The Commonsense

INVESTLETTER

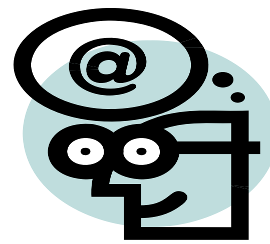
Volume 4 Number 4

Coming Around to Our Way of Thinking

Wall Street

- DJ 11168
- S&P 500 1270
- NASDAQ 2179

Slowly the world of modern finance is coming around to our way of thinking. A 1997 study that struggles to understand why the returns on stocks exceed the returns from bonds by such a large margin correctly reaches the conclusion that stocks are less risky than bonds over the long term. Just as so often has occurred in the past, radical new thinking has failed to gain mainstream acceptance. Many prefer to cling to comfortable, yet disproved theories rather than undertake the painful task of admitting that they are wrong and the uncomfortable consequences this often brings about. Ego often rules over intellect.



Modern Finance may turn out not to be so Modern after all.

A paper by Bernstein and Thaler in 1997 titled *Anomalies: The Equity Premium Puzzle* correctly concludes that stocks are less risky than bonds over long time periods. The time period at which the risks equals out is about 13 months. Over a twenty year period stocks have never declined in real value. (Real value is the value minus the effect of inflation. If you earned 10% and the rate of inflation is 2% you have an 8% real return.)

It is satisfying to see that more is being written correcting this long lived fallacy that is still accepted as gospel truth in the popular investment community. At Investletter, we have maintained that the definition of risk used in modern finance is the underlying problem in deriving satisfactory proof of the popular theories. The definition of risk used is too simplistic to represent a real world model of how investors really interpret risk. Risk encompasses more than stock price volatility. Investors time frames are an important factor along with prior experiences, current level of wealth, ultimate use of the pool of funds and interpretation of information (in the short run). While it may be possible to formulate a better, albeit more complex definition of risk it is little concern to us. That is an exercise better left for the academics to stumble upon.

The important implication for investors who plan to invest for any reasonable period of time (longer than a year at a minimum) is that most of their assets should be invested in stocks. For most who are investing for long term goals the vast majority of their assets should be invested in stocks. We have been extremely comfortable with this concept for a very long time. It is the basis by which we formulate our advice. Our 14 years of experience also bears out the wisdom of this approach. Until the mainstream investing community catches up with us we can enjoy a significant advantage over those under the influence of the Pro's.

When you hear pundits talking about how risk is higher for stocks than bonds remember that they are taking a very myopic view. For most investment timeframes investors are considering, the reverse will be true. Enjoy your larger returns that come along with lower risk. You are still in the minority.

Inside this issue:

Watch List

The recent slide in prices has made many of the candidates on this list much more attractive. Three companies have attracted our attention in recent weeks. Canadian Natural, XTO Energy, and Rayonier have all shown nice dips. Our quest to find another solid energy stock may be solved by Canadian Natural, which is an oil sands producer and XTO which is a natural gas play. Natural gas is extremely interesting. The supply was upset by last year's hurricanes just as oil production was. This led to tight supplies going into winter, which led to prices peaking over $15 per thousand cubic feet. Now the price has dropped back into the mid $6 range. Quite a wild swing. Natural gas producers in this country are struggling to maintain production at current levels. Many of the current holes are running dry. Companies are making huge investments to bring new sources online but this is not enough to increase supplies. The US has been increasing imports of liquid natural gas.

We all hear a great deal about how we need to cut back on oil consumption but we hear very little about the difficulty keeping up with the demand for natural gas. XTO is one company with an aggressive exploration plan for developing new natural gas wells. The increasing tightness of the gas supply should lead to a strengthening of gas prices in the future. XTO is well positioned to take advantage of this trend. The current weakness is linked to the elevated supply we have currently due to the mild winter we had this year. A seasonally cold winter and gas prices could be expected to shoot back up. The share price of gas producers would move higher with the price of gas. Any disruption due to hurricanes or other forces would also tend to cause prices to spike, again pushing the share price of gas producers higher.

