The Commonsense

INVESTLETTER

Volume 5 Number 1

Wall Street

- DJ 12622
- S&P 500 1438
- NASDAQ 2464

The Year Ahead

Aiming to keep our lead over the S&P 500 average.

This year is sure to be interesting for several of our large positions. Our two largest holdings, Astronics (ATRO) and OMI are both positioned for excellent years. Astronics has recently created some waves by delaying their fourth quarter earnings report. This is an event which in our opinion is insignificant.

The delay is predicated on how to account for $3mm in revenue. On the surface this appears to be a rather simple item. In reality it is rather complex. Revenue recognition is a recurring theme in disagreements between auditors and the companies they audit and is one of the top reasons companies cite for making restatements. As in many areas of accounting including revenue recognition, the guidance is very straight forward, but the application to individual situations can be very complex. The accounting rules can not take into account every situation. Management may interpret a fact pattern different than their auditor. To fully develop the facts the auditor may need to contact the customer or other third parties resulting in additional time being required.

Astronics is not the largest company and accounting firms have many clients. Add to this the fact that the timeframe to complete audits has been tightened by the SEC and persistent staff shortages make this a difficult season for the accounting firms. The audit team comes in with a plan and tries to complete their audit as promptly as possible. The financial statements often are not finalized until hours before an earnings release. This leaves little time to sort out an unexpected turn of events. Inevitably problems discovered on an audit often force the delay of an earnings release and associated conference call.

Another factor that creates delays is the requirements of the Sarbanes Oxley Act. The CEO and CFO are required to sign off on the accuracy of the financial statements. Here is a text from section 404 of the Sarbanes Oxley Act:

> *Section 906 of the Sarbanes-Oxley Act added new Section 1350 to Title 18 of the United States Code,[29] which contains a certification requirement subject to specific federal criminal provisions and that is separate and distinct from the certification requirement mandated by Section 302.*

This states that the CFO and CEO attest that the financial statements do not contain any untrue statement of a material fact or omit to state a material fact at the risk of criminal penalty. Executives are much more cautious now that they have to sign off on financial statements and internal controls. Few CEO's are willing to risk prison time to rush possible error filled financial statements to the newswires. Much more frequently than in the past, earnings releases are delayed

Inside this issue:

New Year Prognosticators

until relative certainty surrounding any questionable accounting treatment can be obtained.

Many investors in ATRO have been spooked by the delay and this has led to a 20% drop in the share price. The $3 million in revenue that this hang-up hinges on is certain. Whether it falls in the fourth quarter of 2006 or the first quarter of 2007 remains to be determined. Our position is we don't care when it is recognized, as long as it is and that fact is certain. So we wait for this situation to be resolved and become a distant memory. It does not change any of our thinking on Astronics.

Wall Street makes you an offer each day as to whether you are willing to pay the going rate for a company's shares. You have the choice to accept or wait for a better offer. Because the price does not necessarily match the value, you are best waiting until the value you get is worth more than the price you have to offer.

OMI recently reported their earnings and what a wonderful year they had. The shares rose 20% last year and still remain brutally undervalued. The company is currently valued at $1.4 billion. Last year between operation and ship sales the company brought in $670 million in cash. That large a percentage of cash to market value is unmatched as far as we are aware of. They generated cash representing nearly 50% of the company's worth in one single year. In 2007 the company will generate something close to $350 millions more assuming no more ships are sold.

The popular investment community continues to "miss the boat", so to speak, on OMI's ability to generate huge cash flows. The company ended the year with $180mm in cash and short term investments. Cash is accumulating so quickly that the company can't get rid of it fast enough. It is probable that the company will buy back another 5 million shares this quarter, pay down some more debt and still see the cash account climb. It is not out of the question to see the company buy back another 10 million shares this year. At some point investors will notice this proportionally huge buyback. By the end of 2007 the company could have close to 50% less shares than just three years ago. Each owner will proportionally own twice as much of the company. Which also means each share stakes a larger claim of earnings. The end result being that each share is that much more valuable.

It also makes it much easier to raise the dividend. With fewer shares to pay dividends on, the company can increase the dividend rate without sending any more cash out the door. This is exactly what management has been doing. The dividend has risen 200% in the past three years from $.05 per quarter to $.15 per quarter. An increase of this magnitude could easily occur over the next three years.

