The Commonsense

INVESTLETTER

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Wall Street:

- DJ 8500
- S&P 500 919
- NASDAQ 1774

So Called Experts

People take great comfort in believing we live in a predictable, controllable world. It just isn't so. We really have very little control over the future that awaits us. Small events can play a dominating role in your future course for years to come. Injuries in a car accident could dramatically alter your life. Investing with Madoff dramatically altered the life of retirees who thought they were set for life.

Academic and expert forecaster should not appear in the same paragraph. The record of forecasters in general is abysmal.

To help reduce this sense of helplessness in our lives, people often get a sense of comfort from listening to the forecasts experts provide us. The forecasts help clear up a murky future and provide some expectation for our future.   But, what if the forecasts are no better than flipping a coin or a monkey throwing darts at a list of options. All too often this is the true picture of forecasts. The experts are no better than you and me at predicting the future, maybe even worse. That people continue to crave forecasts persists, because we have trouble keeping score. A prediction by a talking head on CNBC that auto sales will total 15 million in 2010 is unlikely to be followed up on in 2010. It will long be forgotten who said what and it will be on to the next brave prediction.

Investors are more than willing to pay for expert opinions on market forecasts even when the opinions are not expert. This would fall into what J. Scott Armstrong calls the Seer-Sucker Theory. "No matter how much evidence exists that seers do not exist, suckers will pay for the existence of seers." The evidence against experts does not come from a limited number of studies, it comes from a wealth of research. In some instances experts appear to be at a disadvantage to others less knowledgeable.

In one study, mental health workers, students and people with no mental health training were asked to distinguish between 48 normal people and 48 psychiatric patients by looking at paintings the subjects had done. All of the subject's predictions were better than chance, but the accuracy was not influenced by education. Research on stock market predictions by experts have been shown time and time again to be no better than the man on the corner. My local newspaper provides a great example of this phenomena. At the beginning of each year the business section goes to their selected markets seers and examines their prior years predictions and allows them to make new predictions for the year ahead. The results are laughable. The nine experts predicted the Dow Jones Industrial Average would end 2008 between 14,100 and 15,200. The Dow ended the year at 8,516. The expert that predicted 14,100 had a 40% error and that was the best performance.

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On top of their lousy forecast of the Dow average they are also lousy stock pickers. Each expert is given the chance to pick 5 to 10 stocks they think will perform well in the next year. Four of the nine experts had more than 50% losses on their picks and only one performed better than the market average. All nine of them made new predictions for 2009. Not one was too embarrassed by their incompetence to refrain from taking their chance to appear foolish again at the beginning of 2010. If I were a client, I would have serious reservation having any one of these experts exert control over my investments.

Think about experts forecast of weather conditions 100 years in the future as a basis for economic changes to counteract global warming. Compare that with the accuracy of the weather forecast for next week. Would you bet the economy on the word of the experts?

What is it about experts that hampers their ability to beat the lay person when it comes to predicting? This quote helps sum it up. "Expertise … breeds an inability to accept new views." - Laski (1930). Experts tend to be better at ignoring information that proves them wrong. Experts will tend to see relationships they expect based on current academically accepted ideas. Non experts may initially see things the same way, but have an easier time adjusting to disconfirming evidence. The experts have too much academic baggage and have a hard time accepting that the data doesn't confirm their ideas. They have to much invested in the current academically accepted models. A finance professor who has helped build the idea of modern portfolio theory is going to have a hard time accepting evidence that disconfirms his/her idea of reality. It may mean a careers worth of research has been rendered worthless. The layperson on the other hand has no such reputation to preserve and is not married to the current line of reasoning. They can easily discard a line of thought that is proven wrong.

A study using the same research paper with two different conclusion, one favoring the common wisdom of the day and one refuting it was presented to 75 reviewers. Professors and other intellectuals belonging an organization that publish a research journal a paper is to be published in act as reviewers to make sure the paper is publication worthy. The reviewer was more likely to accept the paper when the conclusion agreed with the common accepted theory. Even scientific proof is not enough to dislodge an experts view of how the world works.

