Schacht Value Investors, LLC
5020 South Lake Shore Drive • Suite 814 • Chicago, IL 60615
773-326-1561 • 773-326-1229 fax

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Boy Scouts & Bubble Gum

Let me begin by thanking those of you who have recommended Schacht Value Investors to others. As a result, several new clients have found their way into the fold over the past few months. Please keep the referrals coming! Some have asked if growth is going to be a problem. At present, the answer is "Absolutely not!" Nonetheless, as in investments, not all growth is created equal. A new client with $5 million is preferable to a hundred new clients each with $50,000. With this in mind, as of January 1st, the minimum size for new accounts is increasing to $100,000. Should our success continue, I look forward to increasing the minimum again next year!

Last week I was watching CNBC, in a momentary lapse of good judgment. The appearance of James Grant helped me to justify this indiscretion. Mr. Grant is a particularly incisive market watcher and publisher of *Grant's Interest Rate Observer*. He is an independent thinker and is loathe to follow the whimsy of the crowd. On the subject of US Treasury securities, Grant made the following comment, which I believe can be applied to all areas of investing:

"The safer something seems, the more likely it is to be fully priced."

Investors should pay close attention to these words before flocking into bonds and real estate. Prices on these asset classes have soared in recent years because of their perceived safety relative to equities. While there are exceptions, I believe bonds and real estate are a sucker bet at current levels. The return potential for stocks is higher precisely because of the general drop in stock prices. This is not to say that all stocks offer great value.

Wal-Mart Stores (WMT) is one of the most successful and respected companies of our time. The company is a fierce competitor, has top-notch management, and does a fantastic amount of business. In fact, 2002 sales are expected to total $250 billion with profits of $8 billion. Not surprisingly, WMT is not an undiscovered gem. The fundamentals of Wal-Mart are fairly well known. Today the company is valued at $223 billion ($50.50 per share x 4.4 billion shares). Every time an investor buys a share of Wal-Mart, they are buying a small slice of the $230 billion pie. But is the pie worth it? The intrinsic value of even great companies has a limit.

The $8 billion Wal-Mart will earn this year represents a 3.5% return on their stockholders' $230 billion investment. Not very compelling if you ask me! Wal-Mart must grow at an amazing rate (12-15%) simply to justify its current price tag. This will be a tall order as sales approach $1 billion a day. It was relatively easy for Wal-Mart to grow when it was a smaller company. This success becomes harder to duplicate. Ironically, even if the company delivers on Wall Street's growth expectations, it is already priced into the current value. If Wal-Mart fails to grow as expected, look out below! In short, there is little (if any) upside and a huge downside. Needless to say, you won't find Wal-Mart in our portfolio.

Clearly not everything in the market is cheap. A bursting market bubble does not ensure bargains! Even many tech companies remain overvalued. **Ebay (EBAY)**, the Internet auction company, illustrates this perfectly. The firm is considered a successful Internet survivor. In honor of this achievement, investors have bid its market value up to $21 billion ($67.50 per share x 308 million shares). Despite the hype, 2002 profits will be lucky to reach $200 million, a return on investment of less than 1%. Some investors still haven't learned that trees don't grow to the sky.

Wal-Mart and Ebay illustrate why investors can't just blindly invest money in stocks and expect healthy returns. Pitfalls exist, but bargains are out there for the prudent investor. This is a market that should reward thoughtful stock picking. And that's what we're here for. In the last few months, Schacht Value has been very active in the market.

One new addition is **Electronic Data Systems (EDS)**. EDS manages computer systems for and provides technology-consulting services to other companies. For instance, General Motors is EDS' largest customer. One year ago, EDS was valued at roughly $35 billion ($70 a share x 500 million shares). The company certainly benefited from the tech boom and the perception of growth. Unfortunately, EDS is not alone. The company faces a legion of competitors, including IBM. In fact, while revenues have increased from $12 billion in 1996 to $21 billion in 2002, profits remain about the same (around $1 billion). Because of pricing pressures and rising costs, EDS has had to grow just to stay even. It's a little like running in place!

