Volume 2 Number 7

July 2004

Blue Collar Investment Advisor

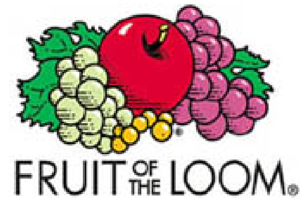
BCIA

Wall Street

- DJ 9962
- S&P 500 1086
- NASDAQ 1849

Berkshire Hathaway

You may wonder why we have a Fruit of the Loom logo on the front page of our newsletter. All subscribers who have purchased Berkshire Hathaway stock are owners of Fruit of the Loom along with more than 60 other companies. Here is a small sample: Tony Lama Boots, Dairy Queen, The Buffalo News, Geico, Quikut (maker of Ginsu Knives), World Book Encyclopedia, Kirby (vacuum cleaners), Halex (electrical connectors) and Benjamin Moore (paint). Their largest segment is insurance which makes up about 63% of their net income. They also derive income from their manufacturing companies and their finance division.



This is only one of Berkshire's many operating companies.

If you take a look at the companies that Berkshire owns you will see one common thread. Almost all of the companies provide a good or service that is consumed repeatedly. For example footwear is purchased over and over again. People will visit a dairy Queen multiple times. The Subscribers of the Buffalo News receive a paper everyday. Geico insurance customers need auto insurance as long as they drive a car. Business' like these generate a steady predictable revenue stream. That helps make them easy to value. You know people are going to need these products and consume them on a regular basis. Plenty of repeat business.

We have mentioned the CEO of Berkshire, Warren Buffett , before and will many times again. Buffett has been criticized in the past for not buying technology companies. He vows he will only stick to what he knows. He has stated that he personally does not understand tech companies. His way of explaining it goes something like this. "Why train hard to jump over 10 ft. hurdles when I can easily step over 1 ft. ones." He does not attempt to pick out companies he does not have the expertise to understand. He is complacent to invest in the ones that he understands much better than other investors.

We listed some of the operating companies, they are very important to Berkshires earnings. They happen to represent only about 36% of the value of the Company. The company is worth over $110 billion. What represents the other 64% of the companies worth? The answer would be the investments they hold. They own over $37 billion in stock and another $36 billion in bonds. This does not include the $31 billion in cash they presently hold. Totaling the stock and bond investments they have comes to over $73 billion. The operating companies generate over $5 billion dollars in earnings per year. These are really big numbers.

The insurance business is the most important of Berkshire's operating companies. They generate amounts of can that are used for investing. Insurance premiums are collected before the service is

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Berkshire Hathaway

provided. There is a lag time between the collection of the premiums and the expenses from claims being paid. The company has the use of this money virtually indefinitely. They will always be collecting premiums and always be paying claims some period of time after they collect the premiums. This money is called float. Berkshire happens to have a lot of it. They have $44 billion to be exact. Much of this float is tied up in the investments we mentioned earlier. They earn a great deal of money by using this float. All insurance companies have float. Berkshire does a better job of investing it.

Check out our new redesigned, more user friendly website. See us at www.ebcia.com.

Another interesting note is that Berkshire is considered one of only two or three insurance companies that are considered insurers of last resort. They will write policies that other insurance companies will not touch. Most often they will not touch them because they can not afford the risk of losing large sums of money. Berkshire can write these large risks and can afford the losses if they occur. Buffett makes sure they are well compensated for these type of policies. Last year the company wrote a policy for a Pepsi drawing that gave a finalist a chance to win a $1 billion prize. Fortunately for the shareholder sake the contestant did not win. They are also insuring the 2004 version of this Pepsi contest.

Company	Percentage of Company Owned	Market Value Value (in millions)
American Express Company	11.8	$7,312
The Coca Cola Company	8.2	$10,150
The Gillette Company	9.5	$3,526
H&R Block, Inc.	8.2	$809
HCA Inc.	3.1	$665
M&T Bank Corporation	5.6	$659
Moody's Corporation	16.1	$1,453
Petro China Limited	1.3	$1,340
The Washington Post Company	18.1	$1,367
Wells Fargo & Company	3.3	$3,324
Others		$4,682
Total Common Stocks		$35,287

Berkshire's stock portfolio is made up of some of America's best known companies. Usually Berkshire is the largest shareholder in the company. Here is a listing of the company's largest holdings.

