The Commonsense

INVESTLETTER

Volume 6 Number 7

Walking Without a Net

Wall Street:

- DJ 12820
- S&P 500 1386
- NASDAQ 2412

Many consider investing akin to walking without a net. Just how risky is it? We have repeatedly expressed our views on risk and our summation is that it is not easily definable and certainly not defined as the degree of change in price. One sliver of risk is the ability to obtain the best possible return for you investments. How likely is it that by investing in stocks that you have more than you started with and will not be hit with huge losses? Ignorance, fear, misinformation and media hype all contribute to investors having a less than informed view of what you can expect investing in stocks.

Now you see it, now you don't. People often see patterns, even those that don't exist.

Investing in the stock market is subject to wild swings in prices, more so than the classical finance models suggest. All kinds of crazy things can happen. The NASDAQ average is still down more than 50% from market highs in 2000. This is eight years later an the NASDAQ still has not returned anywhere near its former highs. How long will it take? The S&P average is not as volatile, being made up of large more well established companies, but it saw a greater than 20% drop in value in a single day back in October, 1987. The Dow Jones Industrial Average dropped 80% during the great depression and it took 20 years to surpass its former highs. Bond markets are not without risk either. Bonds have had 20% drops in value over the course of a year.

Over time the S&P 500 has been pretty consistent and pretty resilient. Using data from 1926 to 2003 the odds are tilted in your favor investing in stocks. Using ten year rolling time periods measured in one month intervals, stocks outperform bonds very often and it is highly unlikely that you will have less than you started with over a ten year time period. Over the period from 1926 to 2003 there was 934 months and 815 rolling ten year time periods. (February 1926 to the end of January 1935 would have been the second rolling ten year time period for example.) In only 3.6% of the rolling ten year periods did you risk having less than you did ten years prior. The inverse interpretation is that you had a 96.4% of making money. A portfolio of all bonds gave you a 99.1% chance of showing positive returns over rolling ten year time frames. Bonds made your risk of losing money very slim over those 815 time periods.

The last time a portfolio of stocks had a negative return was the ten year period ending February 1941. Bond have only had one ten year timeframe with negative returns. A portfolio of stocks has seen a negative return in 30 of the 815 time periods. So what is it that you get when you invest in stocks that rewards you for this greater chance of having negative returns over a ten year timeframe? The answer is higher returns. In over 85.3% of the rolling ten year time frames, stocks outperform bonds. Over a six year rolling timeframe your odds are still 80% that stocks will outperform bonds.

Inside this issue:

continued

If you had money that you absolutely needed to use in two years, for say a down payment on a house, your odds would only be 62.7% that you would do better in stocks. In 37.3% of the two year time frames bonds would be a better bet and have reduced odds for showing a negative return.

Losing it all could happen, but it would mark a first in US equity markets.

This article is not aimed at convincing our subscribers to invest in stocks. We are not aiming to preach to the choir so to speak. Each of you are already are aware of the benefits. However, each of you have friends, neighbors and family who may not have as strong an understanding of investing. Too many avoid investing in stocks because of their ignorance concerning the topic which is fed by misinformation and media hype. Over long stretches of time your odds are extremely small that you will have less than you began with and at no point do you risk "losing it all." To see an investment in the S&P 500 become worthless all of the large companies in the United States would need to go bankrupt at the same time. Could it happen, possibly, but at that point the value of your investments would be the least of your problems.

If you have friends and neighbors who are saving for retirement or some other long term goal and don't have at least some of their money invested in the stock market, they risk accumulating much less than they otherwise could. If they are relying on this money to last for their retirement they are increasing the odds that they will run out of money. Their risk of having to alter their lifestyle is increased. Over the long haul the odds favor investing in stocks to maximize your retirement savings.

For those who assume they are reducing their risk by avoiding stocks, they are increasing the risk they will not accumulate enough. Time greatly reduces your chances of seeing a decrease in your investments. Over a twenty year timeframe stocks are nearly a lock to be worth more. Over the past nine years stocks have gone nowhere. You would not have made a penny invested in the S&P 500 average as discussed on page four of this issue. So what is likely to have after a significant period of stagnation? The longer the market goes nowhere, the more likely it is to rise in future years. The odds should be tilted further in our favor over the next ten years. It is far from a guarantee, but we are comfortable with the odds.

