we are currently investigating that we have found interesting enough to do in depth analysis on. One is an insurer and the other is a tech company. The insurer is Commerce Group, Inc. (CGI) a Massachusetts company that primarily provides auto insurance in that state. On the surface they appear to be a conservative, well run insurance company that generates good profits and writes profitable policies. The two don't always go together. Many insurance companies write policies at a small loss and try and make it up on the investment earnings of their float. Float is the money insurance companies collect in payments before the service is provided. This gives insurance companies a large pool of cash that they can invest and use to generate income. If the investment income and the policy premiums combined is more than the companies expenses they will be profitable. We prefer the companies that are more disciplined in their policy writing and make a profit on their policies.

Our Berkshire Hathaway is the owner of GEICO which does a great job of writing profitable insurance. This is the magnitude of the hurdle to which CGI will have to clear in order to gain a spot in our portfolio.

The other company is Amtech Systems, Inc. (ASYS), a manufacturer of equipment for the semiconductor and solar cell industries. The solar cell business is the segment that interests us. They are undergoing explosive growth. Even with this segment's encouraging performance, the company's share price is depressed. Amtech recently announced they are going to offer more shares to the public. This will increase the number of shares by 65%. The news was not received well in the market. We expect the shares to slide further, especially if they go through with the offering. If the share price gets knocked around enough, it may present an opportunity for us to take a position. Until then we will be busy gaining a better understanding of the company and fine tuning our approximation of what the company is worth.

Below you will see a large drop in Arch Coal's share price. The warm weather we have been enjoying has started to affect all energy stocks. Warm weather means less fuel used leading to a greater supply. When supply goes up prices fall. With long term electricity demand expected to show strong gains over the next twenty years we don't see coal prices staying down forever. In that case forget high tech and we will stick with our boring but cheap formula.

Company	December price	November price	Change from November	P/E	52 Week High	52 Week Low	Estimated '06 EPS	Dividend Yield
Alico/ALCO	$50.63	$56.99	-11.16%	48.0	$62.92	$42.17	n/a	2.20%
Alliant Techsystems Inc./ATK	$78.19	$77.31	1.14%	15.4	$84.90	$72.37	$5.07	n/a
Altria Group, Inc./MO	$85.82	$84.21	1.91%	16.2	$86.45	$68.36	$5.31	4.00%
Arch Coal/ACI	$30.03	$35.90	-16.35%	18.1	$56.45	$25.85	$1.66	0.80%
Bioanalytical Systems, Inc./BASI	$5.50	$5.50	0.00%	n/a	$7.80	$4.75	n/a	n/a
Canadian Natural Res./CNQ	$53.23	$54.27	-1.92%	19.7	$64.38	$40.29	$2.70	0.50%
Graham Corp./GHM	$13.15	$13.60	-3.31%	16.8	$26.00	$12.55	n/a	0.70%
Kensey Nash/KNSY	$31.80	$30.68	3.65%	41.8	$33.69	$21.99	$0.76	n/a
Landauer, Inc./LDR	$52.47	$54.39	-3.53%	22.1	$57.29	$43.11	$2.37	3.50%
Markel	$480.10	$447.75	7.23%	14.4	$494.00	$312.50	$33.25	n/a
ModPac/MPAC	$11.00	$11.00	0.00%	n/a	$12.50	$8.00	n/a	n/a
QLT Inc./QLTI	$8.46	$8.66	-2.31%	26.4	$9.10	$5.93	$0.32	n/a
Servotronics Inc./SVT	$8.30	$8.10	2.47%	12.8	$10.30	$4.70	n/a	n/a
Tejon Ranch Co./TRC	$55.84	$50.77	9.99%	n/a	$57.09	$37.55	n/a	n/a
Universal Forest Products/UFPI	$46.62	$46.65	-0.06%	13.0	$80.28	$43.61	$3.60	0.20%

The Investletter Portfolio

Welcome to the whirlwind of activity known as the Investletter Model Portfolio. Gone is Forgent (FORG), Cell Genesys (CEGE) is pared back facing elimination, Gencor (GNCI) is all washed up and next on the hot seat is Specialized Health Products (SHPI). Wow! The break-neck pace is keeping us busy. Here we go with the rundown.

