The Commonsense

INVESTLETTER

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- S&P 500 1270
- NASDAQ 2172

Buybacks and Splits

Stock splits and share buybacks are two common financial transactions performed by companies to generate interest, excitement or build shareholder value. However, they are not created equal. Stock splits are done to increase the number of shares and make them more "affordable" for small investors. Share buybacks are done to reduce the number of shares and aim to boost the share price through both psychological and economic forces.

Stock splits are not all they are cracked to be. Smoke and mirrors is an apt description

A stock split is nothing more than a bookkeeping entry. The net effect is to increase the number of shares trading in the market. A typical scenario may go something like this: a company does well or receives a lot of hype and their share price rises. When the share price moves above some threshold amount that the board of directors deems significant, like say $30 or $40, the board declares a split. A common split is two shares for one. Neither the share price a company attains before they declare a split or the ratio of the split is a set amount. These two amount s will vary between different companies. Both are determined by the Board of Directors. Some companies (Berkshire Hathaway) never split. This happens to be our preference.

Stock splits amount to smoke and mirrors. It is financial sleight of hand. No one would feel any richer if someone offered them two fifty dollar bills for a hundred dollar bill. Investors routinely read significance into stocks splits where there is none. A company that has 1 million shares and is worth $10 million has a share price of $10. If the company performs a stock split and doubles the number of share to 2 million shares , the company is still worth $10 million. Now each share is worth $5. If you owned 100 shares at $10 before the split and 200 shares at $5 after the split would you have any reason to celebrate. Not in our eyes. Yet stock splits are routinely celebrated by many investors. Some try to justify splits as being related to management's confidence in their company. Management may have confidence, but a stock split will not result in shareholders having any more value than they had before a split.

We view splits as an opportunity for investors to take their eye off the ball. This is the type of noise that causes short term share price movements that have no underlying basis in any fundamental change in a company's financials. No money changes hands as the result of a split and as a result the impact on share prices over time has been non existent. We have owned companies that have had splits and would not sell just because a company split their shares. At the same time we find nothing to celebrate and generally aim to ignore any of the hoopla.

Next month we will finish our discussion with an explanation of how buybacks do create value for shareholders.

Inside this issue:

Watch List

By the time you read this we will probably have made a recommendation to buy Chesapeake Energy (CHK) instead of the company we began investigating from this list, XTO. We like the economics in the natural gas business for the long term and are happy to pick up shares in CHK while the price in natural gas has cratered from the winter highs. Chesapeake is a phenomenal story. They have a very geographically concentrated portfolio of wells and a deep portfolio of drilling sites. The company currently has enough drilling sites to keep them busy for the next nine years. They are bucking the gas industry trend by adding reserves of undeveloped gas as industry production declines. They also have another big advantage over XTO. The company (CHK) has locked in contracts for the delivery of gas representing over 70% of this years production at prices over $9 per thousand cubic feet. Currently natural gas is trading for a bit under $6. They have removed much of the risk of fluctuating gas prices with this hedging. They also have over 50% of 2007's production hedged. The net result of all of this hedging is that the company will probably show stronger earnings this year than XTO, which only has 20% of it's 2006 production hedged. With natural gas production declining, prices are certain to move up in the future.

After you are finished filling the gas tank on your car or truck, you can then think about adding that new fuel efficient furnace or wood fired boiler to lessen the impact of rising natural gas prices. On the bright side last winters mild weather has left us with plenty of natural gas for this winter. As long as the air conditioning season is not too power hungry, we should start this winter with plentiful gas supplies resulting in lower prices.

We also have a new addition to our list below. Markel (MKL), a property and casualty insurer. The company has a top notch management team. They focus on increasing shareholder value and conservative underwriting, two traits that make us very comfortable. We originally looked at this company in the mid to late 1990's. We did not pull the trigger at the time because we felt the company was a bit over priced in the $80 range. Wow, did we (I should say I screwed up because my partner had no input into this decision) screw up. This expertly guided company has been a stellar performer with a management team that just oozes integrity. After a more in depth analysis we will be watching for weakness in their price. Who knows maybe we can pick up a nice bargain.

With a bit more work to go to get our portfolio where we want it ,we would like to use the recent market weakness to make some timely additions, as long as they are at an agreeable price.

