The Commonsense

INVESTLETTER

Volume 5 Number 6

Investing on Emotion

With wild market moves like we have seen recently, it is not uncommon to see investors acting irrationally. Some investors are seriously impacted by these wild swings and become anxious, may have difficulty sleeping, become depressed and suffer assorted other afflictions. I personally find no joy in the recent action, but am well aware that markets move in strange ways and stay as far removed emotionally as I can. Emotion is the enemy of orderly markets and investors everywhere. It is the primary motivator of many to play the buy high, sell low game. When the price of stocks drop some investors flee the markets to avoid further pain, in the process helping drive prices even lower.

Don't let excessive fees keep you from getting what you have coming

The stock market isn't the same as the market for hamburg but similar enough for our example. When the price of beef drops and ground beef for hamburg drops with it, shoppers don't pause in the meat department, become anxious and worry that they should wait to buy because the price may drop more. You will see shoppers loading their cart because they know they have found a bargain. They back up the truck, so to speak, and load up on hamburg. In the stock market just the opposite happens. Of course we are talking about much larger sums of money and about a product (stocks) you already own. The reaction still does not make any sense. Our reaction was to add shares of the companies we thought became bargains, QEP Corporation and K-Tron We also were close to adding shares of Rayonier and Chesapeake.

When stocks go on sale, investors flee. When hamburg goes on sale there are fights in the aisles. Being able to keep your emotions in check is very valuable to your portfolio. Our portfolio dropped to the point we were only up 25% on the years. This past week we added back over five and a half percentage points and are now up nearly 31% on the year again. If we would have sold off many of our position we would have missed out on sizable gains.

How do we know that the recent sell off was unwarranted? We don't. We do know that we still see some of the companies we own selling at reasonable valuation levels. Sort of like hamburger on sale. And, when we see a sale, we are tempted to load up. Our investments are in companies, not stocks. We invest in companies by buying stock, but we aren't investing in stock. It is an important distinction. We own businesses and as long as those businesses continue to perform well and the shares are reasonably representative of the value of the company, we continue to be owners. When the business prospects change then it is time to re-evaluate our position.

The share price reflects the current buyers and sellers estimation of what the company is worth either directly or indirectly. If the buyers are buying a company because they feel that the price is cheaper than the business is worth or near what the company is worth it represents the current

Wall Street:

- DJ 13212
- S&P 500 1455
- NASDAQ 2546

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Financial Planner

view of what a company is worth. The problem is that many other investors (and we use the term loosely in this instance) are buying and selling for a multitude of reason that do not have anything to do with the current value of the business. If any investor sees an imagined pattern in a chart and suspects the price will rise then they may buy based on their belief regardless of what the true value of the business is. Another investor may see the price rise and jump in because it has been rising creating a feedback loop that will serve to derive the price higher. Still another investor may sell his/her shares to build a vacation home, thereby depressing the share price.

This will cause a companies share price to trade above and below what the underlying business is worth. We have no way of knowing or predicting what other investors thought process is when it comes to buying and selling shares, so we avoid even trying. We can come up with a useful estimation of what some businesses are worth. When we find them with shares selling at prices significantly less than the company is worth, we are glad to be buyers.

Emotions are the bane of investors everywhere. The trick is to keep investors from acting on them.

When the focus of investors becomes stocks and what is happening to their prices they are missing the point. They end up expending needless energy figuring out what they should do and what the markets next move is. When the focus is on a business's worth, you have an easy measuring stick to help guide you in making your next move.

Granted it is not always easy to watch the value of your portfolio plummet (although it is always easier when it plummets to the point where you are still up 25% on the year) and emotions cause you to question whether you are making the right decisions. Our warning that the rise we experienced over the past 12 months would not continue forever finally rang true. (Even a broken watch is right twice a day; it still took us quite some time to finally be right.) These bumps in the road jostle us around a bit and eventually come to an end, not that we are predicting this is the end of the market upset. It sure doesn't feel as good is it did when we reported what seemed like monthly gains. Our nearly 40% gains over the past 12 months are very satisfying but difficult to keep up for the long term. Fortunately the companies we own should still show superior results over the next few years. What happens to the share price of our holding over the same time frame is much less clear. Too many people act for reason that have nothing to do with the value of the business for us to be able to predict share prices. We can state with reasonable certainty that the price of our shares will generally track with the value of the underlying business over time. At times the shares will sell for less than the underlying business at which point we are eager buyers. Other times the share price will be significantly more than the underlying business at which time we are equally quick to unload our shares. If someone will gladly pay us more than a company is worth in our estimation, we are more than happy to cede our ownership interest to them. They are welcome to focus on movements in the share prices and we will stick to trying to find excellent businesses we can understand and buy them when they are cheap.

