Volume 2 Number 9

September 2004

Blue Collar Investment Advisor

# BCIA

**Wall Street**

- DJ 10372
- S&P 500 1134
- NASDAQ 2025

## Stock Options

In the popular financial press there are many references to stock options. Many times you hear about them in reference to overpaid executives. This occurs because often it is very applicable. Option can serve a very useful purpose. They provide a means of compensation that does not require a company to part with any of its assets. The asset we most often associate with compensation, cash, can be in short supply with young companies. Options offer a chance to participate in any increase in value a fast growing young company oftentimes provides. You will also hear references to options aligning management and employees with shareholders. Options can perform all of these functions. Too often they are abused to the detriment of the company's shareholders.

***Stock options can serve a useful role. Too often they end up being overused.***

Stock options are the right, but not the obligation of the holder to purchase a set number of shares of a company's stock at some future date at a pre specified price. This right can turn out to be absolutely worthless or verge on a windfall comparable to winning the lottery. The holder has no risk with stock options. If the price of the company is lower when the options vest (are available to be exercised) the holder has no obligation to exercise them. We will use one of our companies as an example.

Lets use Cell Genesys. Assume you are granted options on 100 shares of CEGE that vest in one year and expire in three years. If one CEGE's drugs are approved for use and the price of the stock rises to $50 two years down the road, you may decide to exercise your options. If the stock is trading for $9 now, you would need to pay $900 to exercise the options. The stock you acquire would have a market value of $4500. You have earned $3600 on the exercise. If the FDA rejects the application for one of CEGE's drugs you may see their share price drop to $5. In this case you would let the options harmlessly expire.

Many employees who are hired by small tech startups are willing to risk some of their compensation for the chance to make out big. During the tech boom you had secretaries cashing in options and becoming millionaires. Other firms had employees who accepted below market compensation packages and had options that expired worthless. One side note we are going to mention involves a fate that more than one executive suffered during the tech collapse in the last bear market. Some executives exercised options their companies granted them and held the shares instead of selling them. The exercise of options is a taxable event. If the amount of money made is large enough it

**Inside this issue:**

# Stock Options.

> **Companies whose CEO is unwilling to pay to be an owner has a problem with the option program and an even bigger problem with the CEO.**

can generate a hefty tax bill. Imagine you have a $70,000 a year job and you exercise options that give you a $1 million profit. You decide to keep the shares. When the dot com boom imploded many of the companies saw their share prices drop by 80% or more. Now the shares you hold are worth $100,000. Still not too bad until you consider you may have a $300,000 tax bill. Some of these people that had acquired stock worth millions were forced to file bankruptcy.

It is easy for companies to grant large numbers of options especially when many Officers and Directors argue that they have no value. Because something cannot be valued precisely does not mean it has no value. Some of the arguments that are used to support these large grants are as follows. Stock options cost the company nothing when granted and generate cash when they are exercised. This is true, but ignores the fact that they can seriously dilute the earnings of the shareholders because those earnings are being spread over a much larger number of shares. Another argument is that they align management with shareholders. Management always has the option of aligning themselves with shareholders by purchasing shares on the open market. In my opinion, this shows true conviction and confidence in your company. In a company where a free gift of shares is required to align management with shareholders, that may be an example of a company that needs to examine the character of its management.

Companies find options are easy to lavish freely when they do not cost anything up front. This lends to the practice of granting options in excess. Directors are less restrained granting options than they would be granting bonuses. The granting of a cash bonus has an immediate impact on earnings and generally lead to a more cautious and reasonable approach to compensation. We would rather see companies pay larger cash bonuses than granting an excessive amount of options. Here is an example of option grants at Amgen. The CEO has been granted 450,000 options in each of the past three years. The options expire in seven years. Each $10 change in the share price will result in a $13.5 million increase in value of the options. CEO's often generate huge paydays from the exercise of options. In 2003 Richard Dauch, CEO of American Axle, exercised options worth $23.5 million. This is the amount of money the company could have raised from investors if it would have sold the stock to the investing public. The company earned $197 million in 2003, the $23.5 million did not affect the earnings because it was not paid from the company's cash. It still had a cost, the money that those shares could have raised had they been sold.

If companies were forced to replace options with cash bonuses total compensation would invariably decrease. Paying bonuses would reduce a companies earnings. Boards of directors would be much more cautious handing out big bonuses than options that have no effect on earnings. There is a proposal to begin expensing options being developed by The Financial Accounting Standards Board. Congress is jumping to the aid of business and vowing to block part of this proposal. This happened in the 1980's and played a part in the accounting scandals the past few years.

