Schacht Value Investors, LLC

Capital Management in the Graham and Dodd Tradition

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Many Happy Returns

Annual performance reports will be mailed out soon, but they will only confirm what has become obvious to our clients: 2003 was a phenomenal year. Portfolio returns comfortably exceeded most broad market averages and any expectations we set in advance. And 2004 is off to a similar start.

Given these extraordinary gains, a note of caution is in order. It would be foolish for our clients to expect and for us to insinuate that future returns will look like those experienced in the recent past. Historically, the return on equities has averaged 8 to 12% annually. In this context, 2003 was a very welcome aberration (after 3 years of negative market returns) and we would prefer that our clients view it as such. While we strive every day to deliver substantial returns, it is critical that all clients have reasonable expectations and plan their financial affairs accordingly.

Due to the composition of the returns in the market, our performance is quite surprising. Price discretion in many sectors disappeared with investors diving head first into the most speculative issues, contributing to the over 50 percent rise in the NASDAQ last year. Despite the fact that long-term economic viability and investment value are dependent upon generating profits, in 2003 firms with no profits saw their shares increase more than those of their profitable peers. Related to this, dividend paying companies also underperformed. Some 370 companies in the S&P 500 now pay dividends. These companies saw their shares rise 23% versus 54% for those S&P 500 firms that do not pay dividends. These trends fly in the face of logic and are contrary to historical norms.

As a result of this price activity, there is evidence that certain industries are experiencing bubble-like valuations. To be clear, current excesses have not reached the madness exhibited in the 1990s, but there are signs that many investors have short memories. For instance, the price-to-earnings ratio of the S&P 500 is currently 20 versus about 100 for the tech-heavy NASDAQ. Put another way, investors are paying $100 for each dollar of NASDAQ earnings, while only paying $20 for that same dollar if earned by an often more mature, boring S&P 500 company. It's an amazing premium, one that is unwarranted and one that we refuse to pay.

Despite our lack of participation in the hottest sectors, those driven more by price momentum than fundamental value, we managed to perform admirably last year. Indeed, we are as pleased with how the returns were (or were not) achieved as we are with the returns themselves. And we are well positioned for the year ahead.

Exciting opportunities continue to present themselves despite the fact that the universe of potentially undervalued securities has decreased. In fact, given the direction of the markets, we could not be more pleased with the positioning of our clients' assets. Looking forward we do not see any wholesale changes to the portfolio. We remain skeptical about many of the most popular sectors in the market today, preferring to search elsewhere for value.

In December, we increased our commitment to pharmaceutical companies with the addition of **Merck & Co. (MRK)**. We continue to add to our existing position in **Bristol-Myers Squibb (BMY)** as well. The industry was a decided underperformer last year, driven largely by negative press from Washington and Wall Street. Analysts have focused on the increasingly significant threat posed by generic drugs and the lack of new blockbuster drugs. Meanwhile, Washington has been abuzz with political rhetoric on everything from the new Medicare drug-benefit plan to drug re-importation. Drug companies, like Big Tobacco, make for big targets in an election year. While we do not wish to minimize these issues, the resulting pessimism has been overdone.

With billions spent on research and development, fortunes can change quickly for a pharmaceutical company. Warner Lambert's pipeline was largely empty before its discovery of a little drug called Lipitor, the cholesterol-lowering blockbuster. **Pfizer (PFE)** acquired Warner shortly thereafter.

Both Merck and Bristol Myers seem to offer considerable value at current prices. Their problems are well documented and are no doubt reflected in the current stock quotes. Both have attractive, well-covered dividends: Bristol Myers yields nearly 4%, with Merck at over 3%. We like to get paid to wait. New products are also on the horizon. Bristol has three drugs being filed for approval in the next year or so. And we can't forget recently approved Erbitux, **Imclone's (IMCL)** infamous drug (think Martha Stewart), which BMY will be marketing. Merck had several well-publicized setbacks in its pipeline last year, but the company is remedying the situation. The Zetia/Zocor combination developed in a joint venture with **Schering Plough (SGP)** is coming soon. In addition, Merck has signed a series of agreements with smaller drug makers and completed at least one acquisition to acquire the rights to new drugs. We expect to be well rewarded by Merck and Bristol Myers in the months and years ahead.

Schacht Value also remains committed to the property/casualty insurance sector, with investments in both **Travelers Property Casualty (TAP.a)** and **Berkshire Hathaway (BRK.b)**. Berkshire, our largest holding, was an underperformer last year, but it is reversing that trend, up 12% year-to-date. One recent article title summed things up perfectly: *Stars in Alignment over Omaha*. Indeed they are. Berkshire is benefiting from a very favorable insurance environment, its status as a financial fortress within the industry, and the reputation of its management. Berkshire's insurance and non-insurance companies alike are performing well and continue to generate massive amounts of cash. The company has been putting this capital to work having recently purchased McLane, Wal-Mart's wholesale distribution company, and the manufactured home company, Clayton Homes. At current price levels, we believe BRK and TAP continue to offer considerable investment value.

Our other portfolio holdings have seen so many developments in the last three months that this newsletter could easily reach 10 to 15 pages. Nonetheless, you probably have better things to do with your time, so we have exercised restraint and focused on the highlights. Without question, the most important of these is **Hollinger International (HLR)**, where a revolution has taken place.