If you want to make a professor happy show him or her evidence that confirms what they believe. If you want an accurate forecast poll a couple dozen of your friends, they may not be right, but the advice will come much cheaper than hiring an expert with little difference in accuracy.

People want to believe that experts can provide a measure of predictability in their lives. It helps us feel more in control. In the physical sciences, the laws can yield predictions with great accuracy. Drop a brick from a second story window and we can calculate how long it will take to hit the ground. This does not equate to making predictions in situations involving social interaction. Markets involve complex interactions that do not yield to simple models. Treating markets and other social phenomena as if they can be tamed in the same fashion as physical laws is both naïve and dangerous. Just because we can understand how something works does not mean we can predict its future state.

Remember the next time you watch a business show involving experts making predictions about the future, they are probably on the show based on how entertaining they can make predictions sound, not how accurate they are at predicting. Odds are nobody will ever bother to check their accuracy anyways. Fortunate for them.

Still Naked After all These Years

Naked short selling is alive and well although temporary rule changes have made it much more difficult. Now the damage to an issuer's share price has to be done in a 3 day timeframe, although multiple entities can team up to shift naked short sales around to drag out the effects of these sales. The whole purpose being to drive down a security's price. This temporary rule expires at the end of July and the SEC's next step will be an indication of how strongly new Chairman Shapiro intends on protecting investors. Currently the tables are tilted in favor of the large sophisticated prime brokers. This does not fit with the SEC's mission. From the SEC website:

> *"The mission of the U.S. Securities and Exchange Commission is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation."*

The SEC says that investors are major sources of information. When it comes to naked short selling not a single complaint in 5,000 resulted in regulatory action. You be the judge.

Nowhere is it indicated that the SEC needs to protect loopholes for large brokerage firms to manipulate security prices and convert investors wealth to their own. The SEC is charged with regulating securities exchanges, securities brokers and dealers, investment advisors, and mutual funds in the interest of promoting fair dealing, and protecting against fraud. The main thread that runs through their mission is to protect investors and regulate the machinery that investors interface with, whether it is an exchange to execute a trade or a mutual fund to serve as an investment vehicle.

The SEC does indicate when discussing their mission that investor's concerns are taken seriously and that they consider this a major source of information. The question is how major a source? Again, from the SEC website:

> *"One of the major sources of information on which the SEC relies to bring enforcement action is investors themselves — another reason that educated and careful investors are so critical to the functioning of efficient markets."*

Fortunately, we have recently been provided with some indication of how seriously the SEC takes investor complaints regarding the negative effects naked short selling has on share prices and the survival of affected companies.

The SEC's Office of Inspector General (OIG) released a report on Practices Related to Naked Short Selling Complaints and Referrals. In it were details of complaints being routinely disregarded, but don't take my word for it, here it is from the OIG's report:

> *"Of approximately 5,000 naked short selling complaints received in the ECC between January 1, 2007 and June 1, 2008, only 123 (approximately 2.5 percent) were forwarded for further investigation. Moreover, we found that these complaints were forwarded only because the complaint subjects were involved in ongoing Enforcement investigations. None of the forwarded complaints resulted in enforcement actions, though one of the com-*

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plaints referenced a pending enforcement action involving naked short selling. Furthermore, only six of the approximately 1,900 complaints entered into Enforcement's CTR database during the period we examined, alleged naked short selling. Based on the data available to us, these complaints led to no enforcement actions."

