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"__Look, Mom! Free Money!__"

When I told people I was starting an investment management company, some questioned my sanity. A common reaction was "Wow, you couldn't have picked a worse time!" My sanity aside, I could not disagree more. There hasn't been a better time in recent history to start this firm. It is with this conviction that Schacht Value Investors officially began operation on July 16, 2002.

This will be the first of many client newsletters in the months and years ahead. Although I will try to communicate at least quarterly, there is no set schedule. It may sound trite, but I will only write when there is something to say. The primary focus of these letters will be the "value investing" philosophy, recent portfolio decisions, and general client information.

Throughout this letter, I use pronouns like "us", "our", and "we". There is a reason. As most of you are aware, my personal portfolio is invested alongside my clients' portfolios. This is critical. Money managers who ask clients to "do as I say, not as I do" have little if any credibility. All of us come from different walks of life. What we share is capital and the need to earn healthy rates of return on that capital. Our value approach to investing should accomplish this.

The "value investing" philosophy, when properly employed, has proven to be the most effective way to allocate capital. Practitioners, like Warren Buffett, have demonstrated this for decades. Benjamin Graham, a Columbia University professor, is given credit for laying the philosophical groundwork. Graham was Buffett's mentor and is known as the father of modern security analysis. Graham understood that a prudent analyst is able to systematically determine the "intrinsic value" of a security and make rational investment decisions accordingly. Simply put, this is what Schacht Value Investors attempts to do. The investing process we adhere to is as follows:

- Focus on companies where intrinsic value can be reasonably estimated
- Estimate intrinsic value (What would a rational businessperson pay for this company?)
- Buy when a firm's stock is trading at a substantial discount to estimated intrinsic value, typically 50-60%
- Identify potential catalysts that will encourage the market to recognize this un realized value and thus re-price the stock
- Where possible, encourage managements to create such catalysts (dividends, buybacks, etc.)
- Sell stock when market value of the stock equals 90-95% of the intrinsic value estimate

Not every value investor follows the exact same process, but the concept is the same. Buy securities at a significant discount to their true economic value. This discount creates a margin of safety designed to protect investors against unknowns, errors, imprecision, and sizable losses while allowing for impressive returns over time. The value discipline seeks to simultaneously reduce risk while increasing expected returns for prudent investors.

It is often said that there are only two emotions at work in the stock market: fear and greed. We have seen both in recent years. The recent Internet craze was fueled by greed. History is full of such speculative bubbles. For historical perspective, read Charles Mackay's classic book, Extraordinary Popular Delusions and the Madness of Crowds. It should convince you that emotions play no role in effective investing. In fact, the "madness of crowds" only creates opportunities for those who remain rational. Value investors try to separate reality from emotion. It is not an easy proposition. Emotions are a powerful force. Look no farther than the fear gripping average investors today. Selling has become indiscriminate. It's as if investors are saying, "Sell 'em all and let God sort 'em out". Our firm is positioned to capitalize on the irrational behavior of others.

The Schacht Value Investors equity portfolio currently consists of 18 companies. Every client owns the each of these companies in approximately the same proportion. *(Note: There is one exception. A number of my clients do not wish to own tobacco stocks or other so-called "sin stocks" for ethical reasons. This is not the case for everyone. For this reason, I do not impose a restriction on such investments unilaterally. Instead, I allow clients to state their preference upfront. At present, Philip Morris (MO) is a company that meets all of our investment criteria. It is, therefore, a company that is owned in most, but not all, accounts.)* Two of these investments will be discussed in this newsletter. They were chosen to illustrate the "value" approach to investing and to show that value can be found in the largest and smallest of firms.

Coastcast Corp (COCA) may be the most compelling story in our portfolio. It is the smallest firm we own and it generates the most curiosity. Two reasons come to mind: nobody has ever heard of Coastcast and it currently trades for less than $2 a share. Despite its obscurity and humble share price, I'm not losing any sleep over this investment.

Coastcast manufactures metal golf club heads and orthopedic implants (a strange combination, to be sure!). Shares currently trade at $1.85 and there are 7.6 million shares outstanding. This puts the total current market value of the firm at $14 million (7.6m x 1.85). I told you it was small! This was not always the case. In 2000, the company was worth well over $100 million, but times change. In recent years, Coastcast has faced enormous competition from abroad, especially China. The firm cut 80% of its workforce, reported negative earnings for the year, and was delisted from the New York Stock Exchange last week. In the midst of this, we started buying shares.

