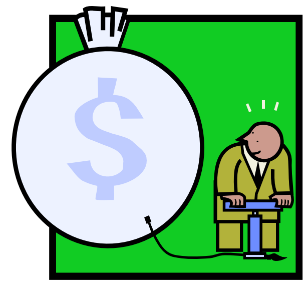
The Commonsense

INVESTLETTER

Volume 4 Number 1

I Would Gladly Pay You Tomorrow...

...for a hamburger today. This deal will probably not cost you much money from the standpoint of inflation's effect on your money. However, carry this out for a year or more and it will start to impact your finances. Inflation describes the buying power your money loses over time. The federal government determines the price of a basket of goods and then measures the price of the same basket of goods a year later to determine the yearly inflation rate. We are going to ignore the difference between the core rate and the producer price index, how often the basket of goods changes and how representative the basket really is and focus on how inflation affects our investment portfolio. We could get tangled up in all kinds of fringe arguments, which are very worthy topics of discussion, but will take up way too much space for the point we are trying to drive home.



Inflations insidious effects are often subtle.

You may hear somebody say the inflation rate is 4%. This means that a basket of goods representing the cost of goods people need to survive has risen 4% over the past year. So if you had to spend $100 dollars today, you would need to spend $104 dollars to buy the same basket next year. If you were given a $100 dollar bill and tucked it under your mattress for a year, you would be $4 short when trying to buy the same amount of goods next year. Items like a computer, gasoline, a gallon of milk, dry cleaning, and other items you use could make up your particular basket. Depending on what combination of goods you use, your personal inflation rate could be higher than the official basket that is used by the government. An example would be a person who commutes 75 miles each way to work. This person would obviously be more impacted by a rise in gasoline prices when compared with someone who can walk to work and does not own a car.

Your investment portfolio also takes a hit from inflation. The relationship is not as clear cut as with your monthly budget, but is more subtle. Many of you are using your investment portfolio as a part of your retirement planning. You will need a certain amount of money to live on and goods will cost some undetermined price when you retire. Obviously the lower the inflation rate, the lower goods will cost in the future. This is a direct impact of inflation on your finances. The other part of the equation is how much in assets you can accumulate.

Your investment returns in part operate outside inflation's influence and to an extent are effected by them. In the long term the value of any investment is determined by how much cash that investment can spin off to investors. If you gave the $100 bill we mentioned earlier to a friend and he told you he would give it back in one year with 10% interest, you would have $110 in one year. Once you take inflation into account you would only be up $6 ($110 - $104). If inflation was only 2% you would be up $8. The next part is where inflation has a more indirect impact on your finances.

Wall Street

- DJ 10865
- S&P 500 1280
- NASDAQ 2306

Inside this issue:

I Would Gladly...

Now we need to consider what other affects inflation has on our investments. Interest rates have been rising over the past year. Many companies have debt that is effected by interest rate changes. This will lead to higher interest expenses and lead to lower profits. A company's suppliers will try to pass on any higher costs they may face by increasing prices. This leads to higher expenses and lower profits. A company that faces these increased expenses will try to pass on these higher costs to their customers. In the end consumers like us face higher prices for items like tires, gasoline and assorted other goods. When inflation rates are rising and interest rates are rising, companies often have difficulty passing along the whole amount of these rising costs to their customers. (This obviously depends on how much pricing power a company has and is a generalization from what has occurred in the past.) Companies end up reporting lower profits. Lower profits lead to lower or a slower rate of increase in share prices. Your portfolio grows slower and you end up with fewer assets in retirement. At the same time, the goods you need to buy are more expensive. The company that was growing at 10% when inflation was at 1% may now only grow at 8% when inflation is at 4%. This changes a 9% advantage over inflation when inflation is low, to a 4% advantage when inflation is higher. Our numbers are hypothetical, but dramatize the results from the past. For our purposes, high inflation is bad and low inflation is good.

The aggressive moves by the Federal Reserve Board in raising interest rates is designed to keep inflation low. So far, the results have been marginally successful. This in part explains the expectation of more rate increases.

Inflation's impact hits us both directly and indirectly. In each instance the effects aren't very desirable.

