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Risk

You will not have enough money to retire on. The return you receive on your investments will not be enough to meet your goals for retirement. You will pay too much for a stock you buy. You will fail to beat the market averages. These statements are not some kind of foreshadowing, they help summarize how we view risk at BCIA. This is a great deal different than what you will find in the investment community. Risk to them has a much different meaning. At BCIA we have a philosophical difference with these accepted principles. They just do not make a lot of sense to us.

Too much...Not enough...What is it and how to control it.

The whole accepted notion of risk starts out with the idea that markets are efficient. For the stock market this means that all information is incorporated into the price of a stock nearly instantaneously. Rational people will pay more or less for a stock based on whether they view this new information as beneficial or detrimental to the company. All rational people will not see the same information in the same manner so they surmise that folks who feel strongly one way or another will cancel each other out and those with the average view will determine the change in price. Logically, if all important information is taken into consideration, then the price reflects the actual value of the company in the stock market. You should not pay more than a company is worth or be able to buy a company below its true (intrinsic) value. Accordingly, it is useless to try to buy companies you think will do better than the market because it can't be done without added risk. The only objective that you can accomplish is to reduce risk. This is very fortunate for us because it assures that we have plenty of bargains to choose from.

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This theory of risk is accepted widely in academic circles. The vast majority of college finance classes preach it as fact. They break risk down into two parts. One part is diversifiable risk. This risk can mostly be eliminated by holding many (40 or more) securities. Supposedly, rational investors will eliminate diversifiable risk in their quest to avoid risk. The other part is market risk. Market risk is represented by beta. Beta is the tendency of a stock to move with the market as a whole. If a stock track the movement of the market perfectly it will have a beta of 1. A stock that drops 20% when the market falls 10% will have a beta of 2. A stock that move up by 20% when the market moves up 5% has a beta of 4. The change in the price of a stock contributes to its risk. To minimize the risk in your portfolio, you want the average beta of the stocks in your portfolio to be something close to 1.

Again, this is based on the fact that investors look to avoid risk and that markets are reasonably efficient.

Risk

Coming soon our new redesigned, more user friendly website. See us at www.ebcia.com.

Another way to reduce risk is to spread your money over different asset classes. Stocks, bonds, cd's real estate each make up a different class of assets. The theory is that when one asset is moving down another may be moving up and making money for you. Stocks can be broken down into value stocks, growth stocks, international stock, large capitalization stocks and on and on. Bonds can be broken down by the length of time the bond is issued for, investment grade, junk and more. This is supposed to reduce risk.

To all of this we say baloney. In our opinion it is great that many people believe this because it helps present many opportunities for us to make money. We however, find it laughable. The accepted definition of risk is a recipe for market average returns. At the beginning of this article we gave some examples of what we consider risk. Primarily we consider overpaying for a company the largest risk you can take. Finance theory says that the current price of a stock reflects its true worth. We would argue that not all information that affects the price of a stock should, and some affects it incorrectly. In other words, sometimes Wall Street gets it wrong. To us it makes sense to look for companies that we feel we understand better than others, and buy when they are selling for less than we feel they are worth.

Investing in a large number of stocks is a great way to make sure you have a more difficult time beating the market. It is very difficult to follow 40 companies and understand them well. We struggle when the number of companies we own moves above 15. There are times when we find it difficult identifying 15 companies we feel we understand that also are selling for less than they are worth. That is not to say that there are not more than this number, only that we may have trouble finding this many that we can understand and are aware of. There are some companies that others will understand far better than us that we will have no interest in buying because of our lack of understanding. Modern finance theory says we have a greater risk because we have a small number of stock in our portfolio. We feel differently.

Beta is another poorly conceived idea in our view. Here is a company that does a great job illustrating this fact. It is a company we have no interest owning because we have no clue about the business. The company is Tenneco. They make exhaust systems (Walkers exhaust systems) and suspension parts (Monroe shocks and struts) for cars and trucks. Their price has risen $3 to over $10 dollars in the past year. They have a beta of 1.7. This means that this stock much riskier than the overall market. We own a stock OMI that has a beta of .45 which then should be less risky than the market. OMI's price has varied from around $5 to over $10 over the last year. Because Tennecco's price has had more up and down swings than OMI it is more risky. If we had a thorough understanding of Tenneco and were sure that we could have bought it cheaply we would have gladly invested in it. In this case the stock price rising sharply made it risky according to the concept of beta. OMI was less risky because it moved more smoothly upward. We don't care what a stocks beta is, as long as we can buy it cheap enough.

