The Commonsense

INVESTLETTER

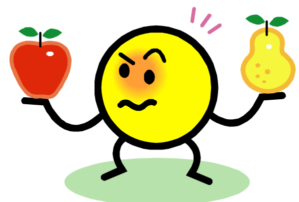
Volume 5 Number 11

Wall Street:

- DJ 13265
- S&P 500 1468
- NASDAQ 2652

Stock Compare

Six of one, a half dozen of the other. It's all about equal, at least in the eyes of Wall Street. Two companies we have experience with provide a nice study of some of the inconsistencies in asset pricing in the securities markets. Mod-Pac (MPAC), a company we have owned in the past operates in the short run printing and custom carton business, packaging and printing. In 2005 they lost their largest customer and have been losing money since. They have burnt through cash balances and are now dipping into a line of credit to support their operations.



Two companies with equivalent market values, but only one clear choice.

Another company we have owned in the past and have added shares in recently, CSP Incorporated (CSPI), makes up the other company in this comparison. CSPI designs and builds high performance cluster computing systems for the defense market used for sonar and signal processing and provides IT solutions and systems integration services. CSPI just completed a large defense contract providing computer systems for Raytheon. Without strong growth in orders it is likely that their 2008 revenues will be somewhat lower than 2007.

So there we have it, printing and boxes versus computers and IT services, MPAC versus CSPI. On our website we have posted a spreadsheet that will be used to aid in our discussion of the two companies. Both companies sell for nearly the same amount. It will cost about $26 million to buy each company. In Wall Street's eyes these two companies are essentially even in their value. Here is our interpretation of each company's financials.

Wall Street puts a heavy emphasis on the Income statement. In our opinion too much emphasis. For our discussion we will begin with the balance sheet. This analysis will be easier if you are holding the spreadsheet or the pdf file equivalent in front of you. MPAC received a large settlement in 2005 from a large customer related to contract termination fees. Some of that money went to reduce debt and some more has been used to fuel their operations. Currently they have very little cash left and have had to borrow from a line of credit to continue operating. CSPI has had more than $10 million in cash and investments on their balance sheet for more than the last ten years. As of this past October they have more than $21 million in cash and investments. They require very little by way of capital equipment to run their business so they make very low expenditures for new equipment. MPAC is forced to buy expensive printing machines to keep up in their business. CSPI has over $5 cash per share. With shares at $7 you essentially get their business for $2. MPAC has $24 million in plant and equipment that will gradually wear out and need to be replaced.

Now on to the liabilities section of the balance sheet. CSPI has $14mm in currently due bills like bills for computer parts, wages, electric and so on. MPAC only has $6 million in current bills.

Inside this issue:

Stock Compare

CSPI also has a large $7 million pension liability that MPAC does not have. When you add all of the assets together and subtract all of what the companies owe, you are left with the owners interest in the business, shareholder's equity. The two companies are nearly identical at $25 and $27 million. Boiled down it can be summed up this way, CSPI has their assets tied up in cash and investments and MPAC has theirs in expensive equipment that will get old and become worthless. Advantage CSPI.

We find a large pile of cash and very little need for capital assets much more desirable than a capital asset intensive business with little cash and net losses. Wall Street is indifferent, assigning them equal value.

On to the income statement. MPAC has revenues over the nine months ending September 30, 2007 of $35 million compared to $34 million over the same period in the prior year. CSPI had revenues of $66 million and $51 million over the same periods. Subtracting out the cost of the products each company sells leaves both companies with gross profits which can be used to compute gross profit margins. For the same 9 month period in 2007 as above, MPAC had a gross profit margin of 8.3% and for the 9 months in 2006 their gross margin was 8.5%. CSPI had gross margins of 23.6% for the first 9 months of 2007 and 21.8% in the first 9 months of 2006. When you are making 8.3 cents on every dollar gross profit it does not leave much left after selling general and administrative expenses for a net profit. CSPI has much more wiggle room with fatter gross margins. When all expenses are subtracted and we get down to the bottom line or net income, the real differences show through. MPAC lost $3 million dollars in the first 9 months of 2007 and $2.9 million in the first 9 months of 2006. CSPI was profitable in both years. The first 9 months of 2007 they made $2.1 million and for 2006 they made $0.4 million. Without the large Raytheon contract, in 2006, they were mildly profitable. MPAC has lost large amounts of money over each of the past 2 years and is not showing any signs of regaining profitability. CSPI has a very scalable business and can easily reduce expenses to adjust to changing business conditions and remain barely profitable or limit losses. MPAC is constrained with the expense of costly equipment that will be a drag on earnings for years to come and can't easily be scaled back after the equipment is bought. CSPI often receives orders in large chunks which can make revenues and earnings lumpy based on the whims of a few customers. MPAC relies on a large number of small customers and needs the markets for their customers products to be strong to see sales rise. Losing a single order is insignificant. Advantage CSPI.