So WHY do we own it, you ask? Simple. Despite all its bruises, Coastcast's intrinsic value is far higher than its $14 million market value. In fact, I believe the intrinsic value of Coastcast is at least $35-40 million (about $5 a share). I arrived at this figure by conservatively estimating the value of Coastcast's assets. Coastcast has $17 million (or $2.21 a share) cash in the bank and ZERO debt. Its other assets are relatively easy to sell and could easily fetch $20 million. Simply put, if the managers of Coastcast closed the doors and liquidated the company, I believe investors would walk away with at least $5 a share. This represents a 170% return given the firm's current market value.

I spoke with Coastcast Chairman and CEO Hans Buehler yesterday. I informed him that our firm owns a substantial portion of Coastcast. I also complimented him on his work in these difficult times. Management has done a great job. They have effectively reduced the size of the company to serve a smaller marketplace. Perhaps their most impressive achievement is that Coastcast continues to generate, rather than consume, cash.

The $17 million sitting in Coastcast's bank account is excess capital. It could be paid out to shareholders without harming the operating business. I told Mr. Buehler that his shareholders are interested in what management does with this cash. I am pushing for a dividend or a major stock buyback that will return the $17 million to shareholders sooner rather than later. The company does not need it. Mr. Buehler and I discussed the need for such a catalyst to force the stock market to re-value Coastcast. Schacht Value Investors plans to submit a shareholder proposal at the 2003 annual shareholder meeting to try to encourage the board of directors to take such action.

The market has severely undervalued this firm and Mr. Buehler knows it. If we bought every share of Coastcast at current levels (and I wish we could), we could immediately write ourselves a check for $17 million. Effectively, we would get $3 million and the operating business for free! Viewed on a per share basis, the math is the same. We are currently buying Coastcast for $1.85 a share. The company's excess cash alone equals $2.21 a share!

Management will play a key role in helping us (shareholders) realize the intrinsic value of Coastcast going forward. While we wait, the cash "problem" keeps getting better. Mr. Buehler expects cash to increase another $6 million in the next several months. Asset sales continue and operating cash flow remains positive. It's nice to have such problems.

Mr. Buehler says that if he and his team fail to mold a healthier, albeit smaller, firm, he'll be the first to "pull the plug". Whatever the outcome, we should do very well. As I mentioned before, the company is worth $5 a share if liquidated. It's worth even more as an ongoing profitable business. This explains why I've happily bought shares between $1.50 and $2.50 a share. Now a bit of arm-twisting, time, and patience are required.

By the way, Mr. Buehler has every reason in the world to enrich shareholders. He owns over 15% of Coastcast. He also mentioned that his wife would kill him if the stock doesn't go up dramatically. In this, he and I have something in common.

Citigroup (C) is the largest company in our portfolio and is among the best known. Citigroup has been tarred and feathered in the press, but its underlying business is solid. It is the world's largest financial services firm with $100+ billion in sales and over $1 trillion in assets. With 50 billion shares outstanding at $30 a share, the company has a market value of $150 billion. Thanks to concerns about the world's economies and a rash of bad publicity (much of it warranted), Citi's stock has taken a beating lately. Connections to Enron and Worldcom have made front-page news. The firm's telecom analyst Jack Grubman was at the center of congressional hearings, the poster boy for biased research. The company has settled several high profile lawsuits as well. None of this has helped the stock price.

The bad news surrounding Citigroup is serious and must not be minimized. Nonetheless, it is my job to put the negatives in perspective. Marty Whitman, a renowned value investor, once wrote, "Because every investment has something wrong, the trick is certainly not to find perfect investments but to arrive at judgments that not enough is wrong to dissuade investing." Citigroup is such an investment.

In the first 6 months of this year, Citigroup earned $9 billion. That's BILLION, with a "B". No fuzzy math here! The firm is expected to earn $16-18 billion this calendar year. The company has an enviable global position and one of the world's most recognizable brand names. Given its economic fundamentals, Citi is worth at least $225 billion ($45 a share). The bad news (true or not) is more than reflected in the current stock price.

Assuming you made it this far, I hope these examples were enlightening. We'll cover more companies in upcoming newsletters. Before I close, I'd like to convey a quick (true) story about a value investor in the making.

On a recent trip to the Washington, DC area, Lindsey (my wife) and I took a side trip to the Baltimore Aquarium. In the plaza at the Aquarium's entrance is a large fish sculpture wrapped tightly with wire. The wire signifies hundreds of broken fishing lines. This is one lucky fish! This explains why visitors clamor to wedge coins in the tightly wound wire for good luck. I watched for a few minutes while children and adults of all ages dug through their pockets in search of coins. Just when I was about to lose all faith in humanity, a young boy excitedly pulled his mother towards the sculpture. He wasn't asking his mother for coins to throw away. Instead he said, "Look, Mom! Free Money!"

The response to my new firm has been incredible. I would like to thank each of you for the advance of trust. If you have any questions or comments, please do not hesitate to call.

Henry W. Schacht, CFA
President and Chief Investment Officer