In all fairness this could have a deleterious affect on small tech companies. Without the large option grants these companies would have a much harder time recruiting top talent. However, it would not eliminate the use of options, only force the expense to be accounted for. We favor this proposal as a means to add some sanity to many company's compensation policies.

## Stock Options

In order to provide an accurate picture of a company's financial position it is important that all information the affects a company be included in a financial statements. Stock options are in effect compensation expense. There are issues that the accounting industry is still struggling with regarding how to record this expense. It is not as straight forward as it is being presented here. Investors need this information in order to make an informed decision when making investments. You may hear it referred to as transparency, the ability to see into a company and see its true financial picture. We strongly support the expensing of stock options.

## Works on the Street

One book we inadvertently left off of our book list in the June issue was *What Works on Wall Street by* James P. O'Shaughnessy. The book-back tested investment strategies using 44 years of market data to find what formulaic investing strategies performed better than the market. The book brought some very interesting insights to light. As a whole we are not a big fan of formulaic investing strategies. It is helpful to understand how some of the strategies performed to help with our selection of stocks. Some of the basic ideas we have always followed. Generally we look for companies with lower p/e (price to earnings) ratios. We will not limit our investment choices based on p/e but take it into consideration when it is useful to us.

Generally investment strategies that follow a value investing approach tend to perform better than growth strategies. Value investing involves buying companies that are undervalued on one or more measure. Growth stocks are companies that are seeing regular sizable increases in earnings. Growth stocks generally have higher p/e ratios and higher price to sales ratios among other measures. They often are smaller companies and pay no dividend. Value stocks tend to be older more established companies that have lower earnings growth rates, p/e ratios, price to sales ratios and pay dividends.

Why would lower growth rate companies perform better then higher growth rate companies? It all depends on the price you pay. A company with strong growth prospects also tends to attract a lot of attention. When many people are interested in a stock the price is driven up. If the price rises the p/e ratio will rise seeing price is the top number in the p/e equation. Stocks that attract a great deal of attention tend to have their price driven up to a level that is higher than the the underlying company is worth. When the value of a stock and the value of the underlying company become out of whack, the price tends to revert back to a price that is closer to what the company is truly worth.

Stocks with lower growth rates are not as well loved by the investment community. The price of these companies tend to trade closer to the real worth of the company. The lower price in turn means a lower p/e ratio. This also affects dividend payout ratios. If you are paying a $1 dividend and your share price is $40 you have a 2.5% payout ratio. If your price drops to $20 your payout ratio doubles to 5%. How can a high dividend help as an investment strategy. With a high dividend yield you can interpret the stock as having had its price beaten down. You will receive a nice dividend payment and the price may be beaten down below what the company is worth. At some point the price may rise to closer approximate what the company is worth.

More than one of the growth characteristics are usually seen in a company that meets the definition of a growth stock. The same holds for value stock, they will share many of the value characteristics. Sometimes you can find a company that shares characteristics of both. This may make an even better investment. Coke was a great example. At one point in the early eighties it shared the characteristics of a value stock. The past twenty years it has definitely been a great growth stock. The folks who bought when it looked more like a value stock have made a handsome profit.

# Watch List

Landauer, BASI, and The St. Joe Co. all reached new 52 week highs the past month. This is not great news for is. We prefer to buy at more reasonable prices. We are still waiting to give the go ahead on Kensey Nash. Their price has inched up again. We insist on not chasing these stocks when their price is rising.

Landauer is a particularly intriguing company. They provide radiation level detection badges and also provide analysis and monitoring for customers. Revenues are collected under a subscription arrangement. Due to the nature of the business they are in they generate a great deal of repeat customers. Their customers are required to monitor their employees exposure levels. The badges have a limited lifespan which provides for a regular income stream. You may have heard us mention it before; this is what we call a toll bridge business. Landauer has over 60,000 customers and very little competition. If you want the product and service you have to go through them to get it. Last year they had a nice fat 24% net profit margin. Most of the cash they generate is paid out in dividends. They have a 3.4% dividend yield which is about equivalent to the rate on a 5 year treasury note. We would just rather pay less to buy them. It may take several years before we find an agreeable price.