Get comfortable with share prices moving all over and remember that they are not always moving because of a change in the value of the business. Trying to predict why a company's stock price is changing or how much will change or when it will happen is a fruitless exercise. Enjoy it when the value of the shares in your portfolio are rising, ignore it when share prices are falling. Don't let your emotions get the best of you in either situation.

Watch List

Don't be the foolish farmer waiting for the perfect day with the perfect weather before he plants his crops. The crops will never get planted and the same applies to investing for your future. The markets are never perfect. There is always some calamity that the pundits guarantee will send the economy out of control and the stock market plummeting. Rationalizing that you are waiting for a better time or a better set of circumstances is a great recipe for inaction.

Envision, if you can, walking through the New York Stock Exchange with the commercial media talking heads on one side warning of all of the impending doom and gloom and on the other side the large hedge fund managers and brokerage houses buying and selling like crazy, all trying to discourage you from investing because the time is not right. They are jumping in front of you trying to block your view and hollering that you can't do this on your own you need their "professional" (otherwise know as money grubbing) advice. That is how the market is for many investors.

With the bump in the road we have experienced in the sub prime mortgage implosion all of this fear is amplified. The first step in moving past this fear is to face it. At Investletter we just keep looking for undervalued companies and ignore the noise. Just like some folks who are afraid of heights refuse to look down because what they don't see can't hurt them. What we don't hear or read does not affect us. The fear mongers are not going away but we have no obligation to pay any attention to them.

No matter what the media types say or how wacky the market trades, we still own a portfolio of mostly undervalued companies. Some deeply undervalued. This does not by any means guarantee that the stock prices will trade higher next month. Over a longer time frame they will definitely trade higher, whatever the long term turns out to be. You have our permission to block out the noise, focus on what is important and move forward, even if it is contrary to what the popular media espouses.

Company	July price	June price	Change from June	P/E	52 Week High	52 Week Low	Estimated '07 EPS	Dividend Yield
Alico/ALCO	$48.03	$60.99	-21.25%	n/a	$65.00	$45.86	n/a	2.30%
Alliant Techsystems Inc./ATK	$99.11	$99.15	-0.04%	20.6	$102.81	$75.50	$6.22	n/a
Altria Group, Inc./MO	$66.47	$70.14	-5.23%	13.2	$90.50	$66.91	$4.28	4.20%
Amtech Systems/ASYS	$12.13	$8.75	38.63%	51.4	$13.33	$6.65	$0.31	n/a
Arch Coal/ACI	$29.89	$34.80	-14.11%	21.2	$42.59	$25.85	$1.24	0.90%
Bioanalytical Systems, Inc./BASI	$6.76	$7.23	-6.50%	n/a	$7.80	$4.98	n/a	n/a
Canadian Natural Res./CNQ	$68.41	$66.35	3.10%	14.5	$74.57	$40.29	$3.55	0.50%
Culp/CFI	$11.90	$9.00	32.22%	19.6	$4.37	$12.30	$0.52	n/a
Graham Corp./GHM	$35.90	$28.15	27.53%	19.3	$37.50	$12.55	n/a	0.30%
Kensey Nash/KNSY	$24.41	$26.81	-8.95%	40.6	$33.69	$22.26	$0.47	n/a
Landauer, Inc./LDR	$47.60	$49.25	-3.35%	21.9	$57.29	$45.50	$2.20	4.00%
Markel/MKL	$465.50	$484.56	-3.93%	11.2	$505.89	$389.00	$33.83	n/a
ModPac/MPAC	$10.16	$10.21	-0.49%	n/a	$12.50	$9.24	n/a	n/a
QLT Inc./QLTI	$6.57	$7.44	-11.69%	26.1	$9.92	$6.29	$0.26	n/a
Servotronics Inc./SVT	$10.76	$10.80	-0.37%	22.2	$12.00	$6.15	n/a	n/a
Specialized Health Products/SHPI	$0.76	$0.76	0.00%	37.5	$0.99	$0.59	n/a	n/a
Tejon Ranch Co./TRC	$39.67	$44.20	-10.25%	n/a	$57.09	$38.85	n/a	n/a
Universal Forest Products/UFPI	$39.54	$42.26	-6.44%	16.1	$54.61	$39.00	$2.05	0.30%

The Investletter Portfolio

Nearly all of our company's announced excellent earnings over the past month. Astronics, Atrion, K-Tron, Headwaters, Chesapeake and Gencor all had very favorable developments. Some of the results were downright staggering.