In order to write this article we looked at the beta of the stocks in our portfolio. The numbers all were a great deal lower than one. Our stocks should not move as much as the market average. The theory says that we are accepting less risk. Likewise we should expect lower returns. I guess this is no help in explaining why our returns handily beat the market last year and have a healthy lead this year. We have also kept a sizable portion of our assets in cash for the past few years earning pa-

Risk

thetically low returns. This has the effect of reducing our returns over what they would have been if we were fully invested. I can assure you we do not do it to reduce risk. We always want to have some money available for the next big bargain. You never know when it will come along.

We also ignore the idea of investing in other asset classes. We invest in stocks because historically they have the best returns over time. Over virtually every ten year period, stocks outperform bonds. Using the commonly accepted principle of adding bonds to your portfolio to reduce risk will also lower your returns over time. This is not our idea of decreased risk. You will not have as many sharp ups and downs, but who cares. You will likely have less money at the end of any ten year time period. Bonds can have very generous returns like during 2002. That would have been great however, you have to be adept at investing in bonds. We are not. We stick to what we know and that is stocks of publicly traded U.S. companies.

So far we have violated the rules governing both diversifiable risk and market risk. Maybe if we ignore them they won't affect us. More likely academia has too much invested in these ideas to admit that they are wrong. We are content to continue ignoring these rules based on the practical evidence we have seen that proves them wrong.

Here we are again back to Warren Buffett. Buffett has earned an average return of more than 23% over the past 50 years. According to modern finance theory, the odds of someone beating the market as frequently as he has is less likely than winning the lottery a half a dozen times. He is not the only protégé of Ben Graham who has superior result over an extended time period. All of these investors look for a margin of safety when they buy stocks. They look to pay much less than a company is worth. The margin of safety is what truly reduces risk. You will hear this concept mentioned in very few college finance courses.

This is how you eliminate risk from your portfolio. Adding more stocks that you do not understand well can only lead to poorer performance over time. Diversification is protection against ignorance not risk. If you truly do not understand the companies you have invested in, adding more of them will help insulate you from the inevitable mistakes you will make. You can see this idea would be comforting after you have been told that all stocks are priced at what the company is worth and that you have a small chance of beating the market. If you are looking for market type returns, buy an index fund that will mirror the performance of the market. This is a great way to diversify. When you do find a stock that you understand that is selling at less than it is worth, you need to buy lots. Paying less than it is worth is your protection. If something goes terribly wrong, the price can't drop too far because the company is already selling cheaply.

As we have stated before we sleep comfortably at night even while owning only nine companies. Some we have owned for ten years. Each of these we have a thorough understanding of how they operate. Overall, we have no idea what the beta of our portfolio is or how much diversifiable risk we have failed to eliminate. We are content to strive to beat the S&P market average by operating with a margin of safety.

Q1 Earnings

First Quarter earning season has passed with mixed but encouraging results. Aflac and Amgen both had strong quarters and beat their earning estimates. Amgen had a 35% increase in sales and an even larger 41% increase in earnings. Sales of their three largest drugs all showed strong increases. Aflac had a healthy 21% increase in their first quarter earnings.

Astronics had sharply lower earnings than the first quarter of last year which we had expected. They have had a steady

stream of contract wins and gave a rosy outlook for next year. They landed the exterior lighting contract for the new Eclipse 500 jet. The Eclipse is still waiting to receive its FAA certification which is expected to occur in 2006.

Consolidated Tomoka had a relatively quiet quarter. None of their large land sales closed during the quarter. They did report that they now have $60 million of income property generating revenues. Their stock price will probably remain soft until their next blockbuster earnings quarter.

OMI had a fabulous quarter. Their quarterly earnings exceeded all of their yearly earnings numbers since 1984 except two. This strength was due to record high tanker rates. As strong as their earnings numbers were, they may beat those numbers next quarter. Rates have remained incredibly strong. The second quarter is traditionally weaker than the first quarter for the tanker companies. Full speed ahead!

Ultralife Batteries had earnings that jumped from .02 to .22 in this years first quarter compared to last years. They have continued to land military contracts for their batteries.