Another company we would love to own is USG. They are the low cost manufacturer of drywall. They are very profitable but are in bankruptcy right now. They have exposure to asbestos liability and were forced to file for bankruptcy due to the size of the liability they face. The US government is working on setting up a fund to satisfy asbestos claims. This will keep companies with this exposure from going out of business and ensure that money remains available for victims with damage from asbestos. The company is extremely profitable and extremely undervalued. We will be interested once they emerge from bankruptcy as long as their price does not rise much further.

| Company | Current price | P/E | 52 Week High | 52 Week Low | Estimated '04 EPS | Dividend Yield |
|---|---|---|---|---|---|---|
| **Altria Group, Inc./**MO | **$45.21** | **9.7** | **$58.96** | **$39.60** | **$4.77** | **6.50%** |
| **Allergan/**AGN | **$77.89** | **27.6** | **$92.61** | **$69.05** | **$2.74** | **0.50%** |
| **Bioanalytical Systems, Inc./**BASI | **$5.45** | **n/a** | **$6.23** | **$3.40** | **n/a** | **n/a** |
| **Genentech, Inc./**DNA | **$51.83** | **81.0** | **$68.25** | **$38.15** | **$0.81** | **n/a** |
| **Gentex Corporation/**GNTX | **$35.01** | **24.3** | **$47.08** | **$32.00** | **$1.46** | **1.80%** |
| **The St. Joe Co.**/JOE | **$48.09** | **46.8** | **$49.08** | **$31.10** | **$1.02** | **0.30%** |
| **Kensey Nash**/KNSY | **$29.19** | **24.0** | **$36.85** | **$19.71** | **$1.20** | **n/a** |
| **Landauer, Inc./**LDR | **$47.26** | **24.0** | **$47.97** | **$35.08** | **$2.03** | **3.40%** |
| **Paychex, Inc./**PAYX | **$30.07** | **32.4** | **$40.54** | **$28.83** | **$0.94** | **1.60%** |
| **QLT Inc./**QLTI | **$16.25** | **19.5** | **$30.70** | **$13.18** | **$0.85** | **n/a** |
| **Sanderson Farms**/SAFM | **$33.31** | **6.5** | **$55.18** | **$19.70** | **$5.12** | **1.00%** |
| **Tejon Ranch Co./**TRC | **$36.75** | **n/a** | **$43.21** | **$30.70** | **$0.00** | **n/a** |
| **USG Corporation/**USG | **$19.20** | **3.1** | **$20.17** | **$12.30** | **$6.09** | **n/a** |
| **The Washington Post Co. /**WPO | **$917.00** | **34.7** | **$983.50** | **$654.00** | **$34.67** | **0.80%** |

| Company | Porfolio Percentage | Current price | Buy Price (less than) | P/E | Dividend Yield |
|---|---|---|---|---|---|
| **Amgen/**AMGN | 4.60% | $57.14 | $60.00 | 23.9 | n/a |
| **Astronics Corporation/**ATRO | 5.50% | $5.01 | $5.15 | 71.4 | n/a |
| **Berkshire Hathaway B/**BRK.B | 16.30% | $2,881.00 | $3,050.00 | n/a | n/a |
| **Cash** | 17.00% | $1.00 | n/a | n/a | n/a |
| **Cell Genesys, Inc./**CEGE | 4.90% | $8.56 | $9.00 | n/a | n/a |
| **Consolidated-Tomoka Land Co./**CTO | 23.80% | $34.55 | $36.00 | 16.1 | 0.80% |
| **ModPac/**MPAC | 9.00% | $10.10 | $10.20 | 15.8 | n/a |
| **OMI Corporation/**OMM | 17.30% | $15.83 | $13.00 | 7.4 | 1.30% |
| **Protein Design Labs/**PDLI | 1.60% | $20.28 | $18.75 | n/a | n/a |

The chart above 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. 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.

# The BCIA Portfolio

OMI has been our dominant performer the past few months. This could accelerate as we approach winter. US crude reserves are at low levels going into the heating season. Among other trouble the recent spate of hurricanes has caused problems at the LOOP (Louisiana Offshore Oil Port). Delays in offloading due to bad weather has slowed down the inflow of crude into the US. Combine these factors with the high demand we have seen throughout the year and we have shipping day rates climbing. Rates climbed about 25% this past week. This is going to result in huge earnings for companies in the tanker business.

The downside to this is the higher prices for home heating oil this coming winter. If you heat with oil, you may be in for a shock this winter.

