

INVESTLETTER



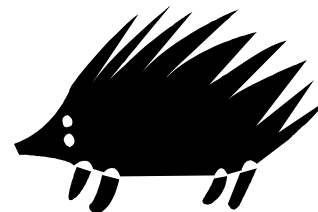
Volume 6 Number 9

Wall Street:

- DJ 9337
- S&P 500 969
- NASDAQ 1721

Hedge Hogs

A hedge is a tool designed to reduce or eliminate financial risk. Nowhere was that more apparent than in the financial results reported by Chesapeake Energy Corporation earlier this month. Chesapeake reported net earnings of \$3.28 billion, or \$5.61 per share in their third quarter ending September 30, 2008. They reported these earnings on a mere \$7.49 billion in revenues. The company certainly doesn't have the near 45% net profit margins this number would seem to imply. How then did they report such huge earnings?



You will not find any of these critter in North America although Chesapeake's quarterly hedging activity appeared something like a "hedge hog".

About \$2.86 billion of the net earnings was due to their hedging activity. As a natural gas producer, Chesapeake sells the gas they produce primarily for end use by electric companies, gas companies and industrial users. In the production of this gas, Chesapeake incurs costs that can't be adjusted quickly. Many of the costs are incurred upfront in land acquisition, obtaining geological information, the drilling process and preparing a well for production. They desire to lock in prices on a good portion of their production to help ensure they will be able to recover their upfront costs. This helps the business eliminate risk. At times, it allows the company to report larger earning than they otherwise would and at other times they lock in their production at prices lower than they could have ultimately realized.

Natural gas prices are affected by a multitude of factors. Cold temperature related to heating season, hot weather related to electricity demand, especially air conditioning, the amount of gas in storage and hurricanes causing supply disruptions to name a few. Chesapeake tries to lock in their pricing when prices are high. Customers have identical needs only in the opposite direction. A fertilizer plant that relies on massive amounts of natural gas may lock in their supply of natural gas for a certain time into the future to ensure they don't see wild swings in the prices they pay. Natural gas can easily rise 50% in a matter of weeks. It can drop just as fast. If you have customers who buy your fertilizer who are sensitive to price changes you may find it hard to pass on a 50% price increase in a couple weeks time. If you lock in the price you pay for your gas supply, you can raise prices more gradually or even less if the higher prices are the result of a temporary spike.

How do you protect your pricing with hedges? The easiest way is with futures contracts. Chesapeake can enter into a futures contract to supply a fixed amount of gas at a certain price at some point in the future. For example, Chesapeake can agree to sell 1 billion cubic feet (bcf) at \$9 per thousand cubic feet (mcf) in a contract ending in March of 2009 to an end user. Both parties know exactly the price they will pay or receive. They have some certainty to their operations. Chesapeake can ensure that the gas they produce will bring a price more than it costs to produce and the end user can be assured that the price they pay for gas does not lead to a product

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priced higher than they can obtain from their customer. The price for both is \$9 per mcf.

Some natural gas customers get the option from their local gas company, sometimes along with offers from additional suppliers, to lock in the price of their gas for the next year. It is a futures contract. You agree to pay a set price and the gas supply company agrees to provide it for that price. Each side has certainty in that set price.

Hedging can bite both ways, creating huge gains as easily as huge losses.

It begins to get interesting when the pricing changes dramatically as natural gas has done this year. The price began the year around \$7, rose to over \$13 and now is back around \$7 per mcf. As a producer you want to sell your gas at high prices and try to lock in contracts when the price is high. Using our \$9 per mcf example, falling gas prices create a big non cash win for gas producers. Even if the contract is not due until some point in the future, the current value of the contract gets marked to the current market price. The initial value of the contract is essentially zero. The producer is selling gas currently valued at \$9 per mcf to a consumer for \$9 per mcf. If the price now drops to \$7, the contract has value for the producer. The producer is now selling gas worth \$7 per mcf for \$9 per mcf. The producer is getting \$2 more than the market price. The producer could easily sell the contract and the right to deliver this amount of fuels to the customer, to another producer. The contract is now worth \$2 million dollars. There are 1 million, one thousand cubic feet units in 1 billion cubic feet (1,000,000 x 1,000 is a billion). With the contract now worth and extra \$2 for each 1,000 cubic feet (mcf) applied to one million of these such units, the contract is now worth \$2 million.