A great number of new ships are coming online over the next three years. This will continue to put pressure on rates over this timeframe. In 2010, stricter regulations come into effect that will force older ships to be removed from service. Rates are expected to be strong in the period immediately leading up to 2010. OMI also has two new clean tankers on order to be delivered in 2009. Management is already positioning themselves for the next upswing in rates.

We as shareholders stand to benefit greatly over the next several years. I have no idea when this superior management team and fabulous operating results will be factored into the share price. I do know that the company is already trading a bit below liquidation value. That does not leave much room for the share to drop any lower. We will continue to sit on our hands and wait. It is an easy decision.

Watch List

One company we have previously investigated Novastar Financial (NFI) has recently been caught up in the sub prime lending implosion. With interest rates rising and home values falling in many areas of the country, buyers who bought homes with the hopes of servicing their loans with equity gains are defaulting on their mortgages at an increasingly rapid rate. The lenders who originate and service these loans have seen their share prices mauled.

Originally we shied away from Novastar because we had difficulty understanding their accounting (we only wish we could use this excuse to explain away Cell Genesys). Their accounting has not become any easier nor our understanding of it any better, but the shares have become a great deal cheaper. So much so that we are going to take a look and see if we can gain a better grasp the second time around. They generously use derivatives and these are not easy arrangements to understand. The likely result is that we will probably pass the second time around as we did the first. In the past we have stated that there is no reward for difficulty in investing. The simple to understand company is equally likely to perform as well as a difficult to understand company. With the simple companies we stand a much better chance of being able to identify which one will perform well. The difficult to understand companies lower our odds so it becomes nothing more than a game of chance. If you were interested in casino results I am sure you know where to find the one nearest you.

So we will continue to stick to the companies who present hurdles we can easily step over as opposed to the ones we have to reach for hidden inner strength to try and barely leap over or worse yet stumble. Even some of the companies we understand well will not perform as we had initially supposed they would. It is always the case that unforeseen circumstances can change the fortune of a company in ways we could not predict no matter how hard we aim to cover all possible scenarios. It will be equally likely that some companies will perform far better than we could have foreseen going into our purchase. As long as we are not being rewarded for added difficulty we look to avoid it.

OMI, Astronics, K-Tron, and Culp are all examples of companies with extremely easy to understand accounting. That is a trait shared by many smaller companies including Alico, Graham, and Bioanalytical Systems below. Maybe it's a bit of the KISS principle; Keep It Simple Shareholder.

Company	January price	December price	Change from December	P/E	52 Week High	52 Week Low	Estimated '07 EPS	Dividend Yield
Alico/ALCO	$52.33	$50.63	3.36%	48.0	$62.92	$42.17	n/a	2.10%
Alliant Techsystems Inc./ATK	$81.00	$78.19	3.59%	15.9	$84.90	$72.37	$5.08	n/a
Altria Group, Inc./MO	$87.39	$85.82	1.83%	16.5	$90.50	$68.36	$5.31	3.90%
Arch Coal/ACI	$29.72	$30.03	-1.03%	17.9	$56.45	$25.85	$1.66	0.80%
Bioanalytical Systems, Inc./BASI	$5.38	$5.50	-2.18%	n/a	$7.80	$4.75	n/a	n/a
Canadian Natural Res./CNQ	$50.02	$53.23	-6.03%	18.6	$64.38	$40.29	$2.69	0.50%
Graham Corp./GHM	$14.21	$13.15	8.06%	16.8	$23.90	$12.55	n/a	0.70%
Kensey Nash/KNSY	$31.68	$31.80	-0.38%	482.8	$33.69	$22.45	$0.74	n/a
Landauer, Inc./LDR	$51.37	$52.47	-2.10%	21.7	$57.29	$43.11	$2.37	3.80%
Markel	$485.10	$480.10	1.04%	15.3	$505.89	$322.00	$31.81	n/a
ModPac/MPAC	$11.11	$11.00	1.00%	n/a	$12.50	$8.00	n/a	n/a
QLT Inc./QLTI	$9.38	$8.46	10.87%	29.3	$9.46	$5.93	$0.32	n/a
Servotronics Inc./SVT	$8.31	$8.30	0.12%	12.8	$10.30	$5.80	n/a	n/a
Tejon Ranch Co./TRC	$54.03	$55.84	-3.24%	n/a	$57.09	$37.55	n/a	n/a
Universal Forest Products/UFPI	$48.90	$46.62	4.89%	13.6	$80.28	$43.61	$3.60	0.20%