Watch List

The stock market has been struggling mightily lately. Since last fall prices have seen a pretty healthy drop. During the last bear market that began in 2000, the share prices of companies suffered much sharper and steeper losses. Companies weren't just overvalued, many were wildly overvalued. Earnings were sometime non existent in many of the companies with high flying share prices. There was plenty of room for prices to fall. During this recent decline things have been different. Corporate earnings are much stronger than in 2000, yet share prices as represented by the S&P 500 average have hardly changed. Companies also have much higher cash balances and are in much better position to survive a downturn. The impression we get is that companies have exhibited some collective corporate memory of the 2000 bear market by maintaining stronger balance sheets. Having a healthy stash of cash and investments or hard assets hanging around can make it much eas-

Watch List

ier to weather any economic downturn and provide the means to prepare for the inevitable upturn in the economy.

Our portfolio provides several stellar examples as does the list below. Timber companies provide a great example. Real estate in general has seen prices dropping over the past two years. Timberland prices have actually strengthened over this time. There have been recent transactions that have been completed at record prices. Rayonier for examplehas both paid higher prices recently to purchase and received higher price on some completed sales. Raw land has also remained strong. Companies like Alico, St. Joe, Tejon Ranch and Consolidated Tomoka all are holding up well in this economic slump. The number of transactions appear to be down, but the price per acre has been strong.

Some of our companies just skip the illiquid assets in favor of cash and investments. CSP, Inc. almost defies logic with a market capitalization a mere $1 million higher than their $21 million in cash and investments. Our former darling (as in earlier this year), Gencor is sporting a comfy $68 million in cash and investments with the whole company valued only $18 million more at $86 million.

American International has seen their share price drop to the point where the company is now only worth $26 million. They have a land deal they have been trying to close $16 million. All or almost all of the land sale will be tax free based on the fact that the company has operating losses from prior years they can carry forward and match against the gains. The gains come from the fact that the company only paid $225 thousand for the property some years ago. They also have another tract up for sale for several million dollars. The company also has a several million dollar payment due, I believe, at the end of September for a past land sale transaction. Land sales aren't much good until they close, but the company still has the land if a deal falls through. Add to this the fact that the Galveston real estate industry is strong from oil and natural gas exploration going on nearby.

Having cash, investments and hard assets like land ,coal, natural gas and oil all help support a company's share price. It explains to some extent why the companies we own have been less affected than the market as a whole.

Company	July price	June price	Change from May	P/E	52 Week High	52 Week Low	Estimated '08 EPS	Dividend Yield
Alico/ALCO	$42.43	$34.36	23.49%	n/a	$55.29	$33.14	n/a	2.60%
Alliant Techsystems Inc./ATK	$99.69	$101.68	-1.96%	15.8	$120.90	$95.00	$7.39	n/a
American Pacific/APFC	$16.12	$17.24	-6.50%	14.0	$19.20	$12.51	$1.16	n/a
Arch Coal/ACI	$54.21	$75.03	-27.75%	25.9	$77.40	$27.76	$2.76	0.70%
Culp/CFI	$6.15	$7.02	-12.39%	16.0	$12.19	$6.10	$0.51	n/a
Gencor/GENC	$11.03	$10.44	5.65%	4.8	$32.88	$8.50	n/a	n/a
Graham Corp./GHM	$89.00	$74.11	20.09%	34.0	$89.00	$24.00	$3.53	0.10%
St. Joe Company/JOE	$35.15	$34.32	2.42%	51.5	$46.82	$26.70	$0.82	1.80%
Landauer, Inc./LDR	$63.92	$56.24	13.66%	26.8	$65.73	$47.00	$2.46	3.10%
Mesa Labs/MLAB	$21.05	$24.00	-12.29%	14.9	$27.00	$17.90	n/a	1.90%
Schuff International/SHFK	$27.50	$28.90	-4.84%	4.3	$35.00	$21.00	n/a	n/a
Servotronics Inc./SVT	$15.25	$15.00	1.67%	12.1	$22.48	$9.55	n/a	1.00%
Span America Medial Sys/SPAN	$13.00	$11.25	15.56%	12.1	$20.19	$9.88	n/a	2.90%
Tejon Ranch Co./TRC	$31.00	$36.06	-14.03%	n/a	$47.72	$29.71	$0.49	n/a
Torm/TRMD	$32.32	$35.01	-7.68%	6.6	$47.10	$26.52	n/a	n/a
Twin Disc/TWIN	$20.11	$20.93	-3.92%	9.2	$37.47	$12.07	n/a	1.40%

The Investletter Portfolio

This is the easiest issue we have written in some months. As of August 1, we have finally put some breathing room between our performance and the S&P 500 average for the year. (See page five for the good news on Astronics.) Enough about that, we want to talk about where the S&P average has been over the past almost nine years from the beginning of 2000 to now. Nine years is a pretty long time in the stock market and over rolling ten year periods the S&P 500 average rarely shows a loss as described in our opening article to this issue. Since the beginning of 2000 the S&P Average is up about 0%. On August 8, 2000 the S&P 500 market average closed at 1,483. On August 8, 2008 the S&P 500 closed at 1,296. The share prices of the 500 companies that make up the average are down on average. Dividends are what gets the S&P 500 average back to the breakeven point.