Investors reevaluated EDS this year as shoes started to drop. EDS failed to win a couple of high profile contracts: JP Morgan and Proctor & Gamble. Two major clients, Worldcom and US Airways, entered Chapter 11 bankruptcy. The selling began and by September, EDS was trading at $40 a share or about $20 billion. Still not cheap! It was at this point that EDS managers revealed that they lost a pile of money betting that EDS stock would go up. Talk about timing! This was the last straw. The stream of bad news was too much. Investors began throwing EDS away.

EDS stock hit $10 a share at its lowest point. Ouch! This valued the entire company at just $5 billion… EDS had lost 85% of its value from its peak, in just 10 months. Just before EDS bottomed out, Schacht Value Investors started buying shares at around $11.50. As timing goes, it doesn't get better than this.

Despite the bad news, the fundamentals of EDS have not changed dramatically. Frankly, EDS is not a stellar business, but it is worth far more than $5 billion. Our initial estimate of intrinsic value was $15 billion or $30 per share. The margin of safety was clearly intact. EDS has also paid an annual dividend of 60 cents a share since 1996. When EDS traded at $70 a share, the dividend meant little. The dividend yield (dividend amount divided by the share price) was less than 1%. But at $10 a share, EDS' dividend yield was 6%. That's as good as most bonds!

Early EDS investors paid too much and then panicked when the rosy outlook got cloudy. Ignorance created an opportunity. As I write, EDS has announced a new contract with Bank of America for $4.5 billion, confirming that the sky is not falling. EDS continues to work through the issues discussed above, but the business is stable. Our intrinsic value estimate has not changed, but the market value has. EDS currently trades near $20 a share, giving us a healthy gain. The market price continues to close in on our intrinsic value figure. If this continues, don't expect to own EDS much longer (not that I'm complaining)!

Over the past month, we have aggressively cut our position in **Roxio (ROXI)**, maker of CD/DVD burning software for personal computers. My interactions with management have been discouraging. Despite the announcement of a share repurchase recently, the managers seem intent on spending the bulk of Roxio's considerable cash holdings on brand marketing and acquisitions. This is misguided and we contend that there are more beneficial uses for the cash. Recent news about a licensing deal with Dell Computer and the acquisition of Napster has created renewed interest in Roxio shares. Schacht Value used this as an opportunity to take some money off the table (between $4.75 and $5.50 a share). Considering most of the shares were acquired at $3 or less, it has been a rewarding holding. There could be far more upside in Roxio, but intrinsic value is becoming harder to calculate and I prefer a clear target. ROXI may be completely replaced soon.

Duke Energy (DUK) has been sold completely. The fundamentals (profitability, etc.) have deteriorated and thus the rationale for continuing to own Duke was weak at best. There are far more compelling investments in our portfolio. I would hate to be accused of watering the weeds!

Some of the proceeds from Roxio and Duke have been invested in a pair of retailers: **JC Penney Company (JCP)** and (more recently) **Sears, Roebuck & Co. (S)**. I've never been a fan of the retail business, but the value offered by these two companies is too good to pass up at current levels. Both companies have problems, but this is more than reflected in the stock prices. Besides, mall shopping is not dead. The holiday shopping season may be better than expected. And department stores are not completely obsolete. We see opportunity here.

Johnson Outdoors (JOUT) is a company that is becoming more prominent in our portfolio. To be fair, JOUT is not my discovery. A friend and fellow investor first introduced the company to me. My attraction to the company was immediate. As a Boy Scout, I used every Johnson product at one time or another. The firm manufactures a host of outdoor equipment including: scuba gear, sailboats, kayaks, Eureka tents, Old Town canoes, Camp Trails backpacks, Silva compasses, Minn Kota trolling motors, and much more. These are quality products with recognized brand names.