This doesn't exactly scream of investor protection. The only way a complaint had any chance of being forwarded was if the subject was already involved in an ongoing enforcement investigation. Out of 5,000 complaints not a single one resulted in an enforcement action. What is the implication; that thousands of investors complaints are worthless? Or is it that the SEC is running interference for the powerful Wall Street interests who will be offering the upper echelon at the SEC cushy jobs once their time with the agency is up? Don't want to step on the hand that feeds you. Only six of the referrals were entered into a database that is received by Headquarters or Regional Office Enforcement staff before they were ignored. At least 4,994 were screened out and tossed aside before they received any kind of consideration.

The second line of defense uses some good ole circular reasoning to defend their actions. The enforcement division maintains that naked short selling complaints it receives generally do not provide sufficient information to warrant pursuit of the complaint. At the same time the SEC prevents the release of any information that shows who is responsible for naked short selling. They maintain that it is a proprietary trading strategy and they are not at liberty to divulge this information. So much for protecting the little guy. At the same time any investor owning 5% or more of a company's shares much file a report with the SEC stating so. It is no wonder that complaints have insufficient information when it is the SEC that prevents the release of the information necessary to help make them complete.

We are patiently awaiting the changes that will hopefully come sometime this month. They will send a strong message as

Company	May price	April price	Change from April	P/E	52 Week High	52 Week Low	Estimated '09 EPS	Dividend Yield
Alico/ALCO	$25.55	$26.53	-3.69%	71.3	$50.32	$20.24	n/a	2.00%
American Pacific/APFC	$6.28	$7.09	-11.42%	7.3	$17.50	$3.90	$0.19	n/a
Arbitron/ARB	$19.91	$20.82	-4.37%	16.2	$50.87	$9.90	$1.45	2.20%
Arch Coal/ACI	$18.53	$13.97	32.64%	9.7	$76.00	$10.43	$0.42	1.90%
Astro Med/ALOT	$6.24	$5.51	13.25%	24.0	$10.00	$3.50	n/a	4.20%
Atrion/ATRI	$110.20	$89.56	23.05%	12.4	$118.00	$63.00	n/a	1.00%
Consolidate Tomoka/CTO	$31.53	$34.79	-9.37%	37.2	$50.57	$21.56	n/a	1.30%
Culp/CFI	$3.82	$4.50	-15.11%	n/a	$7.74	$1.30	$0.50	n/a
Diamond Mgt & Technology/DTPI	$3.75	$2.78	34.89%	n/a	$6.33	$1.84	$0.08	1.70%
Graham Corp./GHM	$13.01	$8.20	58.66%	8.0	$54.91	$6.85	$1.63	0.60%
Landauer, Inc./LDR	$57.63	$52.98	8.78%	25.2	$74.51	$46.08	$2.69	3.50%
Mesa Labs/MLAB	$20.00	$20.00	0.00%	13.5	$24.65	$14.50	n/a	2.00%
Rayonier/RYN	$40.00	$38.62	3.57%	21.1	$49.54	$22.28	$1.33	5.00%
Servotronics Inc./SVT	$6.10	$10.41	-41.40%	4.9	$16.53	$4.53	n/a	2.70%
Span America Medial Sys/SPAN	$10.87	$11.10	-2.07%	7.1	$13.50	$7.76	n/a	3.30%
Torm/TRMD	$10.35	$9.33	10.93%	0.8	$36.09	$7.50	n/a	n/a
Twin Disc/TWIN	$7.24	$6.82	6.16%	4.7	$22.94	$4.02	$0.94	4.00%

The Investletter Portfolio .

to who the new Chairman deems worthy of protecting.

In other SEC news, the agency has proposed changes in the proxy process that we strongly support. They have proposed that large shareholders should be able to have a director candidate included on the company's proxy statement to run against management's candidates. This is a small step in the right direction. It acknowledges that the owners should have some say in the makeup of the Board of Directors (BOD) of a company they own. As it stands now, an owner must produce his own proxy if he wishes to propose directors for election to the company's BOD. This is both complicated and expensive. Management gets to use company money and the owner must use his own funds.

Gaining the ability to propose one director is nice, but does not address why the owners can't propose candidates for all of the board seats up for election.

