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Profits, Not Prophets

Human beings have a natural inclination to assume that the future is going to look very similar to the recent past. Bill Safire effectively articulated this tendency on *Meet The Press* on April 20th:

> "I remember back in the '80s, the expression all the economists were using was, 'As far as the eye can see.' That's where all the deficits were going to lead us. And then in the '90s, with the boom leading to the bubble and income tax revenue flowing to the government, surpluses appeared and mushroomed and everybody was saying, 'There'll be surpluses as far as the eye can see.' And now here we are again saying, 'Deficits as far as the eye can see.' The eye can't see very far."

Of course, Mr. Safire wasn't talking about investing, but the phenomenon of which he speaks is alive and well in today's capital markets. For instance, David Pottruck, CEO of Charles Schwab, recently stated, "At this point, investing seems neither emotionally nor financially rewarding." The statement is shocking (and wrong) on several levels, especially for someone in his position. Nonetheless, rational or not, the negative stock market returns experienced over the past three (3) years have clearly had an effect on investor psychology. Pessimism is *en vogue*.

Ironically, it is the Internet Bubble which so powerfully illustrated the danger in projecting the recent past too far into the future. The mid-1990s witnessed the death of pessimism, skepticism, and uncertainty in the minds of investors. All have returned with a vengeance in the past 3 years. The emotional pendulum has definitely swung the other way.

Global events have certainly not helped the emotional spiral. Early in the year, SCHACHT VALUE clients were asking me one question with regularity: What are you doing in response to the Iraq situation? My answer: "Nothing". Frankly, even if I knew exactly how the Iraq situation would play out, it would not affect our investing process.

SCHACHT VALUE continues to search for companies we understand, selling at dramatic discounts to their underlying intrinsic value. We identify and encourage catalysts that will help this price/value disparity shrink and/or disappear; once it does, we sell and move on. Emotions have no role to play. Due to the pessimism of others, there is no shortage of opportunities in today's marketplace. As a result, the past few months have seen some changes in our portfolio.

During the first quarter, we moved completely out of **Roxio (ROXI)**, the maker of CD/DVD burning software for personal computers. I discussed the rationale behind this move in the December newsletter. Roxio was a very profitable holding despite its short time in the portfolio. It's entirely possible that we left a significant amount of money on the table, but I have doubts about management's ability to realize the full value of this company. Stock option grants have gotten out of control at the company as well. For these reasons, your capital was put to work elsewhere.

Our holding in **Vintage Petroleum (VPI)** was also sold completely during the first quarter. We initially purchased Vintage because the valuation looked attractive and there was a catalyst on the horizon. T. Boone Pickens, famous for his 1980s takeover attempts of oil companies like Gulf, presented a plan to the company's board of directors designed to unlock the value of Vintage's assets. The board of directors ignored the proposal despite Mr. Pickens being the company's largest shareholder. Instead of pushing harder, Boone Pickens sold the majority of his shares. The catalyst we had hoped for did not materialize, so we followed Mr. Pickens out the door. The result: With the dividends we collected, owning Vintage Petroleum was a breakeven proposition.

Now before you start singing, "Ain't no tellin' where the money went", let's talk about some additions to the portfolio.

In January, we started to accumulate shares of the mutual fund company, **Janus Capital Group (JNS)**, formerly known as Stilwell Financial**.** During the go-go Internet Bubble, the name Janus became synonymous with growth investing. For investors who wanted to be in on the action, Janus mutual funds were the place to be. Janus managers loved tech and they were rewarded, at least for a while. Performance was phenomenal and investors threw money at Janus. Assets under management reached $300 billion in 2000. As the size of Janus exploded so did its profitability. The company was practically printing money. In 1998, Janus earned $152 million. In 1999, profits were $313 million. In 2000, Janus made $663 million.

On July 12, 2000, Janus (Stillwell) became an independent company when its parent company, Kansas City Southern, distributed Janus shares to investors in KCS. Janus stock became as hot as its mutual funds the company managed. After the spin-off, shares quickly traded up from the mid-30s to over $50 a share in a matter of weeks. The company's market value exceeded $12 billion. And why not? After all, Janus was a "growth stock" (sarcasm intended). Janus' shareholders and mutual fund investors thought the party would never end. They were wrong.

When the music stopped and everyone had to find a chair, Janus was left standing. By 2002, assets under management had been cut in half! The performance of its flagship mutual funds was pitiful and investors withdrew money at a record pace. In short, Janus had lost its mojo. By October 2002, Janus shares reflected the pessimism, hitting $8.92 a share, valuing the company at just over $2 billion. At this price, Janus was a bargain.