Three other companies we own had unspectacular quarters. Freddie Mac will not announce their earnings until June or July because of their earnings restatement. Berkshire had a solid quarter and we have little concern with their earnings on a quarter to quarter basis due to the way in which the company is run. Cell Genesys is still losing money and inching closer to moving their first drug candidate into phase three clinical trials.

Fat Mailboxes Part II

Here are our recommendations for voting your proxy statements for this year. Overall it is a year with very few controversial proposals. Last month we included our recommendations for six of our nine companies. This month we stated we would provide our recommendations for the other 4. Oops, we included six companies last month and only have two more to report on. Freddie Mac will not have a proxy statement available until sometime in August.

Matter	Recommendation
Cell Genesys–	
1. To elect directors to serve until the next annual meeting of stockholders or until their successors are elected.	For
2. To approve the amendment of the Company's 2001 Nonstatutory Stock Option Plan to increase the number of shares of common stock reserved for future issuance by 500,000 shares and to prohibit future option repricings under the 2001 Nonstatutory Stock Option Plan without the approval of the Company's stockholders.	Against
3. To ratify the appointment of Ernst & Young LLP as independent auditors of the Company for the fiscal year ending December 31, 2004.	For
Ultralife Batteries–	
1. to elect directors for a term of one year and until their successors are duly elected and qualified;	For
2. to approve and ratify the selection of PricewaterhouseCoopers LLP as the Company's independent auditors for the fiscal year ending December 31, 2004;	For
3. to approve the adoption of the 2004 Ultralife Long-Term Incentive Plan;	Against

We are advising that shareholders vote against both companies stock option plans. The management of both of these companies are well compensated and have received overly generous option grants in the past. For this reason we recommend voting against those two proposals.

Company	Ticker Symbol	Portfolio Percentage	Current price	Buy Price (less than)
Aflac	AFL	3.50%	$39.15	Hold
Amgen	AMGN	5.00%	$56.42	$60.00
Astronics Corporation	ATRO	5.00%	$5.03	$5.15
Berkshire Hathaway B	BRK.B	17.50%	$2881.00	$3050.00
Cash		16.50%	$1.00	n/a
Cell Genesys, Inc.	CEGE	2.50%	$10.02	$12.75
Consolidated-Tomoka Land Co.	CTO	25.50%	$33.71	$36.00
Freddie Mac	FRE	9.50%	$57.14	n/a
OMI Corporation	OMM	12.50%	$10.27	$10.00
Ultralife Batteries	ULBI	2.50%	$18.34	$20.00

The BCIA Portfolio

Last month we reported that price moves over the last month had been pretty uneventful. This month we make no such claim. Almost all prices are down including the stocks in our portfolio. Much of this decline is due to the uncertainty in the world around us. Fear will often drive prices down. Greed often brings them back up. We prefer to do our buying when people are fearful.

One very recent development involves OMI. They announced they are in talk to merge with another shipping company. We have our work cut out for us analyzing the implications of this merger if it happens.