How much does it cost to buy one of the A shares of stock? More than $88,000. Fortunately they have another class of stock, the B shares, that sell for more than $2900. The company appears to be a bargain at these prices. They are a cash generating machine. Over the years you would have done pretty well buying Berkshire Hathaway. In 1965, which was a really great year (marked by my birth), shares of Berkshire could have been had for somewhere near $18. (I wish someone would have had the foresight to buy me about ten.) What kind of returns do you need to grow $18 into $88,000? You need to average around 22% per year. That is probably the highest returns ever generated from investing over an extended period of time.

Berkshire Hathaway

Another common question asked is why is Berkshire's share price so high? Buffett does not believe in stock splits. From an accounting standpoint they are nothing more than gimmickry. Would you rather have one $100 share or one hundred $1 shares? It does not make any difference. Buffett just lets the price climb and has no use for using a gimmick to reduce his share price and boost his number of shares. Many other companies do not follow this line of reason. Many other companies also have not performed as well as Berkshire.

Berkshire for the longest time was the only company we were aware of that came with an owner's manual. Each year it is included in the annual report. It gives Buffett's philosophy on managing Berkshire. The manual contains 13 principles that cover everything from financial reporting to thoughts on the use of debt. As you might expect, Buffett espouses the use of debt in a sparing fashion. This owner's manual has shown up again recently in conjunction with Google's pending initial public offering (ipo) of stock. They issued an owner's manual styled after Berkshire's.

We consider Berkshire the anchor of our portfolio. They have the earnings to support a much higher share price then they trade at now. In times of market turbulence, Berkshire often remains steady. Their share price is weighed down to some extent by the advanced age of Buffett. The worry is how well the company will do after he is gone. I have no doubt that it will continue generating oodles of cash. The structure of the company and its culture will keep it chugging forward like a speeding train. Once it is in motion it is tough to slow down.

Everyone should own a share of Berkshire. Even if it is only to get a copy of the annual report. Each one is a masterful lesson on corporate finance.

Despite his advancing age and his steady diet of burgers and steaks washed down with Cherry Coke, Buffett declares himself fit as a fiddle. He reports his doctor declares him as healthy as a man many years younger. With any luck he will be around for many more years to come to the pleasure of Berkshire's shareholders.

How Small Investors Beat The Pros

It has been shown that 75% to 85% of mutual fund managers have underperformed the market in the past decade. These fund managers are well compensated and supposedly well trained. How is it that you are better off parking your money in an index fund that mirrors the markets moves. These professional managers are impeded by numerous hurdles. Small investors can take advantage of the inefficiencies that these large firms create for us.

Most mutual funds have a large amount of funds to invest. A fund that manages $500 million will have trouble investing in a company like ModPac whose total value or market capitalization is only $35 million. If they were to invest $1 million in ModPac, it could take weeks for them to accumulate enough shares to amount to $1 million worth. Assuming they go through this trouble, the share price of Mod Pac could double and it would have no effect on the return of their fund. A $1 million increase in the value of an investment in a $500 million portfolio amounts to a two tenths of a percentage increase in the funds value. If we buy ModPac and it happens to double in price we see an 8% rise in the value of our portfolio. It will not take months to accumulate a position which means our commission costs will be lower. (Since ModPac only trades around 10,000 shares a day it will take some time for a mutual fund to accumulate 100,000 shares. If they buy aggressively they may drive the share price up and pay more for subsequent purchases.)

Another advantage that small investors have is that no one but themselves will see their results. Every quarter mutual funds must disclose their performance. This leads to fund managers being very concerned with their short term performance and leads to some less than beneficial behaviors. The results are seen by thousands of customers and many thousands more prospective customers. We are pretty certain that most customers would rather see great results than sub par performance. If a fund does not perform well it stands to lose customers and have trouble attracting new ones. When you make your money

based on a percentage of the funds you have under management it is not good when customers start to leave. How do the funds respond?

This leads to a herd type mentality. Fund managers often are chasing the same stocks that are doing well presently. You will find that many large mutual funds have a large amount of overlap in regards to the companies they own when compared to other large funds. They all tend to own many of the stocks that make up the market averages. This fact alone makes it difficult to beat the market, when you own the market. This also minimizes the chance they will under perform significantly.