Earlier we said that in the long run a company is only worth the cash it can throw off to its investors. In a follow up to this article next month we will talk about how we use a companies expected future earnings to determine what a company is worth today. It is not directly tied to inflation, but, some of the concepts are similar regarding how you calculate the present value of cash at some point in the future.

Still Naked

This is just a quick update to our article on naked short selling. Two states have made inquiries to the organization (DTCC) charged with clearing trades. Utah and Connecticut have both had their initial attempts rebuffed. In New Jersey, the State Senate has been asking probing questions to a former Board Member of the DTCC who has his sights set on becoming the states next treasurer. The SEC (Securities and Exchange Commission), the organization that oversees the stock markets has issued subpoenas to news reporters in connection with a lawsuit over naked short selling.

This topic is gaining momentum and has a good chance of gaining national attention over the summer or in the fall as we move closer to Congressional elections. We are eagerly waiting to see how this issue plays out and could even benefit if it gives a nice boost to the share price of companies whose prices are being artificially suppressed. We also will enjoy seeing some of the thugs who are profiting at the expense of Joe and Jane Average investor, being forced to divest profits from market manipulation. Watching them make the perp walk and do jail time will also be reassuring. Markets need to be fair to function properly.

Watch List

Out with the old and in with the new. We have done some shuffling of the stocks that we have our eye on. We have removed several companies that we have been following for years. A few because their price never seems to drop down to a price we are comfortable purchasing them at and a couple more because we just are not thrilled with the business. Gone are USG, The Washington Post, Paychex, Sanderson Farms, Allergan and Hurco. USG is a great company but the price has completely gotten away from us. The same can be said of Allergan and Hurco. We will still monitor their performance but don't anticipate getting a chance to purchase them anytime soon. The Washington Post is no longer as desirable a business as it was even 5 years ago thanks to the internet.

We have added a couple of replacements. Canadian Natural Resources has tons of oil sands in Western Canada. Bitumen, as its know, can not be extracted profitably unless oil is priced around $40 per barrel or higher. The amount of oil sands in this region of Canada surpasses the oil in Saudi Arabia. The quality is not as good as light sweet crude so there are many companies including our Headwaters that are working on what is called heavy oil upgrading. This process produces more of the valuable products from the refining process and therefore yields more value for the refiners. This along with the high price of oil are what is spurring the start up of production in these fields. The fields are so valuable that squabbling over the profits are already beginning in Canada between the Provinces.

Another company we have added is XTO a very successful natural gas producer. The other new company is Novastar financial. This company is organized as a real estate investment trust (REIT). They operate in the sub prime lending market which makes them a riskier bet. The significance of a REIT is that they are required to pay out 85% of their earnings as dividends. In return they receive favorable tax treatment. They are currently paying a 21% dividend. The risk is that if interest rates keep rising it may put pressure on their customers causing more defaults. They have some innovative programs to deal with defaults. One example is that the company provides job search assistance to customers who lose their jobs. They spend less money helping people find new jobs than they lose when a customer can no longer make their mortgage payments. Currently we are awaiting the results of controversial tax ruling they are awaiting on from their legal counsel. This is a bit disturbing because it means they have a disagreement with their auditors. Rumor has it that it may have something to do with their status as a REIT. Losing their REIT status would be disappointing and definitely result in lower income.

Company	January price	December price	Change from December	P/E	52 Week High	52 Week Low	Estimated '06 EPS	Dividend Yield
Altria Group, Inc./MO	$72.34	$74.72	-3.19%	14.6	$78.68	$62.70	$5.11	4.18%
Bioanalytical Systems, Inc./BASI	$6.08	$5.62	8.19%	n/a	$10.37	$4.75	n/a	n/a
Canadian Natural Res./CNQ	$62.00	$49.62	24.95%	64.3	$64.38	$24.48	3.08	0.40%
Fresh Del Monte Produce/FDP	$22.99	$22.77	0.97%	10.3	$32.20	$21.40	$1.94	3.52%
The St. Joe Co./JOE	$63.45	$67.22	-5.61%	37.4	$85.25	$58.31	$1.84	0.96%
Kensey Nash/KNSY	$24.41	$22.03	10.80%	52.4	$34.00	$19.32	$0.65	n/a
Landauer, Inc./LDR	$46.76	$46.09	1.45%	25.3	$54.00	$43.90	$2.13	3.70%
ModPac/MPAC	$12.05	$11.24	7.21%	n/a	$18.60	$10.02	n/a	n/a
Novastar Financial/NFI	$31.49	$28.11	12.02%	5.9	$42.55	$24.08	$4.52	21.01%
QLT Inc./QLTI	$6.02	$6.36	-5.35%	n/a	$15.53	$5.93	$0.64	n/a
Rayonier/RYN	$42.75	$39.85	7.28%	18.2	$43.35	$30.67	$1.72	4.03%
Tejon Ranch Co./TRC	$42.42	$39.92	6.26%	n/a	$62.72	$39.15	n/a	n/a
XTO Energy	$49.08	$43.94	11.70%	13.5	$50.01	$26.00	$3.15	0.70%