Astronics has been enjoying the upswing in the airlines capital cycle. Especially the trend to include in-flight entertainment as part of new plane construction and retrofit work on older planes. The AES (Advanced Electronics Systems) subsidiary that was acquired for $13 million a couple of years ago generated $58 million in sales in the first 6 months of the year. This has been a major driver in the increase in shareholder value.

Astronics quarterly results had them earning $.53 per share. This was a 120% increase over the same quarter last year. Through the first six months the company has earned $1.08. This is already record earnings for any year in the company's history. They have never earned more than $1.00 per share in any year. The company has forecast the second half of the year to be a bit slower than the first half, not because of any slowdown, but because of timing issues. They will still record a huge increase in earnings.

K-Tron also had absolutely huge earnings numbers. As a response the share price has dropped. We have responded by stepping in and buying more shares. When an excellent company goes on sale, we are more apt to be buyers than sellers. K-Tron earned $1.84 in the second quarter which was 56% higher than the earnings in the same quarter last year. The company also announced that they have a record backlog of more than $54 million in work. This ensures that next quarter's results should remain strong. K-Tron has a legitimate shot at earnings over $7 per share this year. At the current price ($89), the company has a forward P/E ratio of 12.7. A company growing sales at more than 20%, with low capital expenditures and generating loads of cash is valued mighty low with a P/E of 12.7. We conservatively value the company at more than $120. Back in 2005 when we purchased our initial shares we felt the company was undervalued. Today the company has significantly boosted its value by controlling costs and adding acquired companies at agreeable prices. The value of the business has risen faster than the share price leaving today's shares still undervalued. They are undervalued enough that we feel comfortable adding to our position as pointed out by our recent subscriber alert. The company is rapidly paying down debt and increasing cash, giving them plenty of flexibility for future acquisitions or to initiate a modest dividend. This is a great example of excellent management continuing to provide market beating returns to their shareholders. It makes it easy to stick around for more.