One more notable change has been made. Broker non votes will no longer be voted in favor of a company's director slate. When a shareholder receives a proxy and then does not relay his/her instructions to the broker holding his shares, the broker can vote the shares as they see fit. It is almost always in favor of managements candidates. Which makes sense if the brokers want to see further investment banking business from the company in question. If an opposing slate of directors put forward by a dissident shareholder is running close in voting the broker non votes cast in favor of the company can be enough to cause their defeat. This power is being taken out of the brokerage firms hands.

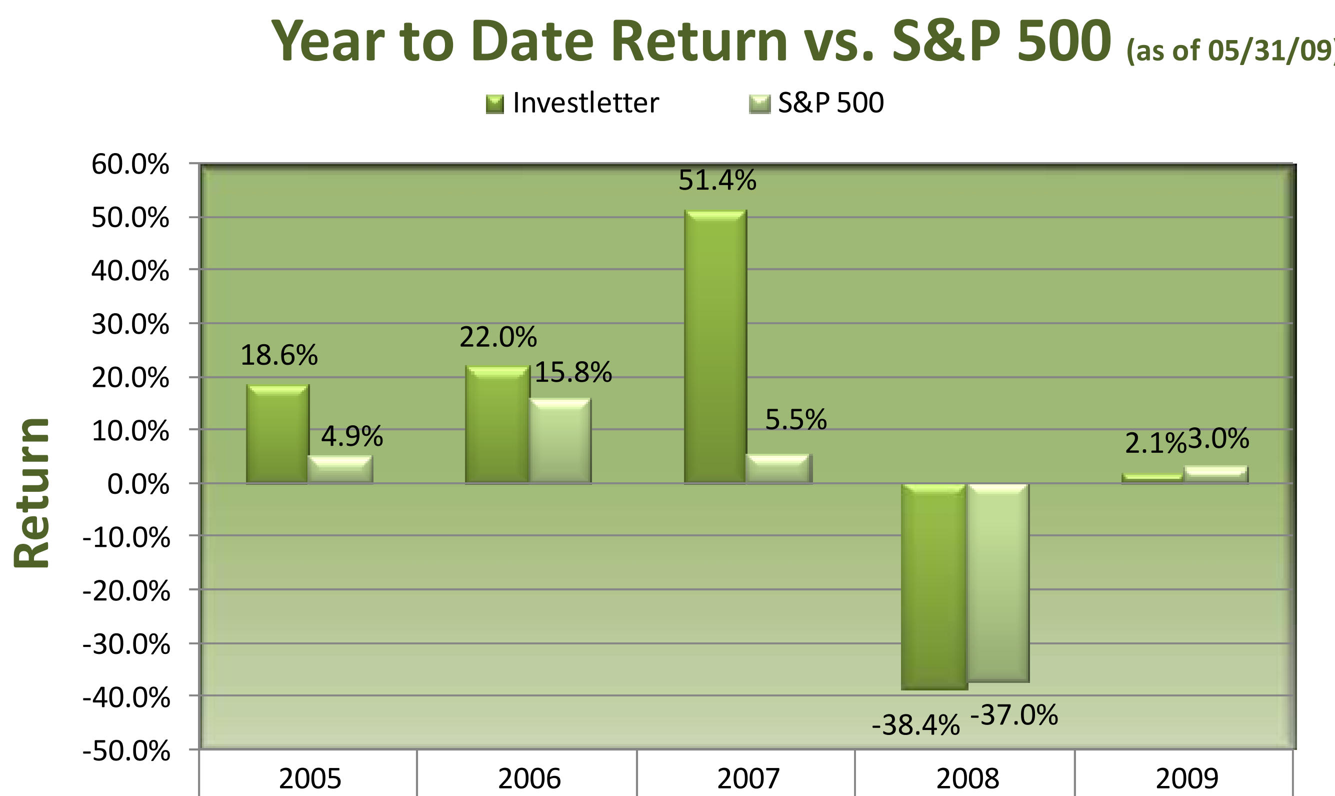
This could be an indication that the proposed change to the proxy rules will also be put in place and that the owners will get a fair shake at electing their own representatives to board seats. Making this change and eliminating naked short selling loopholes will go a long way towards restoring the investing public's faith in fair markets.