When it is all said and done CSPI is the clear winner in our opinion. They have a scalable business that should allow them to remain barely profitable or better while they wait for one or more sizable orders. They have a ton of cash which allows them tons of flexibility. They can buy back shares, institute a dividend, pay a large one time dividend, acquire another company and still have plenty left to tide them over in any rough patch. MPAC needs to see an increase in sales in the next year or they are going to risk being forced into bankruptcy. There is no indication that they will be able to regain profitability any time in the near future.

Supposedly markets are rational. Theoretically, participants will allocate capital to the investments that will offer the largest return. In the markets these two companies are judged as equals. This comparison is just another example of the current finance theory failing to explain reality. Many investors will complain that our comparison is faulty because we aren't comparing companies in the same industry. That would be fine if we were limiting our investment to a particular industry. The only limits we have are defined by the extension of our understanding and bordered by our ignorance. Both of these companies we understand; only one of them makes any sense investing in.

Watch List

Modern finance theory is predicated on the fact that changes in security pricing is linear in nature. The prices should line up nicely under a bell curve and risk calculations based on the same are supposed to allow you to categorize a stocks risk based on the shape of the curve. All of this breaks down in real markets because the prices never agreed to follow along with the academic's assumptions. In reality what you end up with is many more wild price changes than models predict you should see.

In the book The (Mis)Behavior of Markets by Benoit Mandelbrot, he discusses this issue by analyzing the Dow Jones Industrial Average. From 1916 to 2003 the Dow Average should have had 58 days where the price had moved over 3.4% in one direction or the other, in fact there were more than 1,000 such days. What should be a rare occurrence is actually quite frequent. A 7% change in the price should occur every 300,000 years instead of on 48 occasions over this time frame. Either the past century of price movements have been so rare an occurrence that they will never be repeated for thousands of years or the underpinnings of modern finance are built upon assumptions that are so far from actual experience as to render the whole of it useless. If you have been with us for years I am confident you will realize that we choose the latter.

Modern finance serves as the topic of study for more than one investment advisory professional designation. With so much effort having been expended into developing this line of thinking, many find it too painful to just abandon it.

The book we mentioned is very entertaining and written by a certifiable genius. You don't have to understand all of what the author is writing about to pick up the main points. Mandelbrot is trained as a mathematician and the father of the area of mathematics called fractals, which interpreted is the study of the jagged. Where linear mathematics organizes numbers that are orderly and neat and tidy, fractals helps interpret numbers that have no apparent pattern. It helps explain how much wildness there is so to speak. Sort of like what you see in the stock market.. The book should be required reading in college finance courses. Right now academia has too much invested in failed ideas for this to happen.