The Investletter Portfolio

The fate of our portfolio is tied to the fortunes of a few companies. If you look at the chart below, five stocks make up 60% of our portfolio. Add in our 26% cash position and that explains 86% of our portfolio. Our concentrated position is responsible in large part for our market beating performance. We try to concentrate our investments in the companies that we know very well and that have limited downside risks. Astronics, Berkshire, Chesapeake, OMI, and Rayonier all have strong businesses and four of them have hard assets that limit how far the share price can fall.

Berkshire has a large amount of cash and investments; Chesapeake announced a 20% increase in their natural gas reserves recently; OMI has a fleet of ships that are selling for record prices; Rayonier has trees and land that get more valuable over time. Astronics is the only exception, they do not have any hard assets that can buoy the price and they have the potential to be more volatile. Our attraction to Astronics has more to do with the fact that they are a relative unknown on Wall Street and we have a huge advantage understanding their business. They have contracts that have long development lead times, but have very predictable revenue. The developmental stage for many of their contracts' has ended and now they are headed into the ramp up phase where revenues will rapidly rise and cause earnings to surge along with the increased production. They are entering into what could easily be a six year capital expenditure cycle for the aerospace industry. The driver for what could be a longer than usual cycle is the pent up demand from the 9/11 tragedy. The ensuing financial difficulties and lower passenger counts caused the airlines to delay replacing outdated and worn out planes. This could only be delayed so long. The higher fuel prices are also acting as a driver. Many of the newer planes are much more fuel efficient.

The wildcard in the whole equation is the new very light jet (VLJ) market. These new low price jets are expected to revolutionize air travel. The sales volumes are projected to be huge. Astronics has content on most of these new planes. They will be recognized as a first line supplier to these businesses. To a company like Boeing they are a bit player among huge companies acting as suppliers. If the VLJ's takeoff (no pun intended) Astronics can expect to grow rapidly along with them. It has the potential to be a very exciting and rewarding next couple of years for this company.

The other companies in our portfolio are much riskier. As such we allocate much less capital to them. We have a couple of them that have the potential to hit homeruns for us but the net effect will be small on our portfolio. With a company like K-Tron, we wish we had a much larger investment in them, but have so far found it difficult to commit more capital at current prices.