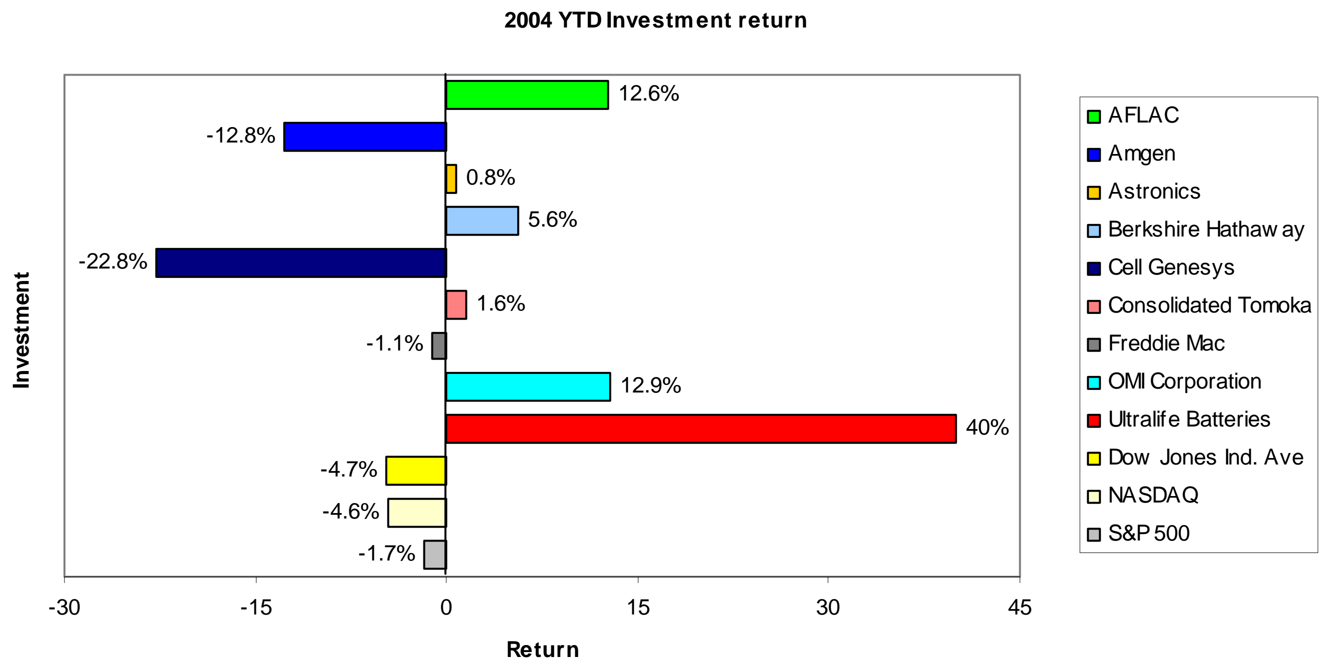
Several of our companies are selling for rather reasonable prices. Amgen, Astronics, Berkshire, Cell Genesys, Consolidated Tomoka and Ultralife Batteries are all selling at less than our buy price. If you have not purchased one or more of these companies yet, now is a great time to pick them up at fairly reasonable prices.

One other small change from last month. We have purchased one of those smoke detectors with a ten year warranted battery from Ultralife Batteries. For any of you who dread changing smoke detector batteries yearly, this is a great way to spend $20. In the long run I expect that it will be a cost savings and a convenience. The smoke detector that I replaced was due to be replaced...really, it was.

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.

Still Outpacing S&P 500

We have been able to keep ahead of the return on the S&P 500 so far this year. Our portfolio is up 3.7%, while the S&P average has returned –1.7%. That leaves us in front by 5.4%. This is about half of the lead we had a short time ago. The good news is that many of the stocks we own are selling at much more reasonable prices. With the economy's strong performance over the past two quarters and expected strong performance going forward, we expect that this correction will prove to be a good buying opportunity. The graph below shows the performance of the stocks currently in our portfolio so far this year. We have excluded three stocks that we sold earlier in the year. Two of those stock we sold had nice gains for the year and the other one had a small negative return. You can see that six stocks have positive returns for the year and three have negative returns so far. Our four core stocks (Berkshire, Consolidated Tomoka, OMI and Freddie Mac) have only one loser among them. The graph is nowhere as dramatic as the year end 2003 graph that had so many double digit winners. The company with the largest return, Ultralife Batteries, makes up only a small part of our portfolio. It has very little effect on our overall return figure. Nonetheless, we will gladly accept whatever contribution it makes.



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Interest Rates

Principles Don't Change.

Interest rates affect everything from the price you pay for housing to the cost of a gallon of milk.

Interest rates change the price of everything. Yes, everything. Recently, there has been a great deal of attention devoted to the exercise of guessing when interest rates are going to move higher. We are very familiar with the fallout from rate changes, but we don't concern ourselves with excessive worrying about when they are going to occur.

Interest rates are determined officially by the Federal Reserve Board headed by Alan Greenspan. The Fed reacts to changes in the economy and adjusts the interest rates to accomplish several objectives. The Fed may lower rates to spur economic activity or increase rates to fight off inflation. Interest rates are not solely determined by the Fed. There are many markets that have their own interest rates determined by a number of factors. In the housing market you may have one interest rate, another in the market for certificate of deposits and another for government bonds. If these rates change to a large extent the Fed is forced to act and change their rates.