Company	June price	May price	Change from April	P/E	52 Week High	52 Week Low	Estimated '06 EPS	Dividend Yield
Altria Group, Inc./MO	$73.43	$72.35	1.49%	13.6	$78.68	$63.60	$5.30	4.40%
Bioanalytical Systems, Inc./BASI	$7.31	$6.25	16.96%	n/a	$7.80	$4.75	n/a	n/a
Canadian Natural Res./CNQ	$55.38	$53.74	3.05%	16.9	$64.38	$36.60	$3.27	50.00%
CSP Inc./CSPI	$7.07	$7.05	0.28%	n/a	$11.96	$5.59	n/a	n/a
Kensey Nash/KNSY	$29.50	$29.45	0.17%	44.0	$34.00	$19.32	$0.67	n/a
Landauer, Inc./LDR	$47.90	$46.60	2.79%	22.0	$54.00	$43.11	$2.18	3.80%
Markel	$347.00	$337.75	2.74%	13.4	$361.99	$307.41	$25.84	
ModPac/MPAC	$9.95	$10.70	-7.01%	n/a	$18.60	$9.55	n/a	n/a
QLT Inc./QLTI	$7.08	$7.22	-1.94%	14.8	$11.35	$5.93	$0.48	n/a
Rayonier/RYN	$37.91	$38.89	-2.52%	23.2	$47.50	$34.00	$1.64	4.96%
Tejon Ranch Co./TRC	$41.16	$41.68	-1.25%	n/a	$62.72	$38.43	n/a	n/a
XTO Energy/XTO	$44.27	$41.22	7.40%	11.0	$50.01	$34.15	$4.04	70.00%

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 some time 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.

June was marked as a rather unremarkable month. We are close to making some portfolio changes to try and boost our performance through the rest of the year. The only large holding showing significant strength was OMI. This is the beginning of a period that should be marked with quite a bit of good news for OMI. Rates have recently been strengthening and several of the ship sales they have announced will be reported in this quarters numbers. The company will almost certainly have bought back another large chunk of shares and will have plenty of cash left to pay down debt or offer a special dividend to shareholders. We can hardly contain our excitement to find what combination of the above they choose.

All of our biotech holdings continued their weak performance in June. Amgen is becoming a company that we are having less patience holding. Management makes sure they are very adequately rewarded. So much so that it has been at the expense of the shareholders, the true owners of the company. This is a classic sign to us that it is time to move on. Expect Amgen to be unloaded as soon as we find an agreeable price.