Some of you may be aware that before we started this newsletter we spent five years testing our strategy before we felt comfortable asking anyone else to listen to what we have to say. The beginning of 2000 encompasses most of this five year testing phase. Over that time frame we have seen the Investletter Portfolio rise 265%. (As of August 8, 2008). Since we began publishing the newsletter in 2004 we have seen the Investletter Portfolio increase 165%. Reminiscing is nice, but it isn't going to help make any superior investment selections. This does not guarantee anything in the future. It may be a small indication, but it takes a long time to have enough evidence to be able to reliably state that the above results are due to skill. Although, each year's results and the cumulative outperformance over the years certainly is beginning to firm up the proposition that it is skill and not luck.

So, it is a relief to finally see some breathing room between the Investletter Portfolio and the S&P average. Next it is time to get back in the black. We need continued strong operating performance from some of our smaller companies. CSP, Inc. (CSPI) and QEP, Corporation (QEPC) have both had their share prices pummeled. Each of these two could show explosive price changes with continued strong results. Amtech (ASYS) is another company that could easily show rapid changes in share price. A solar manufacturer, of the type ASYS supplies equipment to has recently announced they plan to double their output in 2009 and increase production another 50% in 2010. You can't show increases of this magnitude without adding new equipment.

The one hallmark we continue to maintain is our conservative approach. We aim to select companies with a some margin of safety in one form or other. Some it is a price so low that it is difficult to see it going much lower. Others it is the hard assets they own. Still others, the solid future growth prospects. Only by receiving this margin of safety can it help insulate your portfolio from losses.