Date	Security	Symbol	Price	Order Type	Qualifiers	% Portfolio or Position	Outcome
4/30/2009	Gencor	GENC	$8.30	sell	limit	100%	filled
01/09/2009	Constellation Energy	CEG	$26.50-$26.65	sell	limit	50%	filled
1/2/2009	EDCI Holdings, Inc.	EDCI	$3.65-$4.50	buy	limit	5%	filled
12/30/2008	Rohm & Haas	ROH	$59.75	sell	limit	6%	filled
12/30/2008	CSP, Inc.	CSPI	$2.65	buy	limit	2.5%	filled
12/18/2008	QLT, Inc.	QLTI	$2.32	sell	limit	3%	filled
12/15/2008	QLT, Inc.	QLTI	$2.09	buy	limit	3%	filled
12/03/2008	Constellation Energy	CEG	$28.00	sell	limit	50%	filled

Company	Portfolio Percentage	May price	April Price	Percentage Change	Buy Price (less than)	P/E	Dividend Yield
American International/AMIN	**4.10%**	**$1.12**	**$1.19**	**-5.88%**	**n/a**	**n/a**	**n/a**
Astronics Corporation/ATRO	**14.80%**	**$9.50**	**$10.93**	**-13.08%**	**$8.25**	**14.5**	**n/a**
Berkshire Hathaway B/BRK.B	**7.00%**	**$2,972.00**	**$3,065.00**	**-3.03%**	**$2,700.00**	**55.9**	**n/a**
Cash	**31.30%**	**$1.00**	**$1.00**	**n/a**	**n/a**	**n/a**	**n/a**
Chesapeake/CHK	**5.30%**	**$22.66**	**$19.71**	**14.97%**	**$20.00**	**n/a**	**1.20%**
CSP Inc./CSPI	**13.50%**	**$3.20**	**$3.00**	**6.67%**	**$4.00**	**39.0**	**n/a**
EDCI Holdings, Inc./EDCI	**10.00%**	**$5.15**	**$4.70**	**9.57%**	**$4.70**	**n/a**	**n/a**
K-Tron International/KTII	**10.20%**	**$86.19**	**$80.42**	**7.17%**	**$80.00**	**9.4**	**n/a**
QEP Corporation/QEPC	**3.80%**	**$1.50**	**$2.45**	**-38.78%**	**n/a**	**n/a**	**n/a**

Performance

Our small lead over the S&P 500 average has turned into a small deficit as of the end of May. In early June, we have regained the lead. Slowly many of the irrational situations seem to be beginning to reverse themselves. A company like CSP, Inc. (CSPI) can only have so many owners willing to sell shares at 60% of net cash value. Currently the company trades at about 80% net cash value. You can think of the market in CSPI's shares as prices stacked one on top of another. The owners at the bottom of the pile willing to sell shares at lower prices dictate the price of the shares in the market. As these owners willing to sell for say $3.00, become ex owners, the only owners left are those who will not part with their shares for anything less than $3.10. As long as no remaining owners drop down and become willing to sell back at the $3 mark, the shares will keep rising. When fear ruled, selling became unhinged from any rational link to the value of the underlying asset. Now that this turbulence is dissipating, owners are demanding more rational price for their shares. CSPI should be able to get back to at least their net cash value this year or $4.25 per share.



	2005	2006	2007	2008	2009
Investletter	18.6%	22.0%	51.4%	-38.4%	2.1%
S&P 500	4.9%	15.8%	5.5%	-37.0%	3.0%

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