Even though the gas has not been produced and will not be delivered until sometime in the future, the contract has value. According to the Generally Accepted Accounting Principles (GAAP) this change in value is reported on the income statement in this case. Chesapeake had \$2.8 billion of these type of gains show up in their net income this past quarter.

Earlier this year when gas prices shot up to more than \$13 per mcf, Chesapeake reported huge losses related to their hedging activity. The good news is that over time, Chesapeake's hedging activity results in them being able to sell their gas at prices on average at

Open Swap Positions as of October 30, 2008

Quarter or Year	Natural Gas		Oil	
	% Hedged	\$ NYMEX	% Hedged	\$ NYMEX
2008 Q4	62%	9.15	43%	78.09
2009 Total	38%	9.33	48%	81.19
2010 Total	40%	9.58	37%	90.25

Open Natural Gas Collar Positions as of October 30, 2008

Quarter or Year	% Hedged	Average	Average
		Floor	Ceiling
		\$ NYMEX	\$ NYMEX
2008 Q4	14%	7.75	9.32
2009 Total	30%	7.21	9.27
2010 Total	2%	7.71	11.46

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prices a bit higher than market prices. In any given year that may not be the case. This year it has about evened out so far. So while the company reports wild swings in quarterly results, the underlying business is much more even over longer time periods. As is so often seen, it is the accounting that is tricky, not the underlying business. Here is a look at the future hedging activity of Chesapeake. (see above) Notice that they have a portion of their 2009 and 2010 production already locked in. Many of the hedges the company uses are not a simple as plain vanilla futures contracts. Futures contracts were the easiest means to make our point.

The hedging activity can vary rapidly. The company could close out positions early and book the gains on contracts that have increased in value and even re-hedge certain production. Next year the company has about 70% of production already hedged and it lends a degree of certainty to how much revenue they will generate. Often the underlying business will be profitable and at the same time the hedges can make any particular quarters results very wild. Any prolonged large change in price could still have a very substantial positive or negative effect on the long term profitability of the business. It will affect the availability of future hedges at agreeable pricing. I doesn't do any good to hedge gas at \$3 per mcf if it costs more than this to bring it up out of the ground. If natural gas drops to \$3 per mcf for the next three years Chesapeake will not be able to find partners willing to enter in agreements to take delivery of gas at \$9 per mcf. If the price swings between \$6 and \$10 per mcf, Chesapeake will have plenty of opportunity to hedge in the \$8 and \$9 dollar area. This is more than enough to cover the cost of production and healthy profits.

While gas prices will to a large part determine the profitability of our investment in Chesapeake, skillful hedging can add a bit of extra profit by securing prices that on average exceed the average market price over time.

Company	October price	September price	Change from September	P/E	52 Week High	52 Week Low	Estimated '08 EPS	Dividend Yield
Alico/ALCO	\$39.39	\$47.73	-17.47%	n/a	\$50.32	\$33.02	n/a	2.80%
American Pacific/APFC	\$11.55	\$13.06	-11.56%	10.6	\$19.20	\$10.05	\$1.07	n/a
Amtech Systems/ASYS	\$6.41	\$9.31	-31.15%	20.5	\$17.74	\$6.02	\$0.31	n/a
Arch Coal/ACI	\$21.41	\$32.89	-34.90%	8.9	\$77.40	\$29.36	\$2.42	1.80%
Atrion/ATRI	\$98.96	\$103.30	-4.20%	13.2	\$63.00	\$133.88	n/a	1.30%
Consolidate Tomoka/CTO	\$36.90	\$43.19	-14.56%	15.9	\$68.09	\$24.00	n/a	1.30%
Culp/CFI	\$2.88	\$5.92	-51.35%	9.0	\$10.02	\$2.84	\$0.32	n/a
Graham Corp./GHM	\$21.00	\$27.05	-22.37%	11.8	\$54.91	\$12.50	\$2.02	0.20%
St. Joe Company/JOE	\$30.92	\$39.09	-20.90%	n/a	\$46.82	\$25.02	\$0.25	1.70%
Landauer, Inc./LDR	\$54.06	\$72.75	-25.69%	21.8	\$73.52	\$46.82	\$2.48	3.90%
Mesa Labs/MLAB	\$17.00	\$21.25	-20.00%	12.1	\$27.00	\$16.00	n/a	2.40%
Rayonier/RYN	\$33.08	\$47.35	-30.14%	16.6	\$49.54	\$26.58	\$1.99	6.40%
Schuff International/SHFK	\$16.00	\$26.25	-39.05%	2.5	\$35.00	\$15.00	n/a	n/a
Servotronics Inc./SVT	\$6.00	\$7.50	-20.00%	9.2	\$22.48	\$5.20	n/a	2.80%
Span America Medial Sys/SPAN	\$12.00	\$11.90	0.84%	11.6	\$14.41	\$8.03	n/a	4.20%
Tejon Ranch Co./TRC	\$29.06	\$37.15	-21.78%	68.7	\$44.51	\$24.64	\$0.56	n/a
Torm/TRMD	\$16.44	\$23.79	-30.90%	3.9	\$42.50	\$11.52	n/a	n/a
Twin Disc/TWIN	\$7.75	\$13.76	-43.68%	4.1	\$37.47	\$6.54	n/a	4.00%