The Fed considers its primary objective to keep inflation low. To do this they will raise rates to slow the growth in the economy. The economy is all of the transactions that go on in the U.S. Higher rates mean that it costs more to borrow money. Someone looking to buy a house will tend to borrow less. This lower amount will result in having the same cost as borrowing more when the rates are lower. The economic growth rate does not care what interest rates are, it only measures how much is bought and sold. If you were planning to borrow $100,000 at 5% and interest jumps up to 6%, you may end up borrowing only $90,000 for that new house. So the economy registers only a $90,000 transaction instead of a $100,000 transaction. Your neighbor may put off buying that new car she was planning on. Many smaller or delayed transactions mean a slower rate of economic growth or with too large an effect, a recession. A recession is a negative growth rate in the economy. This means that the economy will actually get smaller than the previous period.

Inflation is highly correlated with rapid economic growth. Inflation will make the value of a dollar today worth less in the future. It is worth less because inflation causes prices to rise meaning buying that new car next year will cost more than it would this year. You will need more dollars. Inflation is also more prevalent in times of low interest.

However, we originally said raising interest rates will change the price of everything. By analyzing the house example above you can see the pressure that higher rates have on housing prices. Imagine now that you are selling your house. When interest rates are low you will have more people who can afford to buy your house. Borrowing $100,000 at 5% will result in a payment of approximately $540 for a 30 year mortgage. This is the same payment that would be generated borrowing $90,000 at 6%. The folks who could afford your house and the ability to borrow the $100,000 when interest was at 5% can no longer afford your house when interest rates jump to 6%. What effect will this have on the price of your house? You may be forced to lower the price you are selling your house for to attract a buyer. This trend also works in reverse. With interest rates at extremely low levels for the past few years we have seen a rapid rise in housing prices. This illustrates how changes in interest rates can affect the prices in the housing market. Now all we have remaining is to explain how interest rates affect the prices of everything else.

Interest Rates

Interest rates only affect part of the price of goods and services. Other factors may cancel out the affect that interest rate changes have. Oil is a good example of this. OPEC has cut the supply of oil and the demand for oil is increasing. This is driving the price up.

Higher interest rates have the effect of decreasing the amount of money that people have to spend. People buy on credit. With interest rates higher, more of consumers income will go towards making interest payments on their credit balances. If people have less money to spend after making payments on their debt, it means they will be buying less goods and services. If manufacturers and service providers sell less goods and services, they will have pressure to lower their prices. They will try to increase sales by lowering prices. Lower prices can also mean lower profits for companies.

That does not mean that prices for all goods and services will go lower. It only means that their will be pressure to lower the price. Above we said that raising interest rates is the tool that the Fed uses to keep inflation low. This is how higher rates cause that to happen.

Higher rates, lower asset values.

This also plays into the stock market. Interest rates affect stocks with much similarity. When interest rates rise, investments that pay interest start to look more promising. A saver that is not willing to tie his money up in a CD that pays 3% may be willing to do so when rates rise to 5%. The price of bonds becomes cheaper. Interest rates and bond prices are inversely related. When interest rates rise bond prices drop. A bond with a lower price will be a more attractive investment. There is a limited pool of money that people can earmark for investing. All of these investments are in competition with each other for investment dollars. If CDs and bonds are attracting more money, that means less is available for investment in stocks. This translates to a lower demand for stock. When demand is lower prices tend to fall. This explains the reaction that has occurred on Wall Street the past few weeks with the hint of an interest rate increase.

Stocks can be thought of as providing a yield something like interest rates. This can be calculated by dividing a companies earnings by its share price. The company in our example earns $1 per share. If the company is selling for $20 dollars on the stock market then it has a 5% ($1/$20*100)earnings yield. If interest rates are 5% and jump up to 10% investor will want to earn more from stocks. They would expect stocks to also yield somewhere near 10%. The company still earns $1 so we could expect the share price to drop to $10 ($1/$10*100) to give the same yield.

Interest rates do change the value of everything. Sometimes the effect will be small and overcome by other factors so that you don't see it. Other times the effect will be fairly dramatic. The risk of rampant inflation is far worse than the changes caused by rising interest rates. This discussion in no way covers all of the effect that interest rates have on the economy and value of goods and services. We only hope it gives you a basic understanding of why some of recent events have played out the way they have.

If ever there are any questions about article or content please feel free to email us at subscribe@ebcia.com. Until next month.

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