Another company we are glad to see the share price dropping is Rayonier. Their primary product is timber production. Timber has some neat characteristics. If prices are low producers can elect not to cut down their trees. The result is that for each year they avoid cutting down a tree it becomes larger. When you don't sell, your inventory becomes larger (as in bigger trees). They also have recently formed a subsidiary to sell off some of their larger land holdings for real estate development. The revenues this operation is targeted to generate will be a nice addition to an already solid business. The other nice feature the company has is their nice, nearly 5% dividend. This is as much as a one year CD and you still have the opportunity for price appreciation of the shares. If we can get the company cheap enough it will make for a nice, conservative investment.

Company	May price	April price	Change from April	P/E	52 Week High	52 Week Low	Estimated '06 EPS	Dividend Yield
Altria Group, Inc./MO	$72.35	$73.16	-1.11%	12.8	$78.68	$63.60	$5.31	4.36%
Bioanalytical Systems, Inc./BASI	$6.25	$6.62	-5.59%	n/a	$7.80	$4.75	n/a	n/a
Canadian Natural Res./CNQ	$53.74	$60.20	-10.73%	11.6	$64.38	$28.51	$3.55	0.38%
CSP Inc./CSPI	$7.05	$7.25	-2.76%	n/a	$11.96	$5.59	n/a	n/a
Kensey Nash/KNSY	$29.45	$30.17	-2.39%	27.1	$34.00	$19.32	$0.67	n/a
Landauer, Inc./LDR	$46.60	$49.20	-5.28%	19.6	$54.00	$43.11	$2.18	3.62%
ModPac/MPAC	$10.70	$10.84	-1.29%	n/a	$18.60	$10.02	n/a	n/a
QLT Inc./QLTI	$7.22	$8.22	-12.17%	16.4	$11.35	$5.93	$0.49	n/a
Rayonier/RYN	$38.89	$41.16	-5.52%	22.0	$47.50	$34.00	$1.68	4.87%
Tejon Ranch Co./TRC	$41.68	$45.13	-7.64%	n/a	$62.72	$39.15	n/a	n/a
XTO Energy/XTO	$41.22	$42.35	-2.67%	10.0	$50.01	$30.50	$4.01	0.56%

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.

Several of our investments have shown considerable weakness. PDL BioPharma (as Protein Design Labs is now known), Headwaters and Cell Genesys all showed significant drops. The only one that causes us any concern is Headwaters. The tax legislation they have been waiting for has not materialized as of yet. There is a possibility that the legislation could be done by July but we have seen so many projections fail to come to fruition that we are becoming a bit skeptical. The absence of this legislation will cost the company millions of dollars in tax breaks. This issue regarding section 29 also affects Gencor.

PDL BioPharma is just going through a normal fluctuation in price. At some point the value will move up again. Biotech stock are notoriously volatile. Cell Genesys has also been beaten down. They appeared on the regulation SHO list that highlights stocks that have significant naked short sales. It is likely that there is some illegal manipulation going on in their shares. The best cure will be for the company to make a very encouraging announcement regarding one of their drug candidates or to partner up with a more established drug company. With their price this low they also become a takeover candidate. It has been some time since one of our holding was gobbled up. CEGE could be next. The good news would be that the company would be bought at a healthy premium, while the downside is that it would not capture all the value that the shareholders could garner if the company can go it alone and successfully bring a product to market.