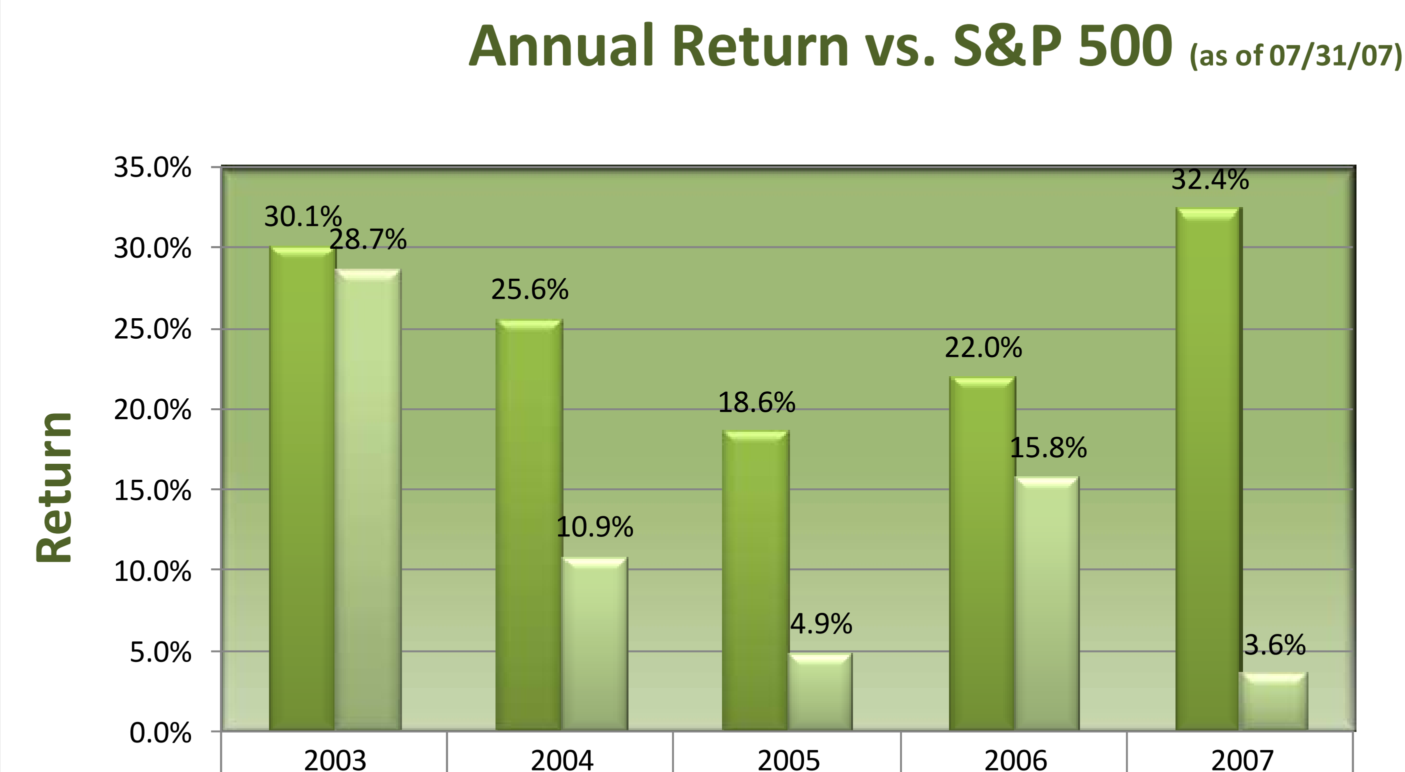
Company	Porfolio Percentage	July price	June Price	Percentage Change	Buy Price (less than)	P/E	Dividend Yield
American International/AMIN	6.90%	$4.95	$4.45	33.30%	$4.95	n/a	n/a
Astronics Corporation/ATRO	23.40%	$34.72	$33.62	3.27%	$26.00	27.1	n/a
Atrion/ATRI	6.10%	$104.42	$98.79	5.70%	$93.00	17.4	0.80%
Berkshire Hathaway B/BRK.B	7.00%	$3,604.00	$3,605.00	-0.03%	$3,300.00	15.0	n/a
Cash	14.20%	$1.00	$1.00	n/a	n/a	n/a	n/a
Chesapeake/CHK	6.60%	$34.38	$34.60	-0.64%	$33.00	10.2	0.80%
Gencor/GNCI	7.10%	$9.30	$9.30	0.00%	$9.70	7.9	n/a
Griffin Land & Nurseries/GRIF	5.90%	$37.79	$36.23	4.31%	$38.00	32.7	n/a
Headwaters/HW	1.20%	$16.13	$17.27	-6.60%	$17.50	7.5	n/a
K-Tron International/KTII	7.60%	$98.06	$100.53	-2.46%	$90.00	17.6	n/a
Protein Design Labs/PDLI	0.90%	$23.29	$23.30	-0.04%	$21.00	n/a	n/a
QEP Corporation/QEPC	6.40%	$10.94	$6.25	75.04%	$12.00	14.9	n/a
Rayonier/RYN	6.50%	$42.34	$44.96	-5.83%	$41.00	18.9	4.70%
Terra Systems/TSYI	0.20%	$0.24	$0.29	-17.24%	n/a	n/a	n/a

Year to Date

Last month we said we have a chance to widen our lead over the S&P 500 average if a few of our companies keep up their strong operating results. That is in part what happened. July was another robust month. As shown below, we are now up 32.4% this year, far outpacing the 3.6% returns offered by the S&P 500 market average. Over the 43 months we have been publishing, we are up 140% versus 40% for the S&P 500 average.

Strong operating results at QEP Corporation (QEPC) sent their shares surging upward shortly after we purchased them. The shares rose over 60% from our purchase price. The company recently bought out some warrants that an investment company held. They paid $2.3 million to buy back the warrants which is good news for shareholders. It functions the same as a share buyback.

Our other big mover for the month was American International (AMIN). We sent out an email mid month explaining what happened when the 20% stock dividend the company issued took effect. Sometimes when a price resets for no good reason, it stays that way. So far this appears to be the case for AMIN. When you look at our holdings on page 4 you will notice that the shares rose from $4.45 to $4.95 or 11%. Factor in the 20% stock dividend and the shares rose more than 33%.