Today Janus is trading at over $14 a share. With approximately 240 million shares outstanding, Janus is valued at $3.5 billion. It's still a bargain in our opinion. The company is managing almost $140 billion (and rising), about the same as in 1998-1999. Money management is an inherently profitable business. With this level of assets, profits should be considerable (over $150 million this year), despite past mistakes. Janus mutual funds are even performing better on average. Ironically, one of their top holdings is **Berkshire Hathaway,** our top holding, and perhaps a sign that Janus has learned from its mistakes.

In addition to its mutual funds, Janus owns a 33% stake in **DST Systems, Inc. (DST)** worth $1.3 billion. DST is apparently interested in buying the stake. A deal with DST is only one option, but it seems that management is determined to realize the value of DST and put the capital to use elsewhere. Many Wall Street analysts are still skeptical about Janus and its management, but this attitude is more than reflected in the current stock price. The earnings power of Janus and its DST holding make this an attractive holding.

In February, we began buying shares of **Lincoln Electric Holdings (LECO)**, the world's largest manufacturer of arc welding and cutting products. This Cleveland, Ohio based company is widely studied in business schools for its unique approach to compensation. LECO has a top-notch management and some of the highest paid, most productive workers in the country. The economic downturn has hurt Lincoln, but the company remains in good shape. The firm is quite profitable and generates $75 million+ in excess cash each year. A good portion of this cash is paid out in dividends. The rest LECO has been investing. In past years, LECO has expanded its international presence, buying welding-related firms (whole or in part) in Italy, Venezuela, Poland, and Taiwan. Over 40% of the firm's sales come from overseas. Last year, LECO signed a deal to buy South Korea's Hyundai Welding for $143 million. Two months later, the deal was called off without explanation. This caused a sell-off in Lincoln shares (from $31 to $20 a share) that we do not think was warranted. We used the opportunity to acquire a position. At $20 a share, LECO is valued at approximately $850 million, a reasonable price for this franchise. Welders are unglamorous, but essential, products and we think our ownership in Lincoln will be rewarded.

The last portfolio addition I'd like to mention is **Utah Medical Products (UTMD)**. A colleague of mine who runs a huge value-oriented mutual fund introduced me to UTMD and suggested I take a look. With a market value of under $100 million, Utah Medical is too small for his fund. It would be a drop in the proverbial bucket. Our bucket is a great deal smaller and their loss is our gain. UTMD manufactures disposable and reusable medical devices with a focus on women and babies. The firm's products are used in a wide variety of situations including: neonatal/pediatric intensive care, labor and delivery, laparoscopy, electrosurgery, and blood pressure monitoring. UTMD generates $7+ million in excess cash a year. In 2002, shares outstanding went from 5 million to 4.4 million, a drop of almost 12%. Management believes that UTMD stock is undervalued and is using its excess cash to repurchase and retire shares at a bargain price. This has an amazing compounding effect. Our ownership stake in the company continues to grow without having to even buy more shares! I wish Arthur Shorin at **The Topps Company (TOPP)** and some of our other CEO's would take notes.

The free cash flow and the commitment to opportunistic share repurchases alone are enough to make Utah Medical a bargain at the current price of $19 a share ($85 million). Nonetheless, the deal gets better. Last year, UTMD won a verdict against a subsidiary of **Tyco International (TYC)**. Yes, THAT Tyco! The US Federal Court in Utah said that a Tyco product infringed on a UTMD patent. Tyco was ordered to pay Utah Medical $20 million and there is a permanent injunction against further marketing of the Tyco product. The appeals process should be completed by the end of 2003, at which time, UTMD expects the verdict to be upheld. UTMD will no doubt use any cash received to pay off debt and repurchase more shares when it is advantageous. Even without the Tyco money, UTMD is an undervalued company. The intrinsic value of UTMD today is closer to $30 a shares than it is to the current market price of $19.

Nearly all of our portfolio companies experienced notable developments since the last client letter. Allow me to focus on a couple of them.

Berkshire Hathaway (BRK.B) has not received enough attention in our newsletters so far. This is especially true given its weight in the portfolio. I will begin to rectify the situation now. Berkshire Hathaway is one of the world's largest companies, yet few people have ever heard of it. Even fewer people (including many investment professionals) understand the company. Often Berkshire Hathaway is likened to a mutual fund with Warren Buffett as its portfolio manager. This characterization serves only to illustrate the ignorance of the person using it. It is a simplistic view at best and does Buffett and the company a huge disservice.

At its core, Berkshire Hathaway is an enormous property and casualty insurance company. The business is conducted on both a direct and reinsurance (insuring other insurance companies) basis. GEICO is only one of its numerous insurance subsidiaries. Berkshire also owns an eclectic group of non-insurance subsidiaries including: Acme Brick, Benjamin Moore, Flight Safety, Fruit of the Loom, Dairy Queen, Helzberg Diamonds, NetJets, The Pampered Chef, and many more. These have been acquired with the billions in cash the insurance and non-insurance subsidiaries have generated over the years.