The Investletter Portfolio

The new reality that has been thrust upon us required some quick action to rapidly adjust our portfolio. This quick fire activity is not something we have much experience with, as we prefer slow and plodding, giving ourselves plenty of time to digest changing situations. So many changes have happened so fast that we felt forced to try and adapt to what seemed likely as a result of the new economic reality. With oil prices plunging, Amtech Systems prospects for solar equipment sales becomes much less appealing. The fact that the company's prospect for increasing profits looked very good in a strong economy with strong demand keeping oil prices high, looked dramatically different in an economy being choked off due to lack of credit availability. Credit collections are in for a rough go and firms like ASFI have seen their prospects plummet with rapid changes employment levels and housing values.

We put together a chart below to summarize all of the changes we have made over the past two months. Our sales have

Date	Security	Symbol	Price	Order Type	Qualifiers	Percent of Portfolio	Outcome
11/16/2008	Rohm & Haas	ROH	\$73.00	buy	limit	6%	
11/14/2008	Anheuser Busch	BUD	\$68.75	sell	limit	n/a	filled
11/10/2008	Constellation Energy	CEG	\$24.05	buy	limit	6%	filled
11/02/2008	Rohm & Haas	ROH	\$69.80	buy	limit	5%	open
10/22/2008	Anheuser Busch	BUD	\$60.10	buy	limit	4%	filled
10/19/2008	Anheuser Busch	BUD	\$62.50	buy	limit	4%	filled
10/10/2008	Atrion	ATRI	\$93.00	sell	limit	n/a	filled
10/10/2008	Asta Funding	ASFI	\$4.00	sell	limit	n/a	filled
10/10/2008	Amtech Systems	ASYS	\$6.70	sell	limit	n/a	filled
09/24/2008	Rayonier	RYN	\$46.00	sell	limit	n/a	filled
09/22/2008	Consolidated Tomoka	CTO	\$48.50	sell	limit	n/a	filled