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 currently priced. This can be compared to what the company is currently selling for and be used in making short term purchasing decisions.

We have begun the year with what seems like our annual January swoon. We again have fallen behind the S&P 500 average that we use as our benchmark. Maybe we are projecting our current results too far into the past (and are definitely too lazy to verify such triviality), but we are pretty sure this is at least the third or fourth year in a row that we have started off in the hole in January. We are not implying that we will pull ahead as we have in past years because we have no idea what lies ahead. We also have spent some time thinking about what makes yearly results so important anyways. Maybe we should report results every 3 year or every 5 years. Why not every 30 months? The choice of a year is arbitrary anyways. If you are planning on cashing out in a year then you might be interested in the yearly performance. If you plan on keeping your money invested for 5 years, 10 years or even longer then isn't your results over that time frame much more important than what we did last year or what our performance is this year?

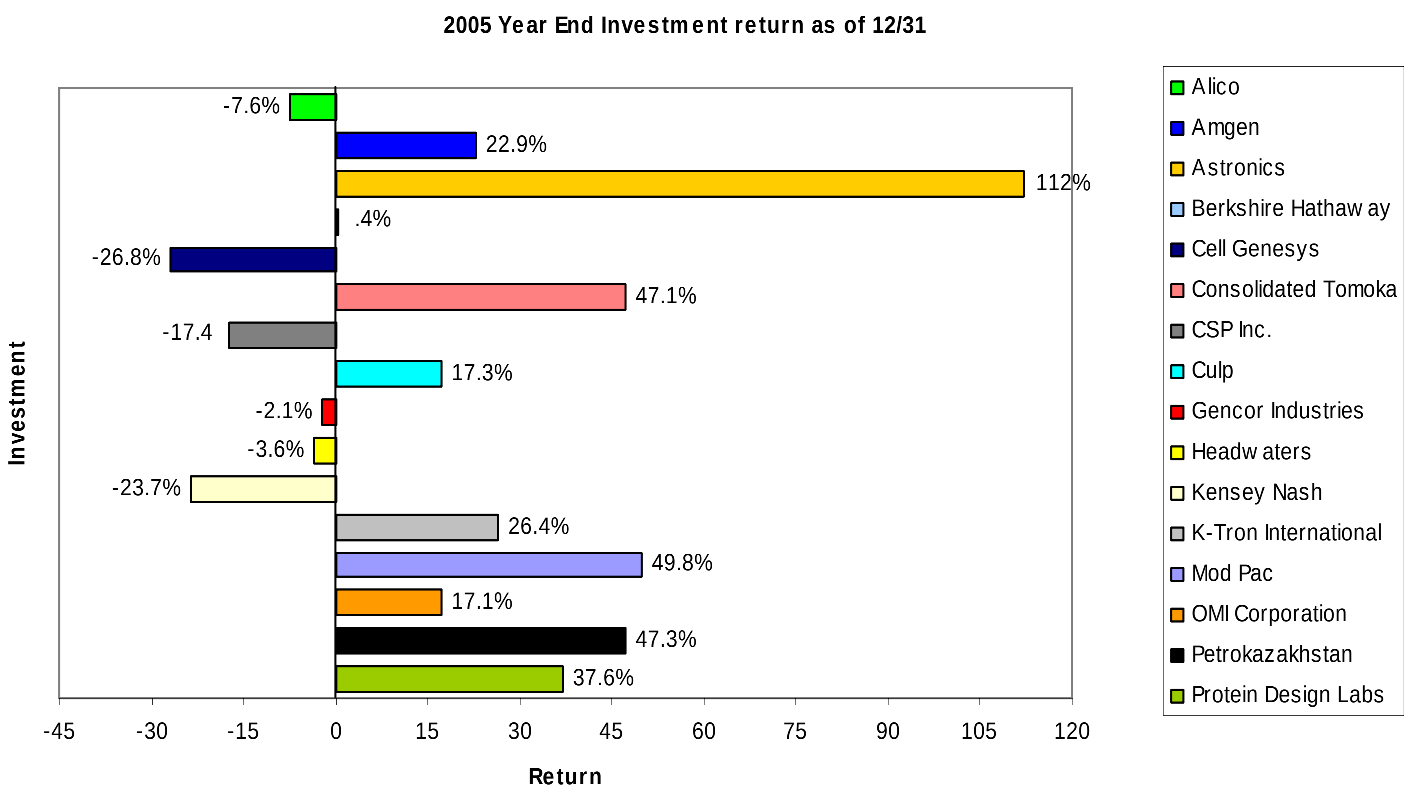
There will come a time when we don't beat the S&P 500 average over the course of a years time. When, who knows? The likelihood is that it will happen. It will not be great for the person who plans to liquidate all of his/her investments that year, but it is still highly likely to happen. This is not meant to lay down a trail of excuses before it happens either. Our goal is just to lay out realistic expectations and explain how it fits into the big picture. Our goal is still to outperform the S&P average over time. Over a long time. As we have stated before our approach is not for everyone.