Mutual funds try to convince their customers that "they need to be in it for the long haul." Their own record shows they don't practice what they preach. Many funds have over a 100% turnover ratio. They may not own any of the stocks at the end of the year that they owned coming into the year. Funds are discouraged from sticking with solid companies that are having a short period of difficulty. The most extreme outgrowth of this avoidance of anything stock that appears to be a dud is called window dressing. Just before the end of a quarter a fund manager will sell his stocks that have performed poorly and replace them with stocks that have performed well recently. This does not improve the performance of the fund, but it sure makes it look like the manager owned all of the right stocks. His quarterly report gives the impression that his fund was loaded with wonderfully performing stocks.

One of he best lines we have heard explaining the behavior of fund managers states that "it is better to be wrong conventionally than to be right unconventionally."

Mutual funds often are required by their stated objectives to maintain an almost fully invested position. If stocks as a whole become extremely overvalued, as was the case at the beginning of the year 2000, some funds do not have the option to move into cash. We can move as much as we like into cash, as we did at the beginning of 2000 when we moved to about 50% cash.

The single factor that may prove the most difficult to overcome relating to fund performance is management fees. Mutual funds charge fees to manage your money. These fees are on a percentage basis. If a fund has 2% total fees for managing your money, it makes it real difficult to outperform the market. Mutual funds tend to under perform the market by just a hare more than their average fees amount to. If a fund has higher fees, on average it will under perform the market by more than a fund with lower fees.

Many of the thing you hear about managing your own investments are untrue. Mutual fund managers are not the brightest bunch. We are familiar with popular finance theory and are not surprised fund managers have such a poor record. Many small investors make much better decisions and are much less easily swayed by the day to day noise in the market. Small investors can beat the market and we intend to be one of the many. We hope you enjoy the ride.

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Company	Porfolio Percentage	Current price	Buy Price (less than)	P/E	Dividend Yield
Amgen/AMGN	4.40%	$53.61	$60.00	29.3	n/a
Astronics Corporation/ATRO	5.70%	$5.20	$5.15	52.6	n/a
Berkshire Hathaway B/BRK.B	17.10%	$2,996.00	$3,050.00	n/a	17.1
Cash	23.80%	$1.00	n/a	n/a	n/a
Cell Genesys, Inc./CEGE	2.80%	$9.04	$9.00	n/a	n/a
Consolidated-Tomoka Land Co./CTO	26.70%	$38.45	$36.00	19.1	0.63%
ModPac/MPAC	3.70%	$9.19	$10.50	15.0	n/a
OMI Corporation/OMM	14.40%	$13.07	$11.00	9.7	1.54%
Protein Design Labs/PDLI	1.40%	$16.91	$17.00	n/a	n/a

The BCIA Portfolio

Over the past month we have had (what for us amounts to) a radical shift in our holdings. Gone are Aflac, Freddie Mac and Ultralife Batteries while we have welcomed back Protein Design Labs and ModPac. Previously we stated that we may not have much activity in the way off changes in our portfolio. This recent period has been an obvious exception. We have been active not out of any boredom from sitting idle; the opportunities have just presented themselves all at once.

We are still analyzing Tejon Ranch which we mentioned last newsletter and have uncovered another interesting company with significant land holdings. The company is St Joe. They are more complex than our Consolidated Tomoka and generate revenue from a variety of sources.

We repurchased ModPac because of a special one time $22 million payment they are going to receive in August. When a company is selling for $35 million and they receive a payment of this size without having to perform any work or generate any expenses, we are always interested. I am willing to explore any and all tips that any of you may have relating to similar circumstance. I will venture a guess that I will not receive any tips. This type of event is so rare that this is the only time I have ever seen it. I am confident that the company is worth far more than they are selling for. We will be estimating what we feel the company is worth and passing along the information to you, so we all can take advantage of this unusual mispricing. You may already have it by the time you read this. We probably will also be increasing the percentage of ModPac we hold in the portfolio. Be prepared to do some buying.

Our biotech companies are presenting a nice buying opportunity. Their prices have been decimated. Now is a great time to buy. Cell Genesys just moved their first drug candidate into phase three clinical trials. Three or four years ago this would have been a quick 20—30% bump in price. This year it has meant a steady spiral downward. All the better to pick up shares cheap, which is exactly what we have done. These stocks still represent a very small part of our portfolio. We are hoping for real big gains down the road as they eventually bring products to market.