Company	December price	November price	Change from November	P/E	52 Week High	52 Week Low	Estimated '07 EPS	Dividend Yield
Alico/ALCO	$36.50	$44.39	-17.77%	n/a	$65.00	$35.00	n/a	2.90%
Alliant Techsystems Inc./ATK	$113.76	$116.83	-2.63%	17.9	$120.90	$77.78	$6.34	n/a
Altria Group, Inc./MO	$75.58	$77.56	-2.55%	17.3	$90.50	$63.13	$4.37	3.90%
Arch Coal/ACI	$44.93	$37.86	18.67%	39.8	$42.59	$27.18	$1.13	0.60%
Bioanalytical Systems, Inc./BASI	$8.67	$8.64	0.35%	n/a	$9.39	$5.25	n/a	n/a
Canadian Natural Res./CNQ	$73.14	$65.47	11.72%	17.6	$87.17	$44.56	$4.15	0.50%
Culp/CFI	$6.96	$8.32	-16.35%	12.9	$12.30	$5.07	$0.54	n/a
Graham Corp./GHM	$52.40	$70.00	-25.14%	18.7	$76.20	$12.67	$2.08	0.20%
Kensey Nash/KNSY	$29.92	$26.96	10.98%	33.2	$33.00	$22.26	$0.90	n/a
Landauer, Inc./LDR	$51.85	$50.21	3.27%	21.1	$54.46	$45.50	$2.46	3.90%
Markel/MKL	$491.10	$482.15	1.86%	13.9	$554.95	$454.83	$35.24	0.40%
ModPac/MPAC	$7.49	$8.20	-8.66%	n/a	$11.90	$6.60	n/a	n/a
QLT Inc./QLTI	$4.42	$4.94	-10.53%	31.6	$9.92	$3.51	$0.14	n/a
Servotronics Inc./SVT	$14.50	$12.40	16.94%	21.2	$17.00	$8.20	n/a	n/a
Specialized Health Products/SHPI	$0.87	$0.85	2.35%	31.1	$0.99	$0.66	n/a	n/a
Tejon Ranch Co./TRC	$40.85	$38.65	5.69%	n/a	$56.95	$35.80	n/a	n/a
Torm/TRMD	$35.24	$38.40	-8.23%	3.3	$47.10	$30.79	$2.30	14.70%
Universal Forest Products/UFPI	$29.46	$28.61	2.97%	17.0	$54.61	$27.93	$1.73	0.40%

The Investletter Portfolio continued on page 6

The chart below reflects some small adjustments to our portfolio. It reflects some cash inflows and outflows that have altered our percentages to a small degree. The weightings of our investments is not an exact science nor should it be interpreted that way. We tend to weight our portfolio towards investments we feel are undervalued to a large extent and with less risk. There are investments weighted with a lower percentage of our portfolio we feel are to a large extent undervalued, but riskier. Transmeridian Exploration(TMY) is an example of a company undervalued to a large extent with a fair amount of risk.. A large predictable company like Rayonier will tend to get a larger allocation of our investment dollars. They remain undervalued, but aren't particularly risky. QEP is riskier but undervalued to such a large degree that it makes it easy to accumulate shares with little risk.

Currently we have three companies that could be classified as workouts. Gencor, Protein Design Labs (PDLI) and TMY. Gencor is sharply undervalued due to the large cash balance they have accumulated as a result of Internal Revenue Code section 45 tax credits that their partnership interests have taken advantage of. We aren't enthralled with the business, but the large amount of cash and investments is irresistible. If the share price were to jump up close to what we perceive the value of the business to be, we would have no hesitation exiting our position. The company recently starting to trade on the NASDAQ national market may help us get the boost in share price we are looking for. PDLI is in the process of auctioning themselves off. This process has dragged on longer than anticipated. At some point we hope to see our position disappear due to acquisition or multiple asset sales. TMY is also in the process of being acquired. The market remains skeptical this deal will be completed. It is nothing we haven't seen before. Two other Kazakhstan based oil companies we have owned in the past have been acquired under similar circumstances. In each instance the sale price was something higher than the market price after the deal was announced. Never has the sale price been more than 100% higher than the market price after the deal was announced. If the deal falls apart, we may take a small hit. If the deal is completed we make out like bandits. A chance of a small loss a strong chance of outsized gains; we will take our chances. It does explain our relatively small weighting in TMY.