At the end of March, Berkshire Hathaway was holding $16 billion cash. Cash continues to flow into Berkshire, and Buffett keeps putting it to work (or trying to). This year has seen a flurry of deals coming out of Omaha. In February, Berkshire inked a deal to buy textile manufacturer **Burlington Industries**. Burlington struck a deal with Berkshire while in Chapter 11 bankruptcy. Berkshire would pay $579 million to the company's creditors and it would emerge as a debt-free wholly owned subsidiary of Berkshire. The deal would have been a positive for both firms, but the plan was challenged in bankruptcy court. WL Ross & Company emerged with a rival plan, which it contended was a better deal for creditors. For the moment, any deal is on hold.

In April, Buffett was finally able to put a dent in his cash pile. Berkshire Hathaway has agreed to buy modular-home builder **Clayton Homes (CMH)** in a deal valued at $1.7 billion. Buffett has always been a disciplined buyer and this deal is no exception.

Finally, just last week, Berkshire Hathaway agreed to purchase the McLane Company from **Wal-Mart Stores (WMT)** for about $1.5 billion. McLane is one of the largest wholesale distributors of groceries and other items in the United States. The current environment should continue to provide many acquisition opportunities. It's a good thing. By my count Buffett has at least $13 billion cash left and that doesn't count the cash that has come in since March.

Berkshire Hathaway is SCHACHT VALUE's largest holding for good reason. Despite a market value of $110 billion, we are getting an amazing bargain. Our intrinsic value calculation indicates that Berkshire is worth <u>at least</u> $175 billion or $3,800 per B share, almost 60% higher than the current price. Also, few companies are as capable of increasing intrinsic value over time. A related point is that Berkshire from top to bottom has some of the best leadership in business today. The word "unique" is overused to be sure. Nonetheless, it is safe to say that Berkshire Hathaway is a unique company in structure, culture, and content. It's a rare treat to be able to buy a company of this caliber at a discount.

I look forward to discussing this holding with you further in the months and years ahead. In the meantime, I encourage all readers to visit the company website (<u>www.berkshirehathaway.com</u>). Pay particular attention to the <u>Owner's Manual</u> link and Buffett's recent letters to shareholders.

This will give you a great understanding of the company and its management. If you get bored, take a break and buy a Berkshire Hathaway T-shirt!

There are countless books on Warren Buffett and Berkshire Hathaway. If you want to learn more, I highly recommend Robert Miles' book *The Warren Buffett CEO: Secrets from the Berkshire Hathaway Managers*. Miles describes the group as follows: "Primarily, they are centimillionaires who work hard for a group of billionaire board members and long-term millionaire shareholders." We hope all of our clients join the latter group with Berkshire's help.

Lastly, I'd like to mention **Coastcast (COCA)**, a recurring theme. On April 24th, management announced that the board of directors is "reviewing alternatives for the possible acquisition of its publicly-owned stock." This is progress! I've heard the first step in any 12-step program is to admit you have a problem. This statement by Coastcast is such an acknowledgement. The press release might well have read, "Hello, my name is Coastcast and I am undervalued." At the moment, it seems the only action under serious consideration is a buyout led by CEO Hans Buehler. In any case, the market greeted the news with enthusiasm. COCA stock shot up to $2.40 a share soon after the announcement. It has since retreated a bit, but a clear catalyst is in sight. SCHACHT VALUE is in favor of a management buyout at a fair price ($3.50 or higher). This has been communicated to the board of directors. To show our commitment to seeing that COCA leaders do the right thing, I will be attending the company's annual meeting on June 12th in LA.

All in all, the first months of 2003 were a time of great progress and opportunity. The pessimism surrounding today's economy and capital markets is as unfounded as the euphoria that preceded it. With all the hand wringing being done by many investors and pundits (and indeed because of it), SCHACHT VALUE is finding an abundance of attractive investment opportunities.

We understand that the future is full of unknowns. Our investment process is not based on long-term forecasts or fortune-tellers, but rather on understanding companies and having the discipline to buy them at rational prices.

Many investors have rediscovered risk and uncertainty the hard way. Some say they'll never invest in the stock market again. They fail to realize that risk and uncertainty are not new (or even bad) concepts. The response brings to mind a quote I heard recently (from a philosopher):

> "Philosophers spend their lives kicking up dust and then complain that they can't see."

It seems the philosophers aren't alone.

All my best,

Henry W. Schacht, CFA
President and Chief Investment Officer