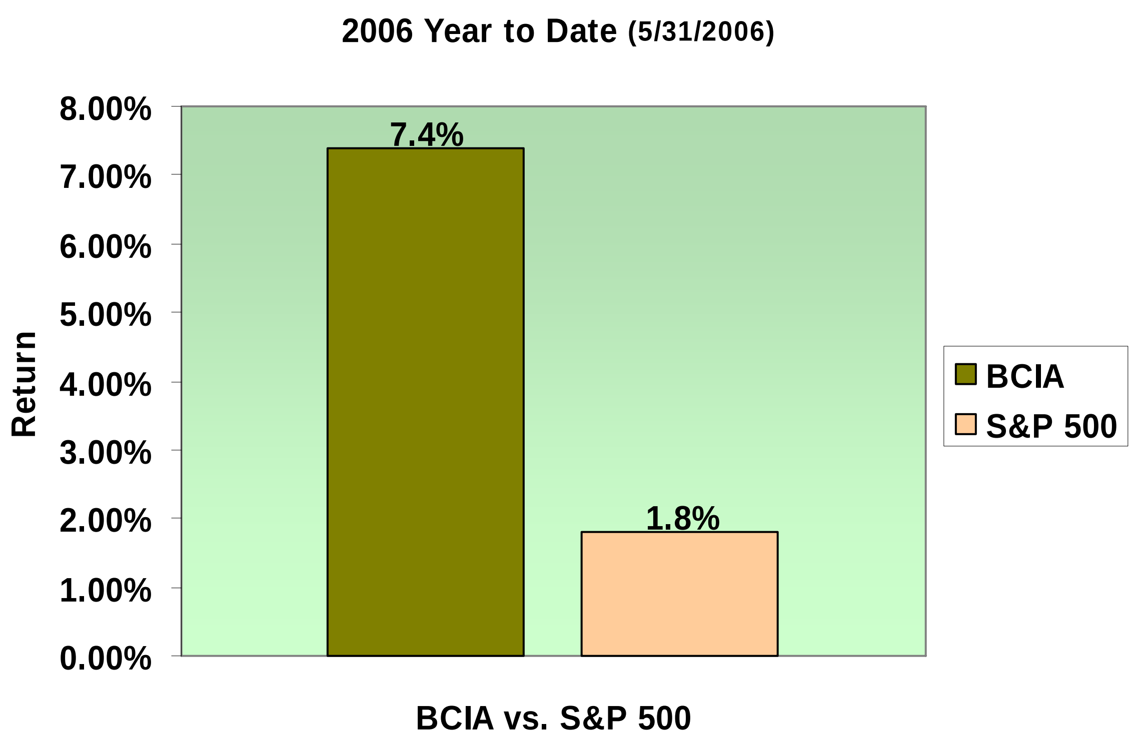
We have already added more shares of Astronics and are considering adding more shares of Cell Genesys. We are also looking into the prospect of adding more K-Tron if they are selling cheap enough and to lighten our Alico holdings while possibly adding some Rayonier (RYN).

Company	Porfolio Percentage	May price	April Price	Percentage Change	Buy Price (less than)	P/E	Dividend Yield
Alico/ALCO	17.40%	$55.00	$50.20	9.56%	$50.00	44.0	2.00%
Amgen/AMGN	3.90%	$67.59	$67.70	-0.16%	$60.00	22.5	n/a
Astronics Corporation/ATRO	12.10%	$13.95	$14.45	-3.44%	$13.00	35.0	n/a
Berkshire Hathaway B/BRK.B	8.90%	$3,069.00	$2,952.00	3.96%	$2,900.00	14.7	n/a
Cash	17.30%	$1.00	$1.00	n/a	n/a	n/a	n/a
Cell Genesys, Inc./CEGE	3.60%	$6.19	$6.80	-8.97%	$6.50	n/a	n/a
Culp/CFI	2.70%	$4.66	$4.64	0.43%	$4.15	n/a	n/a
Gencor/GNCI	7.50%	$9.25	$9.30	-0.54%	$8.50	3.6	n/a
Headwaters/HW	3.20%	$27.45	$33.68	-18.50%	$25.00	8.0	n/a
K-Tron International/KTII	4.20%	$47.80	$49.89	-4.19%	$40.00	16.5	n/a
OMI Corporation/OMM	17.30%	$18.64	$19.28	-3.32%	$18.00	5.5	2.10%
PDL BioPharma/PDLI	1.20%	$20.25	$28.78	-29.64%	$24.00	n/a	n/a
Terra Systems/TSYI	0.70%	$0.70	$0.70	0.00%	$0.70	n/a	n/a

Performance (March)

Again, we have widened our lead over the S&P 500 as of the end of May. Overall the markets have shown signs of weakness. The combination of interest rate hikes, the concern of increasing inflation and worry over a slowing economy have caused the recent slump in the stock market. That is good for us. We have been able to add some shares of companies we already own and have been seeing some bargains in issues we don't own. The market is pretty fairly valued overall. We see plenty of issues that are selling at attractive prices and a few that are selling for prices higher than we feel they deserve.

Our 5.6 percentage point lead over the S&P 500 average gives us a bit of breathing room in our quest to outperform the market for the seventh straight year. As long as corporate profits stay strong we can expect to see the stock market hold its own this year. If corporate profits tail off then the forces mentioned above could allow the markets to finish in the red for the year. Either way our aim is to finish in positive territory.



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