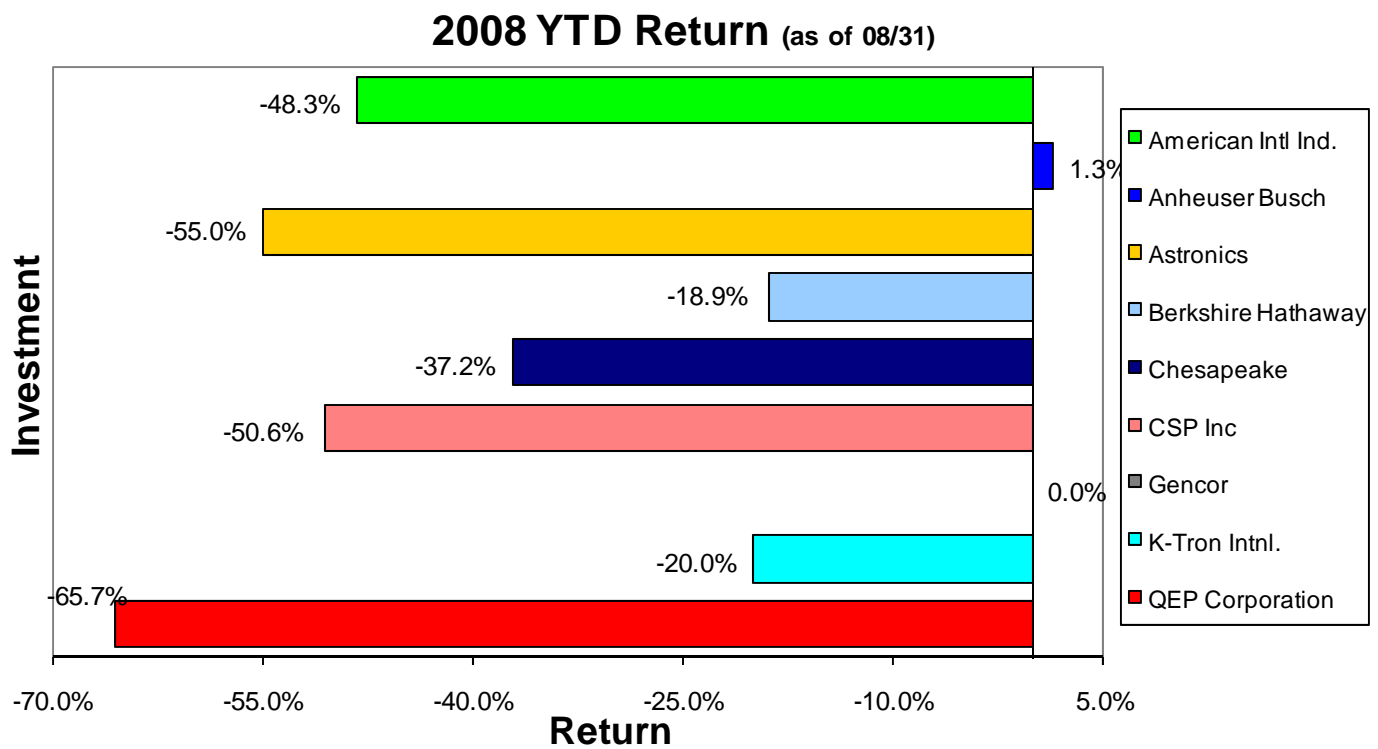
helped us add a measure of conservatism by increasing our cash level. Our purchases have targeted workouts involving large well capitalized companies buying other companies for cash. One position, in Anheuser Busch, we have already closed out at a small 12.2% gain. This returns on these deals are small, but entail a reasonably small amount of risk compared to other investments currently. Most of the deals we are interested in have the financing lined up and have shareholder approval by the acquiring company in the case of Rohm & Haas and Anheuser Busch. Another plus is the money will not need to be tied up for any extended period of time as each transaction should close by the end of next spring.

Company	Portfolio Percentage	October price	September Price	Percentage Change	Buy Price (less than)	P/E	Dividend Yield
American International/AMIN	5.80%	\$2.14	\$2.74	-21.90%	n/a	n/a	n/a
Anheuser Busch/BUD	7.90%	\$62.03	\$64.88	-4.39%	\$60.00	19.9	2.50%
Astronics Corporation/ATRO	17.50%	\$12.50	\$18.27	-31.58%	\$10.50	9.4	n/a
Berkshire Hathaway B/BRK.B	8.10%	\$3,790.00	\$4,395.00	-13.77%	\$4,000.00	15.8	n/a
Cash	26.70%	\$1.00	\$1.00	n/a	n/a	n/a	n/a
Chesapeake/CHK	4.60%	\$21.97	\$35.86	-38.73%	\$20.00	6.1	1.40%
CSP Inc./CSPI	7.90%	\$3.67	\$5.27	-30.36%	\$4.00	7.6	n/a
Gencor/GENC	4.00%	\$6.25	\$8.08	-22.65%	\$6.50	3.8	n/a
K-Tron International/KTII	10.00%	\$93.99	\$128.83	-27.04%	\$95.00	11.2	n/a
QEP Corporation/QEPC	7.50%	\$3.65	\$5.33	-31.52%	\$3.75	3.9	n/a

Performance

We still are holding a small lead over the S&P 500 average but it has nothing to do with strong performance. The performance of our small companies has been horrific. Our competitive advantage is greatly reduced when fundamentals no longer play a significant role in determining price. It is difficult to make a case for fundamentals when a company like CSPI trades at less than 75% of their cash and investment value. The company has no long term debt and is cash flow neutral right now. When this market finally settles down, we would not be surprised to see stronger companies start buying up weaker companies at fire sale prices. There are still many companies with large cash balances that will make easy pickings'. Companies can easily buy distressed rivals to increase market share and position themselves for an eventual strengthening economy.

Our move back into workouts (Anheuser Busch, Rohm & Haas and Constellation Energy) after our failed attempt earlier this year with Transmeridian is characterized by large companies with financing already in place. Not a huge payoff, but a chance for a nice double digit gain over a very short time frame. A couple of small gains in this market will be a nice relief from the unrelenting pounding that the markets have been subject to.



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