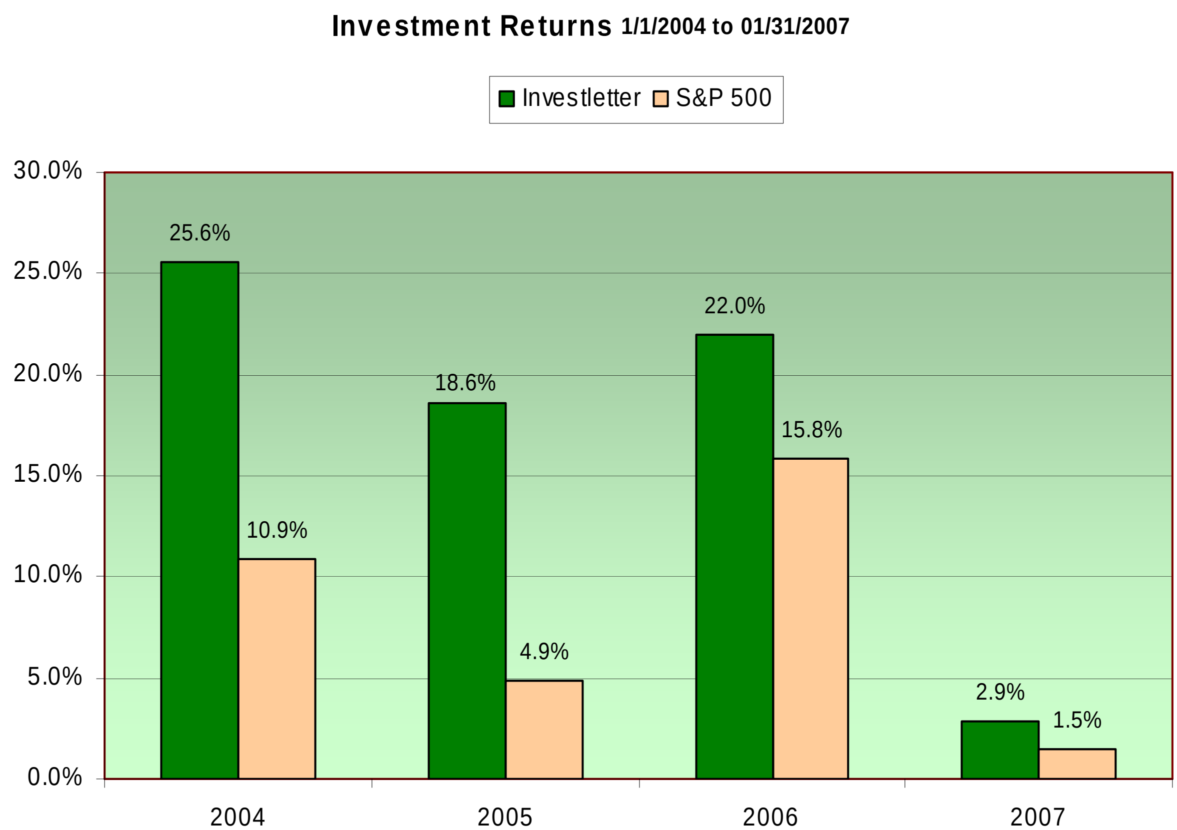
Oh, why do we have so much cash! There is my monthly rant about having too much cash. Fortunately we are very close to adding shares of Amtech Systems, a company we covered in last month's newsletter.

Company	Porfolio Percentage	January price	December Price	Percentage Change	Buy Price (less than)	P/E	Dividend Yield
Astronics Corporation/ATRO	16.50%	$18.50	$17.13	8.00%	$16.95	24.3	n/a
Berkshire Hathaway B/BRK.B	9.10%	$3,667.00	$3,666.00	0.03%	$3,100.00	4.5	n/a
Cash	26.30%	$1.00	$1.00	n/a	n/a	n/a	n/a
Chesapeake/CHK	7.30%	$29.61	$29.05	1.93%	$30.00	6.6	0.80%
Culp/CFI	3.20%	$6.45	$5.15	25.24%	$4.40	19.6	n/a
Headwaters/HW	2.20%	$22.72	$23.96	-5.18%	$22.00	10.4	n/a
K-Tron International/KTII	5.10%	$68.61	$74.67	-8.12%	$55.00	18.8	n/a
OMI Corporation/OMM	19.10%	$22.06	$21.17	4.20%	$20.75	4.3	2.60%
Protein Design Labs/PDLI	1.00%	$20.51	$20.14	1.84%	$21.00	n/a	n/a
Rayonier/RYN	8.50%	$43.20	$41.05	5.24%	$41.00	18.9	4.30%
Specialized Health Products/SHPI	1.40%	$0.78	$0.72	8.33%	$0.40	n/a	n/a
Terra Systems/TSYI	0.30%	$0.31	$0.40	-22.50%	$0.30	n/a	n/a

Performance

Our 2007 has started out with a bang. A strong performance by Rayonier and Astronics have helped propel our model portfolio to a early lead over the S&P 500 average. Our four largest holdings last year, Alico, Astronics, Berkshire Hathaway, and OMI, had returns of 37.4%, 57.6%, 22.6% and 20.0% respectively. That was the main thrust behind our 22% returns in 2006. In 2007 we will be looking for another strong year from Astronics, Berkshire Hathaway, OMI and newcomers Rayonier and Chesapeake. As long as these companies perform well our portfolio will do well. Large gains from some of our smaller holdings can give a needed boost, but their impact is limited.

K-Tron Industries was our largest gainer last year with a 122% return. Their performance this year will be much less spectacular. Next month in this space will have a graph that shows all of our investments and their 2006 performance. Even our bombs, like Cell Genesys with a 46.7% drop in value. Only 61% of our investments last year had positive returns. You don't have to get them all right to have good performance numbers. Our next task is to stay in front of the S&P 500 average and post our eighth straight year of market outperformance.



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