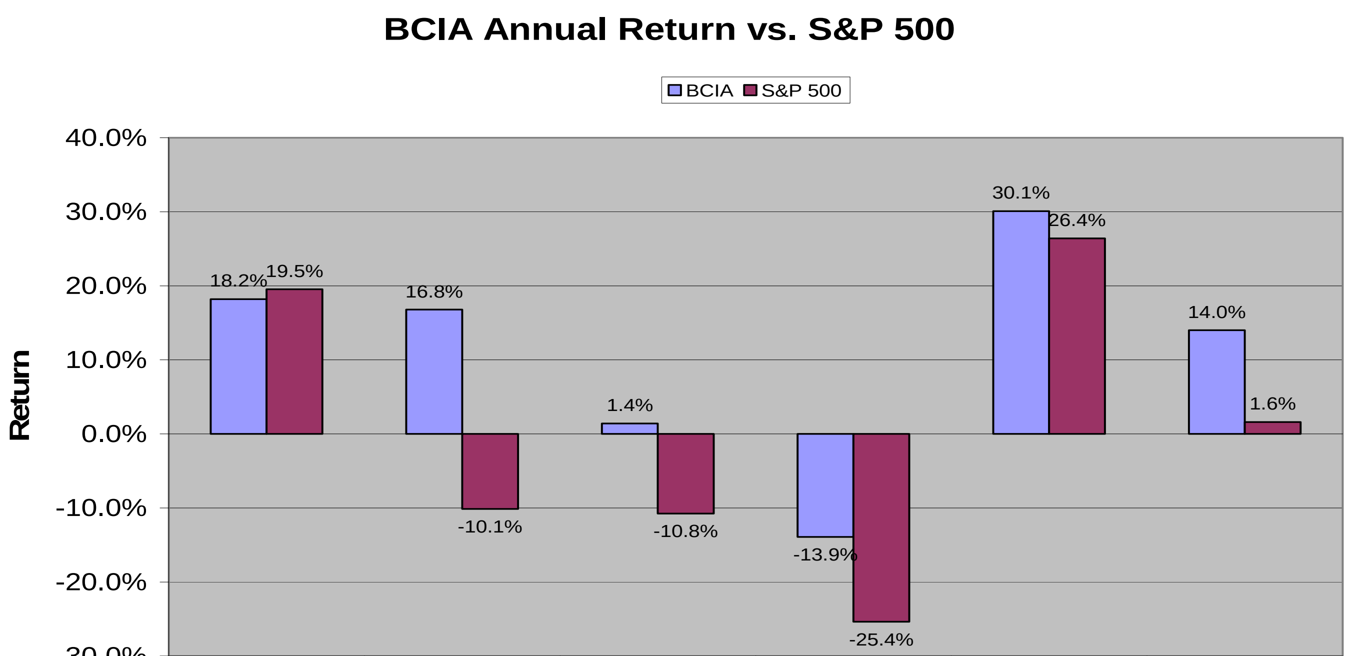
Consolidated Tomoka's price has been affected by the hurricanes in Florida. They received only minor cosmetic damage and some blown over trees but that was enough to send the share price down. All the better to accumulate shares.

Lastly, Astronics has a nice slide show presentation from the Annual Gabelli Aircraft Supplier Conference. (I bet you didn't even know there was one. Me neither.) The slide show does a great job showing the direction they are heading. It was very encouraging to see that their business should pick up over the next few years. Maybe we will finally see the stock price move up. Here is a link to the slides. http://www.astronics.com/relations/src/20040910-gabelli-presentation.pdf

# Returns

We have had a rewarding past month. Our portfolio has risen nicely. We are now up 14% on the year. The market has climbed back into positive territory again. The S&P 500 average is now up 1.6% on the year. The NASDAQ average is down 4.6% for the year and the Dow Jones Industrial average is down 2.0% for the year. Overall this has not been a great year for the stock market. On the plus side earnings have been growing nicely. This has the effect of making the market more reasonably valued. At the present levels we are not finding any great bargains. However at levels just below this we were finding some issues that were priced reasonable enough to attract our interest. Finding good investments is just tough business. Third quarter earnings will be coming soon as will presidential elections. Each of these events will add a bit more clarity.

Over the past six years we are up 79% this is much better than the S&P 500 –8%. Over the short term it can be difficult to see how you will ever make any money in stocks. Over the long term the gains sort of sneak up on you. We welcome these kind of surprises.




| | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 |
|---|---|---|---|---|---|---|
| BCIA | 18.2% | 16.8% | 1.4% | -13.9% | 30.1% | 14.0% |
| S&P 500 | 19.5% | -10.1% | -10.8% | -25.4% | 26.4% | 1.6% |

Year

## Subscription Information

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# Turnover

The concept of turnover is often mentioned when examining mutual funds as an investment vehicle. It is no less important when considering the management of your own self directed portfolio. Turnover is often cited as a reason actively managed funds on average underperform the market. Actively managed means the fund has a manager who selects stocks with the goal of performing better than the market. The opposite would be a passively managed fund which would most often be an index fund. A high turnover ratio is often associated with higher fees that will drive down investment returns. Obviously the more expenditures for fees that you have, the less money you will end up with in your account.