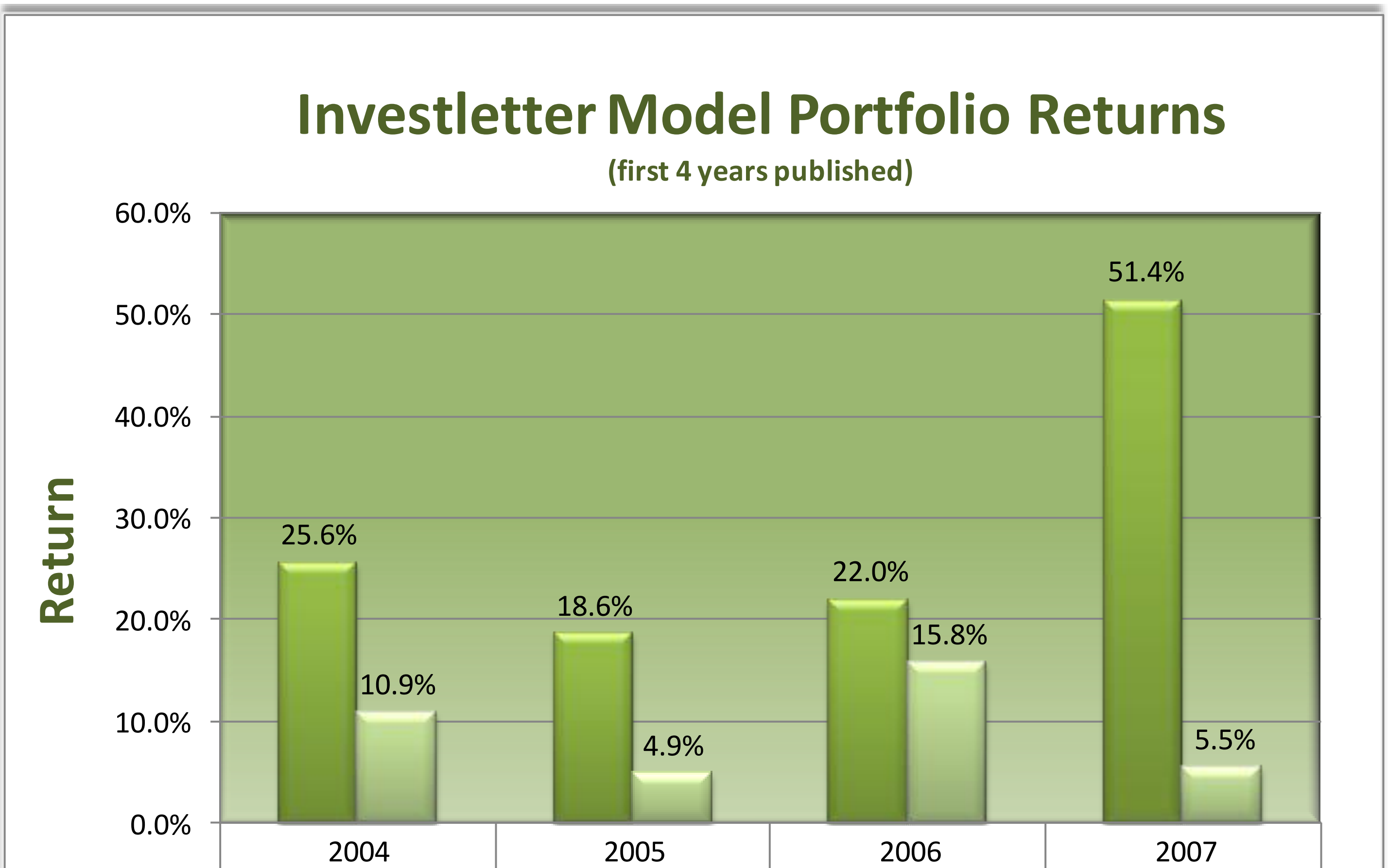
While the allocation of our assets is not scientific, due to the fact that there is no science to base it on, it is not done by chance either. It also played a major part in our success in 2007. continued on page 6