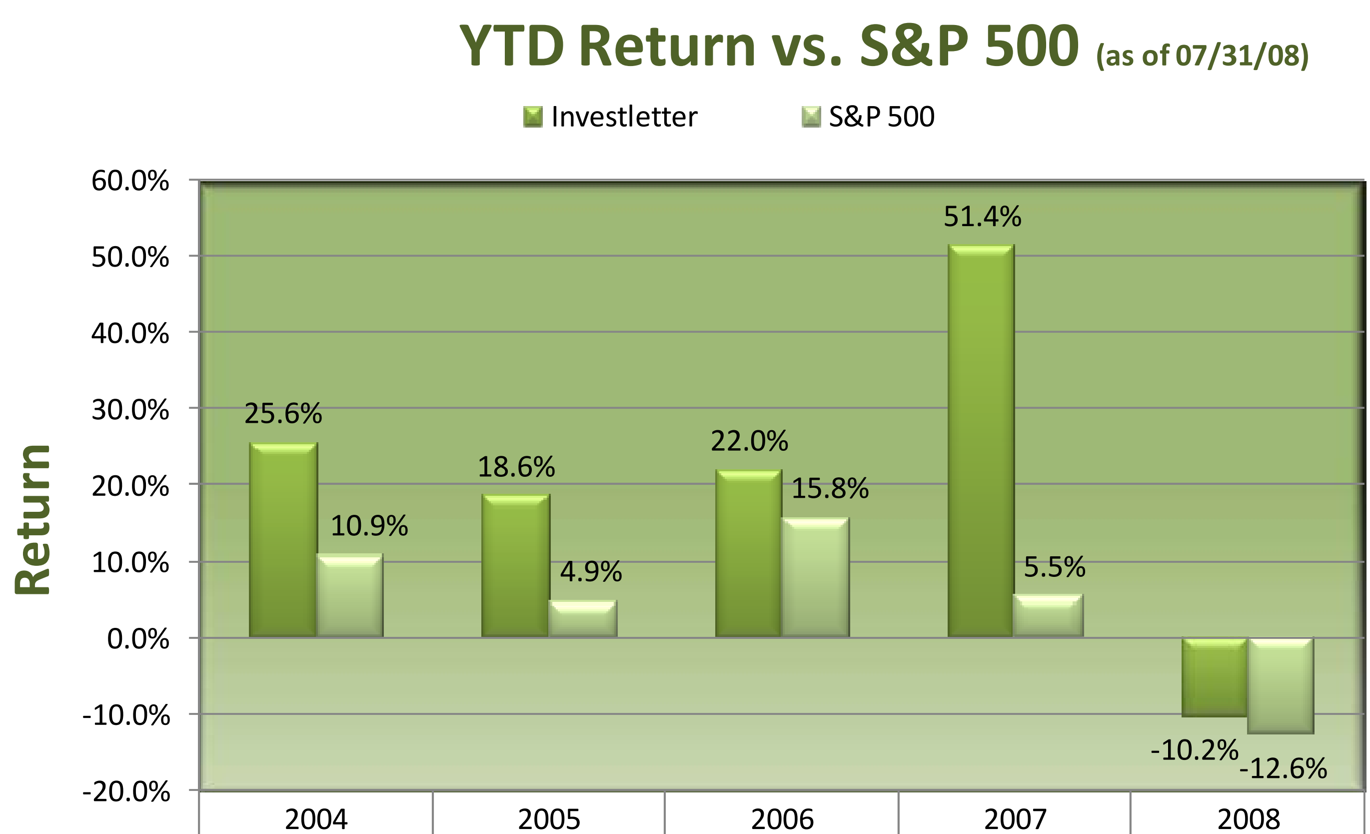
Company	Portfolio Percentage	July price	June Price	Percentage Change	Buy Price (less than)	P/E	Dividend Yield
American International/AMIN	7.00%	$3.33	$3.89	-14.40%	$3.50	n/a	n/a
Amtech Systems/ASYS	6.00%	$9.41	$10.74	-12.38%	n/a	29.6	n/a
Asta Funding/ASFI	2.40%	$8.00	$9.06	-11.70%	$10.00	3.4	2.00%
Astronics Corporation/ATRO	12.70%	$14.60	$13.91	4.96%	$13.80	11.0	n/a
Atrion/ATRI	7.30%	$110.42	$95.82	15.24%	$93.00	15.2	0.90%
Berkshire Hathaway B/BRK.B	6.30%	$3,829.00	$4,012.00	-4.56%	$4,000.00	15.6	n/a
Cash	7.70%	$1.00	$1.00	n/a	n/a	n/a	n/a
Chesapeake/CHK	8.20%	$50.15	$65.96	-23.97%	$40.00	12.3	0.60%
Consolidate Tomoka/CTO	2.60%	$39.59	$42.06	-5.87%	$39.00	15.0	1.00%
CSP Inc./CSPI	9.20%	$5.74	$5.95	-3.53%	$5.70	8.1	n/a
K-Tron International/KTII	11.40%	$138.79	$129.60	7.09%	$90.00	16.6	n/a
Protein Design Labs/PDLI	0.40%	$11.22	$10.62	5.65%	n/a	14.4	n/a
QEP Corporation/QEPC	9.60%	$6.38	$5.62	13.52%	$5.60	8.8	n/a
Rayonier/RYN	9.20%	$46.72	$42.46	10.03%	$41.00	20.1	4.30%

Year to Date

Our small lead at the end of July quickly multiplied on August first with Astronic's excellent earnings report. The company reported record quarterly revenues along with record quarterly earnings. In classic Astronics style no mention was made regarding either. When times are good, management does not present an overly optimistic picture. When they hit a bump in the road, they are not overly pessimistic. Wall Street often reacts just the opposite.

A press release with "Record Earnings" splashed across the headlines is enough to get the attention of a whole slew of momentum investors. The same folks who helped drive the shares to $53 and also back to $13. I have no desire to see a repeat of either. The first half of the trip was pure ecstasy; the second half was pure torture.