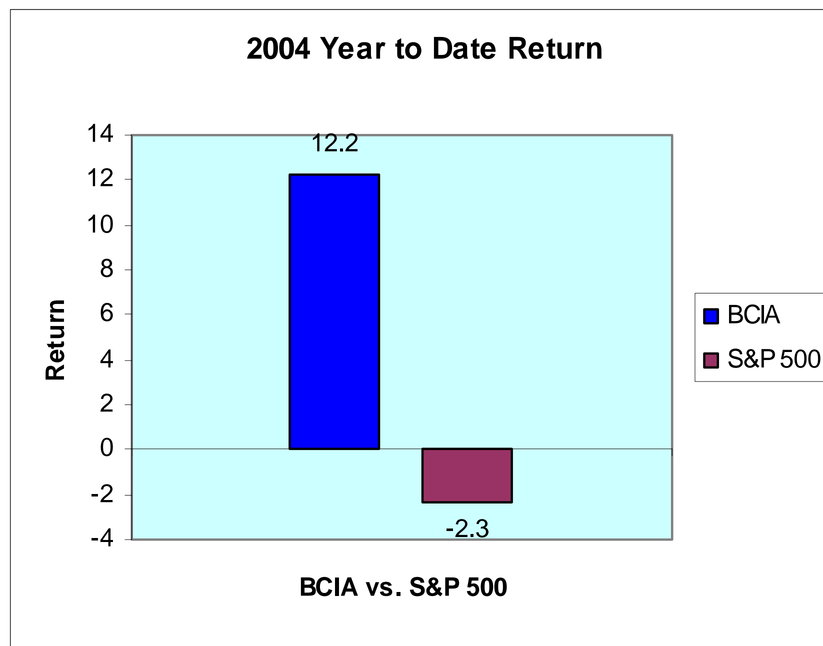
The table above shows our investments and the proportion of our portfolio they represent. As you can see we are heavily weighted towards four stocks. This is considered extremely risky by the popular investment community. We feel perfectly comfortable with it. Our trial issue on the website briefly delves into the issue of how you should build your portfolio. To achieve the same returns we will receive, you can buy all of the stocks we own in roughly the same proportion. You may be able to do better by purchasing the stocks we feel are worthy buys presently. These stocks are represented as the companies that are selling for less than our buy price.

Outpacing The S&P 500 By Even More

Our superior investment strategy has really begun to pay off this past month. Over the past month we have increased our lead over the S&P 500 average. So far our investments have returned 12.2% compared to a –2.3% return for the S&P 500 average. This gives us a 14.5% lead over the S&P. If we can maintain this lead through the end of the year, it will mark the fifth straight year we have outperformed the market. It is difficult to determine what factors affect your performance. We have tried to consider whether luck could be accountable for us beating the market the past years. The answer is that it definitely could be the reason. Based on conservative assumptions we have concluded that there is probably somewhere between a 2% and a 16% chance that our results are due to luck. That does not mean it could not happen, it just is not very likely that luck is the reason. It is important for us to exercise an extreme amount of caution and be skeptical of our results. This will help us avoid overconfidence and the associated lax decision making that would result.

For those interested we used the probability of a binomial random variable to calculate the probability that our picks beat the market. We assumed that investors can beat the market somewhere between 40% and 60% of the time. We used our record of outperforming the market 5 times out of the 5 past years and 6 out of the past 7 and 6 out of the past eight years as our number of trials. History has shown that over time money managers only are able to beat the market average somewhere between 25% to 40% of the time. Our results would be more certain if we assumed that it was only possible to beat the market 25% of the time.

These are the things that keep us awake at night. We have all of our money exactly as it is laid out on page 5. If we expect our customers to follow our advice, we feel it is important that we are reasonably sure of being able to help you grow your money successfully. That is what has us trying to statistically verify that we can indeed do this. So far, everything points to the probability that we can.



P/E Ratios

Price to earnings ratios or p/e ratios as they are known give a quick snapshot of the value that a company offers. A p/e ratio is calculated by dividing the company's earnings per share by its current share price. It can also be calculated by dividing a company's net income by its market capitalization. This would be all of its income divided by the value of all of its shares. Our new portfolio chart on p.5 shows the p/e ratios of the companies in our portfolio.

Be careful what you read, P/E ratios are not always what they seem.