In January we dug ourselves a nice hole. At one point during the month we were down five percentage points to the S&P average. By the end of the month we were three percentage points behind the S&P 500 average. Call out the cavalry, we have been gaining on the S&P in the early part of February. Our biggest accomplishment in January was redeploying some of our bulging cash account. With recommendations to purchase ASFI, TSYI and add more GNCI, and HW we at least accomplished something useful.

Company	Porfolio Percentage	January price	December Price	Percentage Change	Buy Price (less than)	P/E	Dividend Yield
Alico/ALCO	15.10%	$44.60	$45.19	-1.31%	$50.00	52.2	2.21%
Amgen/AMGN	4.50%	$72.89	$78.86	-7.57%	$60.00	26.2	n/a
Asta Funding/ASFI	4.80%	$30.67	$27.34	12.18%	n/a	14.3	n/a
Astronics Corporation/ATRO	8.50%	$10.94	$10.75	1.77%	$9.90	n/a	n/a
Berkshire Hathaway B/BRK.B	18.20%	$2,932.00	$2,935.00	-0.10%	$3,050.00	20.5	n/a
Cash	14.50%	$1.00	$1.00	n/a	n/a	n/a	n/a
Cell Genesys, Inc./CEGE	2.80%	$6.26	$5.93	5.56%	$9.00	n/a	n/a
Culp/CFI	2.90%	$4.61	$4.79	-3.76%	$4.15	n/a	n/a
Gencor/GNCI	6.10%	$8.85	$8.25	7.27%	$7.20	3.3	n/a
Headwaters/HW	4.30%	$34.50	$35.44	-2.65%	$33.00	11.4	n/a
K-Tron International/KTII	3.40%	$36.80	$37.10	-0.81%	$33.00	12.7	n/a
OMI Corporation/OMM	13.10%	$17.56	$18.15	-3.25%	$18.00	5.5	1.74%
Protein Design Labs/PDLI	1.80%	$29.15	$28.42	2.57%	$18.75	n/a	n/a

Performance

Looking back is a helluva lot of fun. It does not help us much going forward, but it sure provides a nice chance to beat our chests. Last years star performer was Astronics with a whopping 112% gain. Six of our holdings dropped in value and 10 increased in value. This highlights the fact that you don't have to be right with every selection you make. You just need to make a few good picks to do well. Again we will hammer on a point we have made before, nobody can make a bunch of stock selections without making a few mistakes. We only hold 11 of the stocks below in our current portfolio. Some have been extremely disappointing like Cell Genesys and CSP Inc. Hopefully we can show a chart that looks something like this next year. If we could only pick which one would be the 80% or 100% gainer at the beginning of the year.



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