We had previously mentioned that CEGE was a candidate for tax loss selling. We doubled our position and sold off the older half of the shares at the end of December. Our timing was awful. We would have been much better selling off in November when we broached the topic. Those who sold outright made out much better as the price has been in downward spiral. We could not have been more wrong about this company.

FORG was purchased as a short term investment and turned into a really short term investment. It was very satisfying to have over a 100% return in a couple of weeks timeframe. That always serves as a nice ego booster even if the events that drove the price have more to do with irrational overactive trading than solid fundamentals. The stock was a steal when we bought it and now is more than fairly valued. Sometimes that market eliminates mispricings fairly rapidly. This was as short a time frame as you will see for correcting a massively undervalued security.

GNCI is another stock that we had no plans on holding long term. The stock has risen nearly 40% in the roughly one and one half years we have held it. The large payment they have received from their partnership interest have finally driven the price up to a level that we feel comfortable exiting at. With the tax code section 29 tax credits scheduled to end at the conclusion of 2007, the gravy train is out of steam. We would not be surprised to see the share price lower than current levels by the end of 2007.

Lastly, we have our shares in SHPI. They are another small company that we invested in that has seen their share price rocket upward. We are waiting to have enough information to decide whether we should exit. The company is growing rapidly but the share price has been growing even faster. The shares up nearly 100% from where we recommended them this past July. We originally said we "are looking for some good operating results and a quick jump in the price." We got both and it soon may be time to say goodbye.

We have been complaining about high cash levels for months, just wait until all of these sales are complete, you will hardly be able to stand the moaning that could soon be on the horizon. This is your fair warning.