You can see that two of our companies have no p/e. Each has a price so that is not the reason why. We run into problem with the earnings part of the equation. Neither of our small biotech companies have any earnings. Without earnings you have no p/e ratio. Here is an easy example to understand p/e ratios. In our example we have a company that sells for $10 per share. For the year the company earns $1. To find the p/e ratio you take The price ($10) and divide it by the earnings ($1). When we do this we get 10. If the company's earnings had been $2 our p/e ratio would have been 5. The p/e ratio answers the question: How much does it cost to buy $1 of a given company's earnings? If you look at ModPac on p.5 you can see that it has a p/e ratio of 15. It follows that it would cost $15 to buy $1 of their earnings. They sell for a little over $9 so from that you can deduce that there earnings per share are somewhat less than $1. It would still cost $15 to buy $1 of their earnings.

Amgen has a p/e ratio of 29. Why would a company have a different p/e? Why would anyone pay more for a dollar of one company's earnings than another? There is no easy answer to this question. One factor that causes investors to pay more is the companies growth rate. Faster growing companies generally have higher p/e ratios. When you buy a stock you are paying for the future earnings it will generate. If a company is growing faster then its future earnings stream will be higher than that of a company that is growing slower. Here is an example. Company one has a higher p/e ratio which means investors are willing to pay more for a dollar of earnings. Part of the reason is the higher growth rate. Company One is growing its earnings at a 32% rate. This is much faster than Company Two's 8% rate. At the beginning Company Two has higher earnings than Company One. At the end of five years, Company One now has higher earnings because of the faster growth. You are buying a stock because of the earnings that it can generate. Company One after 5 years is generating more income. You can see that initially both companies were selling for $10 per share. The growth rates at the end of the 5 year period will determine the p/e ratios that the companies can justify, whatever they may be.

	Company One	Company Two
Earnings	$0.50	$1.00
Price	$10.00	$10.00
Growth Rate	32%	8%
P/E Ratio	20	10
Earnings in 5yrs.	$2.00	$1.50

Earnings growth rates are not the only variable that causes p/e ratios to differ. Some other factors include the predictability of earnings. The more predictable earnings are the higher the p/e may be. The more certain the outlook a company has, the higher its p/e will be. For example, if a company is facing a large amount of litigation it may lower their p/e. The higher a companies debt, the lower its p/e may be. Certain industries also tend to be awarded higher p/e ratios.

P/E

P/E ratios don't always give a true representation of the value that a company offers. Astronics offers a good example. Astronics has an average p/e that falls somewhere in the range of 14 to 16. Their current p/e is 53. Why is it so high. Those of you who own it know it is not because of a rapid increase in the price component. Their earnings have had a dramatic drop. Most of this can be blamed on 9/11. Remember that companies are valued on their future earnings prospects not their present earnings. Even though their earnings are low now, the projection is that their future earnings will be greater. If you just look at the p/e ratio you would determine that the company is way overpriced compared to its historical valuation.

Low p/e numbers are often associated with value stocks and high p/e ratios are associated with growth stocks. Growth stock tend to be companies that are rapidly growing. If you find a company that has a p/e much lower than its historical average p/e this may be an indication that a company is undervalued. Again, you need to understand why that number may be lower or higher for that matter.

The chance of a terror strike provides a big unknown.

P/E ratios give you some insight to how the market perceives a company's worth. At different times that p/e number will change as the markets views on a particular company change. You can use p/e ratios to gather a basic read on how a company is priced compared to different times in its past and how it compares to other companies in the stock market. It is useful as long as it is taken in context with the whole picture. The ratio in and of itself does not grant any specific piece of useful information. Use them as a snapshot of a companies present valuation.

Recent Events

Recently we have seen a drop in the stock market. We do not care much what the level the market is at, but we are sensitive to the prices that it presents us. We have several companies that are selling near record high and some that are selling near 52 week lows. We have recommended buying some of those near their lows. We do not make a practice of trying to predict the market and have no plans to start.

What we do see is companies reporting strong earnings growth and the economy growing at a real healthy clip. This is always good for share prices. You might ask; then why has the market dropped. We feel that the big unknown is the threat of terrorist attacks and the uncertainty over who will be president come January. The terrorist attacks could provide a major shock to our economy again. The election result probably will not have much of an impact.

As long as our companies keep growing their earnings we should be in good shape. Early earnings reports suggest that this will be the case. Happy buying, we look forward to talking with you next month.

Brett Davidson

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