Company	Porfolio Percentage	December price	November Price	Percentage Change	Buy Price (less than)	P/E	Dividend Yield
American International/AMIN	4.80%	$4.78	$5.20	-8.08%	$4.95	n/a	n/a
Amtech Systems/ASYS	4.90%	$12.99	$17.44	-25.52%	$11.15	29.5	n/a
Astronics Corporation/ATRO	16.00%	$42.50	$44.50	-4.49%	$35.00	25.6	n/a
Atrion/ATRI	7.30%	$125.00	$124.24	0.61%	$93.00	17.8	0.80%
Berkshire Hathaway B/BRK.B	6.90%	$4,736.00	$4,414.00	7.29%	$3,800.00	15.8	n/a
Cash	2.60%	$1.00	$1.00	n/a	n/a	n/a	n/a
Chesapeake/CHK	5.70%	$39.20	$39.48	-0.71%	$33.00	12.4	0.70%
CSP Inc./CSPI	1.90%	$6.69	$6.60	1.36%	$7.00	6.5	n/a
Gencor/GNCI	9.80%	$10.25	$9.35	9.63%	$9.70	5.4	n/a
Griffin Land & Nurseries/GRIF	4.20%	$36.50	$37.00	-1.35%	$36.00	32.5	n/a
Headwaters/HW	0.70%	$11.74	$14.35	-18.19%	$14.00	10.0	n/a
St. Joe/JOE	5.20%	$35.51	$34.34	3.41%	$30.00	43.6	n/a
K-Tron International/KTII	9.40%	$119.25	$106.01	12.49%	$90.00	17.4	n/a
Protein Design Labs/PDLI	0.50%	$17.52	$21.20	-17.36%	$21.00	n/a	n/a
QEP Corporation/QEPC	10.30%	$10.31	$10.67	-3.37%	$12.00	12.9	n/a
Rayonier/RYN	8.20%	$47.24	$48.29	-2.17%	$41.00	20.5	4.20%
Transmeridian Exploration/TMY	1.60%	$1.97	$1.40	40.71%	$1.45	28.1	n/a

Year to Date

It is now eight straight years that our investment strategy has outperformed the S&P 500 market average. This past year we exceeded the S&P average by 45.9 percentage points, our largest margin ever. In 2007 we finished with a return of 51.4%, solidly outperforming the S&P 500 market average's 5.5% return. Our smallest margin of outperformance over the past 4 years was the 6.2 percentage points in 2006. Our cumulative return over the four years we have published the newsletter is 175.1% far outdistancing the S&P 500's 42.1% return. A $10,000 investment in the Investletter Model Portfolio would have turned into $27,500 while the same investment in the S&P 500 would have become $14,200 over the same time frame.