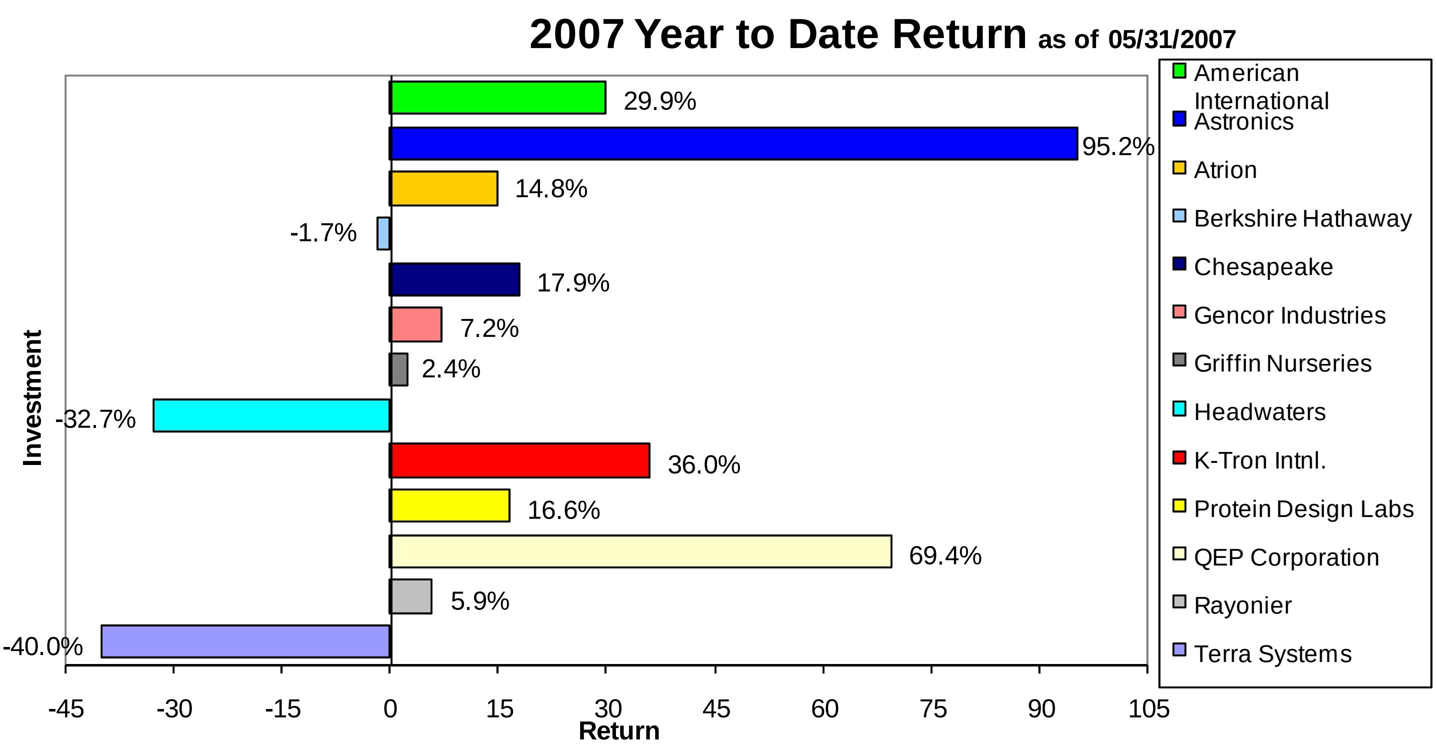


	2003	2004	2005	2006	2007
Investletter	30.1%	25.6%	18.6%	22.0%	32.4%
S&P 500	28.7%	10.9%	4.9%	15.8%	3.6%

Performance

The chart below does not need much explanation. Our larger positions have performed extremely well and our smaller positions have been underwhelming. Our recent order placed to sell shares of Terra Systems is our way of pulling the weeds and watering the flowers. Too often the investors perform just the opposite. You will often hear you can't go wrong taking a profit. Why sell your winners? If a company is well managed and continues to show strong growth why in the world would you want to sell it?

The opposite of this is investors being reluctant to sell their losers. Many investors find avoiding confirmation of their mistakes somehow comforting. It goes back to the desire to avoid pain. When a position is sold at a loss it is admitting you screwed up. Investors who continue to hold in hopes that the share price will return to their purchase price are irrationally looking to avoid the pain of admitting their mistakes. The share price has no obligation to get back to what investors paid for them, to help them avoid the remorse associated with selling at a loss. Terra Systems is a perfect example. We made an error in determining the company was close to commercial sales. The project that they had a chance to land business on is already up and running and they have no sales to show for it. We are going to lose money on the transaction and that is alright. It does not make sense to wait and lose even more.



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