*Minimizing taxes is important, but not if it minimizes your returns.*

Not that long ago transaction fees were regulated in the securities industry. Trading stocks was a much more expensive proposition to the tune of $200 or more per trade. There is a formula that was used so these numbers are only ballpark figures. This is in contrast with $7 trades through a broker like Scottrade. You can see where fees would be much more significant had the fees not been de-regulated. Even $7 commissions can add up if you are making hundreds of trades each year as you would with active trading.

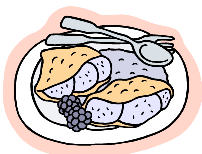
Turnover also makes a statement about how long you generally hold a stock in your portfolio. The longer you hold your stocks the lower your turnover is. Mutual funds are notorious for telling you of your need to invest with a fund and stick with it. They like to emphasize that you need to invest for the long term. When you look at their turnover numbers you wonder out of which side of their mouth they made the statement on. A turnover ratio of one would indicate that you sell the equivalent of all of the stocks in your portfolio once a year. We say equivalent because you could hold some stocks the entire year and with the money dedicated to other stocks make multiple purchases and sales using the same pool of money. Some mutual funds have low turnover ratios and others are ridiculously high. It is not uncommon to see funds with turnover ratios in excess of 100%. Index funds tend to have low turnover ratios whereas an emerging market or technology fund would tend to have a higher turnover ratio.

We have already mentioned how turnover affects transaction costs. It also will generate (hopefully) capital gains. If you make an investment for $1000 and sell it for $2000 you have a $1000 gain. The difference or profit that you made is your gain. Capital gains are taxable. When you pay taxes you have less money left over to invest. Higher transaction costs and taxes play a small part in why we favor a buy and hold investment strategy. It minimizes our costs. Fewer costs means better performance.

This is readily apparent in the mutual fund industry. On average passively managed funds tend to outperform actively managed funds. The difference in performance is almost entirely traceable to the difference in fees. The higher fees result in your returns being lower by the difference in the fees between actively and passive funds. If the difference is .6% you can on average expect your returns to be lower by 6%. This may not sound like much bit it can add up to large amounts over long time spans.

## Turnover

Minimizing turnover and avoiding tax expense should not play a primary role in your decision to sell an investment. If you believe that an investment is selling at an unsustainable price you are much better selling and locking in a profit then holding and watching the value of your position plummet. Of course these situations will not always be exactly apparent to you. What we try to do is avoid picking the flowers and watering the weeds. Often the price of a good company will rise for good cause. There is no need to sell as long as the conditions you bought it for still hold. On the contrary poor performing stocks often see their share price fall for a good reason. Here you can sell and realize a loss that will be to your benefit at tax time. In this instance turnover will be your friend. It will reduce your tax bill.



**These turnovers also can cost you.**

All of this is leading up to the turnover so far in the BCIA stock portfolio this year. This year we have made what probably amounts to a slightly higher than average number of moves. We may make up for this rash of activity by being rather lethargic the rest of the year. Our turnover ratio to this point in the year works out to 28.5%. Another way to look at this number is that we have sold roughly one of every four stocks we own so far this year. This is determined by taking the total amount of all of the sales we have had this year and dividing it by the total value of the portfolio. Even though we have been somewhat active, our turnover number is not real large. The one relatively large holding that we did sell this year was Freddie Mac. Other than that we have some large holdings that just do not change much.

To summarize, turnover for the sake of chasing gains is a poor strategy. However, selling stocks or buying new ones is sometimes necessary. It is helpful when a poor performer you have generates a nice tax benefit. So there you have it, turnover made easy. We hope to have you monitor us so we keep our turnover in line.

## Phishing

We have received several phishing emails over the past few months. This past we week we received one that was spoofing ebay. Phishing emails fake the look of a reputable company to get you to divulge personal information. The emails will often warn you to update your personal information or have your account cancelled or terminated. You will click on a link that will take you to a site that looks just like the company's site that is being spoofed. In this case a site that looks just like ebay's site. A company that has your personal information does not need you to re-enter it for them. These emails are looking to get your account numbers and passwords for fraudulent purposes. Be careful anytime someone asks for personal information in an email. Always ask yourself why they would need the information.



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