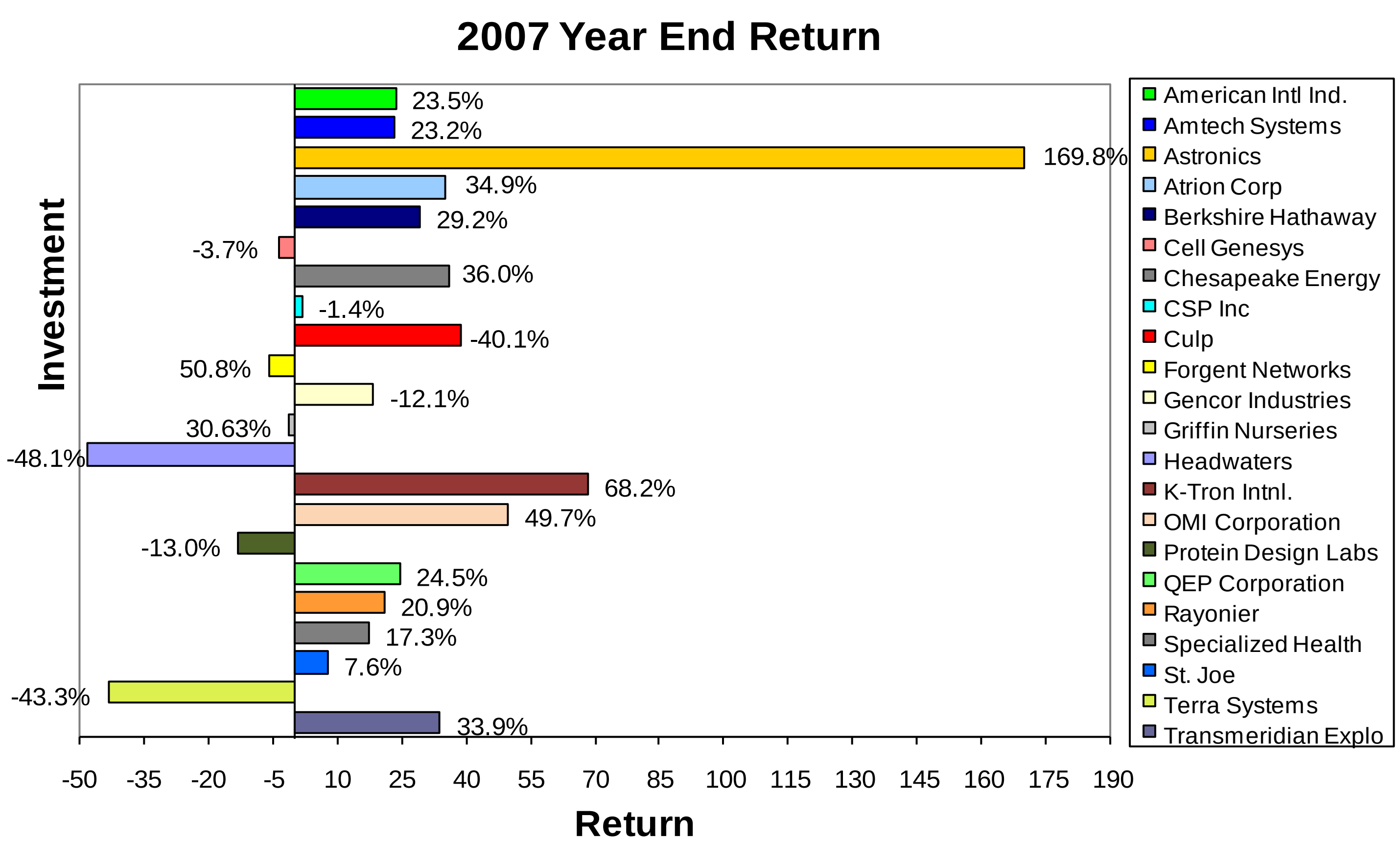
The extra assets that our strategy has produced can now be re-invested to generate even more gains. Nothing better highlights this than the compounding spreadsheet on our website. If you were to start the year with $27,500 and earn 15% returns for 25 years you would break the $1 million mark in 25 years. If you start the year with $14,200 you would have a bit more than $500,000 after the same 25 years. An early head start gives you a huge jump on crossing the finish line early. This example is greatly simplified and makes the assumption that the returns will be equal over time, but you get the idea. If you haven't already, download the spreadsheet from our website and make the changes that suit your particular situation; change the return assumptions and see what you get.



	2004	2005	2006	2007
Investletter	25.6%	18.6%	22.0%	51.4%
S&P 500	10.9%	4.9%	15.8%	5.5%

Performance continued from page 4

Several major events highlighted our 2007 results. We saw the sale of our largest holding, OMI Corporation, occur because of them being purchased by two other tanker companies. We managed to put all of the sale proceeds and then some to work, ending the year with less than 5% of our portfolio in cash. The year's most important event was the triple digit gains that Astronics contributed to our portfolio. At the beginning of 2005 Astronics was trading at $4.92. At the end of 2007 their shares were trading at $42.50. All along we expected ATRO to be a solid performer due to their excellent management team, the niche market they serve and the pent up demand in the aerospace capital expenditure cycle. We never expected a more than 800% return over the span of three years. Fortunately that is the way investing goes. Some of your picks will do better than you expect them to. Others will sorely disappoint. The worst your disappointments can do is drop 100%. Using Astronics as an example it is easy to see that your winners can easily produce gains well in excess of 100%. If at the beginning of 2005 we had made equal dollar investments in four companies with one company being Astronics and managing to select three other businesses that all went bankrupt with their share price falling to zero, we still would have an investment return over the three years of more than 100%. A big winner can erase a lot of mistakes.



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