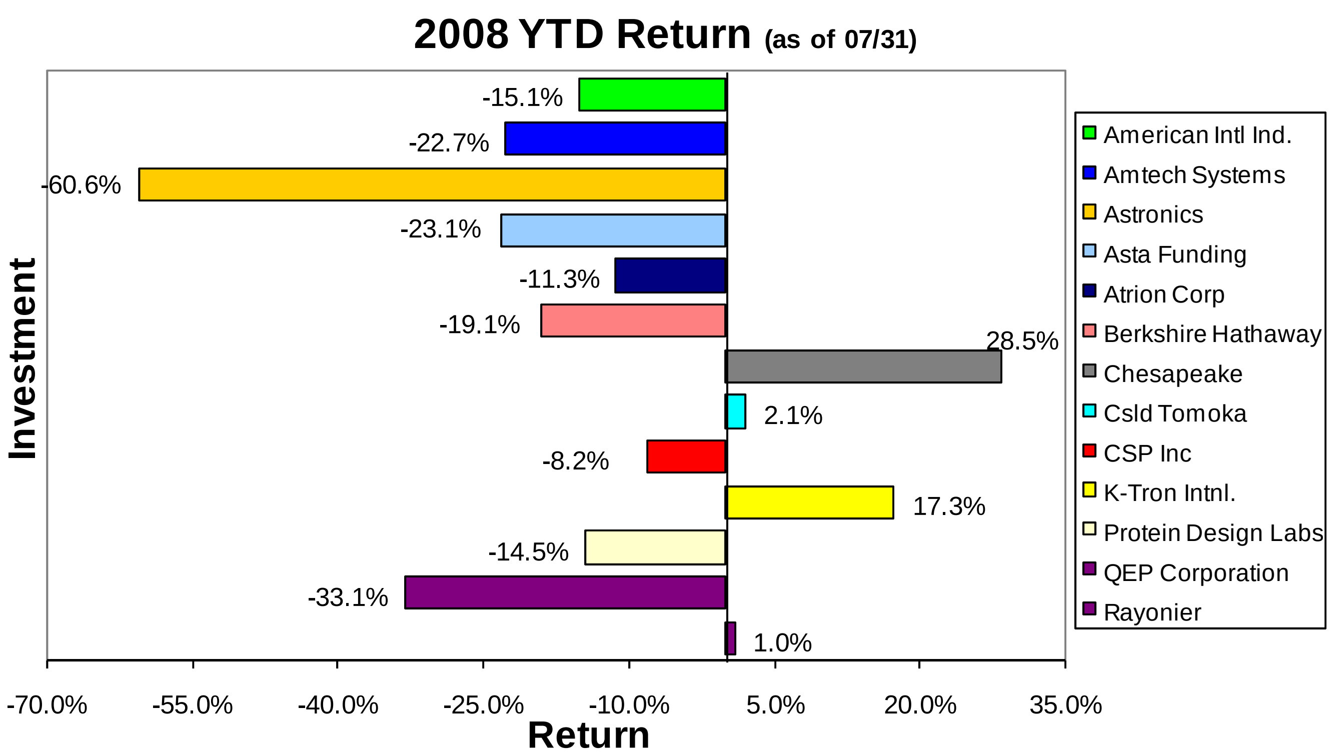
Even when you know a company is trading out of whack compared to its true value, you still can't do anything to change it. Eventually news comes along that returns a semblance of normalcy. Astronics report of $.60 earnings per share when the investment community was looking for $.31 was just the tonic we needed. No splashy headlines and the shares have moved up in an orderly fashion to the mid $20's. It is still a bit less than the company is worth, but it gives us something to look forward to the rest of the year, a steadily rising price. There is always a chance that Astronics will report excellent earnings the next two quarters and we will see a return of the momentum investors and the associated madness. Fortunately, we will be well prepared if it does happen, but would be more than happy to settle for slow and steady… and lasting, instead of the whiplash we have experienced the past eight months.



	2004	2005	2006	2007	2008
Investletter	25.6%	18.6%	22.0%	51.4%	-10.2%
S&P 500	10.9%	4.9%	15.8%	5.5%	-12.6%

Performance

After our early gains in Gencor (GNCI), strong performance by Chesapeake (CHK) and K-Tron (KTII), the performance of much of our portfolio has been lacking. Just after the close of the month one bright spot did appear that helped reverse much of this years pain in the form of Astronics much better than expected earnings report. Several companies have had excellent results, but their share price has not even flinched. QEP Corporation is a great example. The company had an amazing quarter considering the housing market malaise. The share price rose marginally and has since returned to the levels seen just before the earnings release. The company's management has done an excellent job controlling costs and kept the company nicely profitable. At the same time the company's value as an acquisition has risen even more. They have successfully reduced costs at a time when total sales have been under pressure, no small feat. It would be highly desirable to see the company bought in a merger transaction. However, at the current price the shares trade at it is highly unlikely that the price would be even close to fair. The company is extremely undervalued and there is no sign that they are going to be re-valued anytime soon. This is not unique, but a common occurrence during bear markets. Small companies are often dealt an overly harsh adjustment to their price. Our analysis places the company's value at something between $15 and $25. A year from now we would not be surprised to see the company trading over $15 per share.



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