Schacht Value increased its position in Johnson Outdoors dramatically in recent months as the share price dropped to $7. At this level, Johnson had a market value of only $58 million ($7 a share x 8.3 million shares). It did not take long for us to realize that this was an amazing buying opportunity.

In September, Johnson Outdoors sold its Jack Wolfskin subsidiary for $63 million. Not bad for a company that accounted for only 15% of JOUT's annual revenues. The proceeds from the sale were greater than the entire market value of Johnson! Now that the deal is done, Johnson Outdoors has over $100 million in cash in the bank. Even with JOUT currently trading at $11 a share ($91 million market value), we are getting a considerable value. The cash in the bank more than covers our purchase price, so we're essentially getting Johnson's operations for free.

Johnson Outdoors' board of directors is meeting this month to decide what to do with its cash stockpile. Schacht Value Investors sent a letter to the company last week endorsing an aggressive share repurchase. (Contact me if you'd like a copy of the letter.) We'll see if management listens, but don't hold your breath. JOUT was once a subsidiary of SC Johnson (maker of Ziploc bags, Pledge, Raid, and Windex). Johnson Outdoors may be a separate entity now, but it is still controlled by the Johnson family and they don't have a reputation for responding to outside shareholders. In any case, the company is severely undervalued and the market should recognize it in time. We can only hope that the Johnson family helps force the issue.

The Topps Company (TOPP) is another company that we continue to buy at current levels. The company's products include sports trading cards and confectionary products (Bazooka bubble gum, Push Pops, Baby Bottle Pops). Simply put, Topps is a phenomenal business that gets no respect on the market, but the actions of management are certainly not helping.

Topps is currently valued at $360 million ($8.80 a share x 41 million shares). The company has $120 million cash and no debt. ZERO! The company makes $25-30 million profit year after year, but every so often life gets very interesting (in a good way). Topps often gets the opportunity to produce ancillary products for movies or TV shows. For instance, Topps produced all the Pokemon trading cards. It often does the same for movies like Star Wars. These deals are sporadic, but very profitable. This is because Topps' cost structure is largely fixed. Most of the extra revenue earned from these infrequent licensing events becomes pure profit. In essence, net income increases exponentially. Profits of $80 to $100 million are not unheard of. For some reason, Wall Street doesn't like this. For them, Topps is just too unpredictable. I for one couldn't care less. A famous investor (guess who) once said "I'd rather earn a bumpy 15% return on my money than a smooth 12% any day!" We think the intrinsic value of Topps is at least $16 a share.

While Wall Street frets about predicting earnings down to the penny, Topps continues to print money. It's what is (or is not) being done with these profits that should be the concern. CEO and company co-founder Arthur Shorin and his team are hording cash with no apparent plan. They need to invest it at a high rate or return it to shareholders. Sure, cash provides a safety net, but Topps doesn't need one, especially not one worth $125 million! Cash currently represents roughly a third (and rising) of Topps' total value. Business returns are dropping because returns on cash are so low. This is yet another factor weighing on the stock price. Ironically, Topps is a beautiful company being buried under a mountain of cash!

I am planning a trip to New York City to discuss this issue with management. A repurchase of Topps shares or a hefty dividend should be on the table. 2003 promises to be a busy year!!!

Before closing (finally), a quick Follow-Up on two companies covered in our last edition…

Both **Coastcast (COCA)** and **Citigroup (C)** have enjoyed significant gains in the 2 months since our last letter. Coastcast has advanced 5.4% ($1.85 → $1.95) over the period and our enthusiasm for the investment is as strong as ever. We continue to acquire shares and to dialogue with CEO Hans Buehler about how to unlock the company's value. Citigroup is up even more dramatically since October ($30 → $36 or 20%). Because of this gain, our margin of safety has fallen and an exit is in sight. We'll keep you posted.

On behalf of Lindsey and myself, I'd like to wish you and your family a happy holiday season and a healthy, prosperous New Year!

Henry W. Schacht, CFA
President and Chief Investment Officer