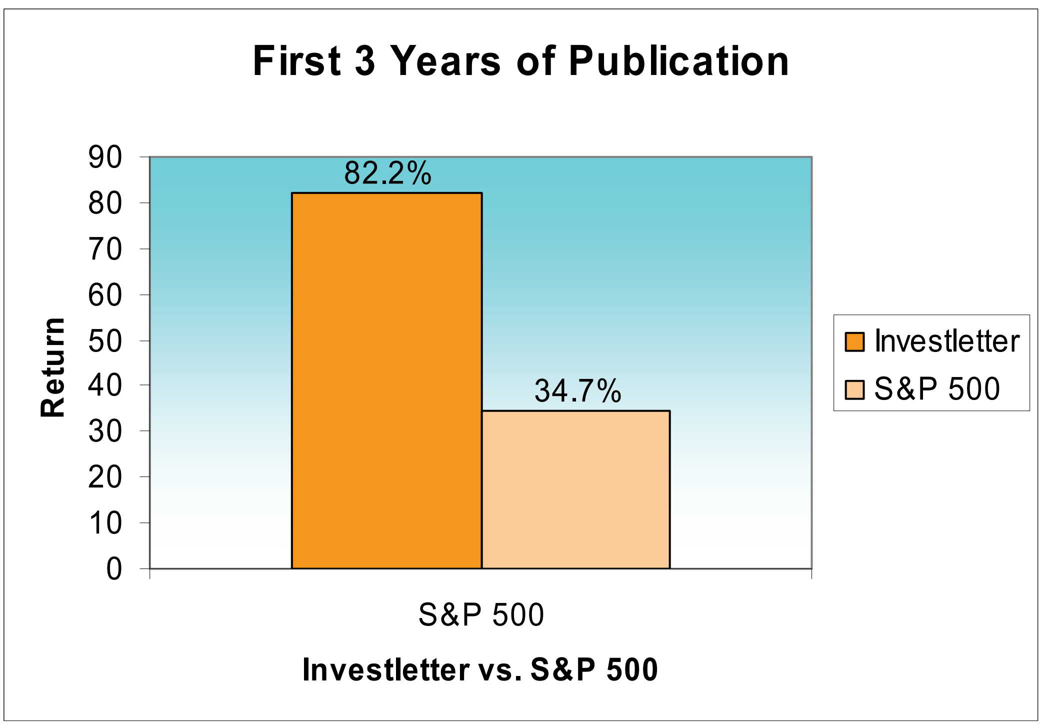
Company	Porfolio Percentage	December price	November Price	Percentage Change	Buy Price (less than)	P/E	Dividend Yield
Astronics Corporation/ATRO	15.70%	$17.13	$17.30	-0.98%	$15.75	22.7	n/a
Berkshire Hathaway B/BRK.B	9.30%	$3,666.00	$3,555.00	3.12%	$3,100.00	13.1	n/a
Cash	21.20%	$1.00	$1.00	n/a	n/a	n/a	n/a
Cell Genesys, Inc./CEGE	1.70%	$3.39	$3.88	-12.63%	$3.00	n/a	n/a
Chesapeake/CHK	7.40%	$29.05	$34.03	-14.63%	$30.00	6.5	0.80%
Culp/CFI	2.60%	$5.15	$4.93	4.46%	$4.40	19.6	n/a
Gencor/GNCI	4.00%	$12.05	$11.15	8.07%	$8.50	10.3	n/a
Headwaters/HW	2.40%	$23.96	$23.92	0.17%	$25.00	11.0	n/a
K-Tron International/KTII	5.70%	$74.67	$66.89	11.63%	$55.00	20.5	n/a
OMI Corporation/OMM	18.80%	$21.17	$23.36	-9.37%	$20.75	4.2	2.60%
Protein Design Labs/PDLI	1.00%	$20.14	$22.69	-11.24%	$22.00	n/a	n/a
Rayonier/RYN	8.40%	$41.05	$41.70	-1.56%	$41.00	18.0	4.60%
Specialized Health Products/SHPI	1.40%	$0.72	$0.61	18.03%	$0.40	n/a	n/a
Terra Systems/TSYI	0.40%	$0.40	$0.38	5.26%	$0.40	n/a	n/a

Performance

December nailed down our seventh straight year of outperforming the S&P 500 market average. Over the past three years that we have published this newsletter our results have been stellar. We have posted gains of 25.6%, 18.6% and 22% for the years 2004, 2005 and 2006. This was 14.7, 13.7 and 6.2 percentage points higher than the S&P 500 average over the same three years. As we have said in the past, our performance is satisfying, but our past means nothing in the present. All that matters now is what we do going forward.

In order to hit our stated goal of doubling our money every five years we need to generate a 10% return over the next two years. This year it would be nice to achieve this goal along with besting the S&P average for the eight straight year, which would land us our double one year ahead of schedule.

The stock market has had a nice run since it pulled out of the Bear market in 2002. The last upturn lasted much longer than the usual four year economic cycle our economy previously exhibited. If that same pattern holds it may be several years before we have our next recession. There is nothing that indicates any slowing is imminent. This slow and steady expansion will help all of our brokerage accounts as stock prices are likely to rise in the absence of any indication that economic growth is slowing. Falling energy prices and low unemployment both should boost this years economy. Although we have started out 2007 by falling a bit behind the S&P average, we have high hopes for another solid year.



Subscription Information

To subscribe to The Commonsense Investletter visit our web site at www.investletter.com. Click on the subscribe link to enter your subscription. Or, you can contact us at contact@investletter.com with any questions. Checks made out to BCIA can be mailed to the address below. A subscription cost $99 for 10 issues yearly. We aim to justify your subscription cost by helping you beat the market average.

The Commonsense Investletter: Published by BCIA
100 Burgundy Terrace, Amherst, New York 14228
www.investletter.com