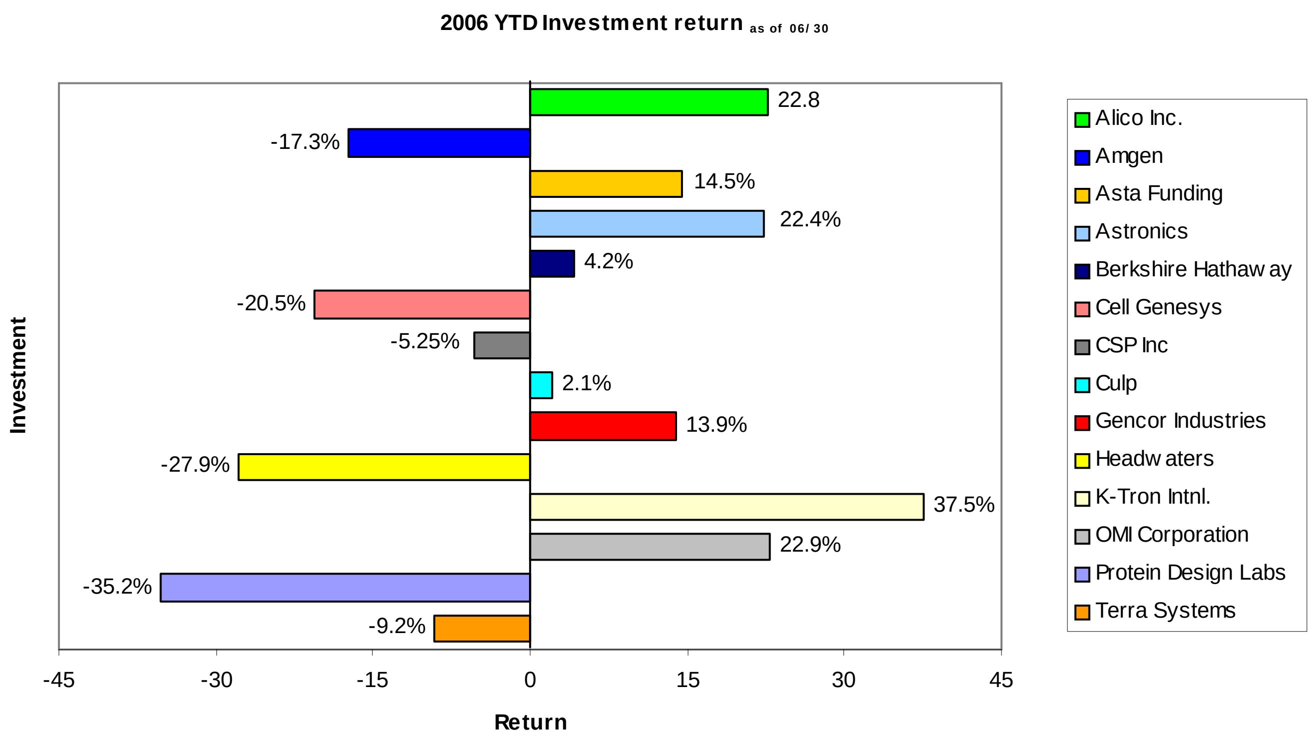
We again have been carrying a healthy cash balance most of this year. With share prices down quite a bit over the past couple of months we are again finding some bargains. You can expect us to move some of our cash back into stocks and hopefully get an added boost in our performance numbers. Carrying as much cash as we have, helps limit our performance in up years and limits some of the damage in down years. It also gives us some funds to jump on a bargain when we see one. We would like to move back closer to 10% cash. You can expect us to try and slowly whittle our cash account down until we reach this amount. How long it takes depends on how soon we can find enough bargains.

Company	Porfolio Percentage	June price	May Price	Percentage Change	Buy Price (less than)	P/E	Dividend Yield
Alico/ALCO	14.00%	$55.11	$55.00	0.20%	$50.00	45.3	1.80%
Amgen/AMGN	3.70%	$65.23	$67.59	-3.49%	$60.00	21.2	n/a
Astronics Corporation/ATRO	13.70%	$13.38	$13.95	-4.09%	$13.00	33.3	n/a
Berkshire Hathaway B/BRK.B	8.70%	$3,043.00	$3,069.00	-0.85%	$2,900.00	14.7	n/a
Cash	17.80%	$1.00	$1.00	n/a	n/a	n/a	n/a
Cell Genesys, Inc./CEGE	2.90%	$5.02	$6.19	-18.90%	$6.50	n/a	n/a
Culp/CFI	2.80%	$4.89	$4.66	4.94%	$4.15	n/a	n/a
Gencor/GNCI	7.50%	$9.40	$9.25	1.62%	$8.50	3.6	n/a
Headwaters/HW	2.90%	$25.56	$27.45	-6.89%	$25.00	8.2	n/a
K-Tron International/KTII	4.40%	$51.00	$47.80	6.69%	$40.00	17.6	n/a
OMI Corporation/OMM	19.80%	$21.65	$18.64	16.15%	$18.00	8.49	1.80%
Protein Design Labs/PDLI	1.10%	$18.41	$20.25	-9.09%	$24.00	n/a	n/a
Terra Systems/TSYI	0.70%	$0.65	$0.70	-7.14%	$0.70	n/a	n/a

Performance

The chart below highlights one of the important aspects of investing we have touched on before. You don't have to be right all of the time to do well. Of the 14 issues we have owned at some point this year, eight have positive returns and six are in the red. We are batting barely above .500 and we still are soundly outperforming the market average. A large portion of the results is just due to fluctuations over the short six month time period. There is not a lot of skill in out performing the market for six months or even a year or two. This in part explains some of our paranoia over outperforming the market over an extended period of time.

In June we again widened our lead over the S&P 500 average. We are up 9.0% at the halfway point of 2006 compared to the S&P 500's 1.8%. Since we began publishing two and a half years ago we have an even more commanding lead. Over the 30 month period, our portfolio has returned 62.8%, compared to the S&P 500's 14.2%. We are in a good position to accomplish our goal of doubling our money every five years.



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