Schacht Value has owned the Chicago-based newspaper publishing company since November 2002. We were attracted initially by the firm's assets including Britain's Daily Telegraph, the Chicago Sun Times, and the Jerusalem Post. Unfortunately, the company was controlled by one Conrad Black through a maze of holding companies. Mr. Black is a flamboyant, controversial figure who renounced his Canadian citizenship in favor of the title Lord Black of Crossharbour and occupied a seat in England's House of Lords. To say that Black has an ego is an understatement, to be sure, and the image of a nobleman is apt.

It was Conrad Black who transformed Hollinger from a humble beginning to a major media player. He took full credit and had no use for anyone who questioned his management. In fact, he is quoted as saying that he “was not prepared to reenact the French Revolutionary renunciation of the rights of nobility” and that “we have to find a balance between an unfair taxation on the company and a reasonable treatment of the founder-builders-managers.” Black could afford to be arrogant. He had a veritable choke hold on Hollinger Int’l with 72.4% voting control. This while only owning roughly 30% of the outstanding stock. It was clear that the labyrinthine structure of holding companies and super-voting shares had only one real purpose: to enrich Black and his cohorts at the expense of outside shareholders. Executive compensation was many times what comparable firms paid, but it was Conrad Black’s world and he did as he pleased. The obvious result was that most media investors went elsewhere.

The fact that Hollinger was undervalued was an open secret. It was often said that the company suffered from an ailment called the Black Effect. In other words if the company was managed by anyone other than Conrad Black, it would warrant a considerably higher valuation. HLR’s board of directors was viewed as a rubber stamp, filled with important people (like Henry Kissinger and former IL governor James Thompson) who paid little attention and deferred to Lord Black. His wife was on the board too! There was little doubt that it would be better off in other hands, but that was a fantasy. Given his firm grasp on the company, few saw any viable way to remove Black or his “Effect”. But there was a tiny ray of hope: a small group of value investors too stubborn (or stupid) to know when to move on, who decided to shake the tree.

Herbert Denton of Providence Capital and Chris Browne of Tweedy Browne started the snowball rolling down the mountain. Tweedy Browne for its part was one of the largest (and long suffering) outside investors of Hollinger. The pressure brought by these firms began with letters, but quickly escalated. Enter Schacht Value at around $10 a share.

In June 2003, mounting shareholder pressure ultimately forced the company to appoint a special committee led by former SEC chairman Richard Breeden. The group was to review a host of issues including the compensation of management, a variety of transactions with related parties, and the general use or misuse of corporate funds. Meanwhile, Black insisted that nothing inappropriate would be found and that the focus on governance matters was unfounded and even a passing fad.

Unfortunately for Conrad Black, by January of this year Mr. Breeden uncovered $32 million in payments to management that were not authorized by the board and a pattern of breaches of fiduciary responsibility. The findings gave a portion of HLR’s board the excuse to grow a collective backbone. Apparently, second only to a woman scorned is a powerful group of politicos and socialites looking out for their reputations. At this point, events began to unfold quickly.

Conrad Black was first relieved of his duties as CEO and later forced off the board of directors. Old friends on the board filed a $200 million lawsuit against Black and his management team to recover improper payments. The board of directors also hired the investment bank Lazard to sell the company as a whole or in pieces. At this point, Hollinger shares were trading at around $16. The “Black Effect” was being erased.

But Conrad Black wasn’t done. Just one day after being dismissed, he agreed to sell his controlling interest in Hollinger via a holding company to the UK’s Barclay brothers. For outside shareholders, it was like trading one noble dictator for another (or two). The drive to realize the value of

Hollinger was seemingly at a standstill as was the crusade to recover any ill-gotten gains. Black, who had initially agreed to repay his portion of the $32 million, reneged. And Richard Breeden openly speculated that if the Barclay deal went through, Conrad Black would wire the proceeds offshore and escape to some friendly haven to escape any judgments against him.

In a last ditch effort, Hollinger's board took steps to block Conrad Black from selling his holding to the Barclay brothers. The two sides faced off this month in the Delaware Chancery Court, which this week ruled that Black could not sell out because doing so would harm minority shareholders. The opinion stated that Lord Black "repeatedly behaved in a manner inconsistent with the duty of loyalty he owed" to Hollinger International and its shareholders. This has always been understood by HLR shareholders, but to have a court state it in such terms is very powerful.

The process to sell Hollinger to the highest bidder is back on track and a clear message has been sent. Black's "rights of nobility" had limits and he had gone too far. Majority shareholders in a control position can only use or abuse their position to a point. The decision also illustrates the changes taking place in the corporate governance world and that outside shareholders can make a difference. Score one for the ignorant masses! With the stock price at $19 a share, we stormed the castle and won. As for Lord Black, he'd better get used to seeing the inside of a courtroom.

In other news that will allow all investors to sleep better, it seems **Johnson Outdoors (JOUT)** is actually going private. It has been a "public" company in name only. The Johnson family has now offered to buy out their fellow shareholders for $18 a share. Apparently they got tired of dealing with outsiders; shareholders can be such an annoyance! We explained last year how our pointed questions were received at last year's annual shareholders meeting. Setting that aside, the Johnson's know value when they see it. At $18, they're getting a good deal. The company, maker of everything from canoes and kayaks to Eureka tents, scuba gear, and Minn-Kota motors, is doing well. The stock price is currently trading over $19 a share in anticipation that the offer will be raised after the board reviews it. Nonetheless, having purchased most of our shares between $7 and $10 a share, we have no regrets, including the loss of the Johnson family as business partners.

Lastly, let's talk about **Enpro Industries (NPO)**, a company that earned the right to be mentioned in this letter long ago. Our first purchase was in May 2003 at under $9 a share. By year-end, it was at $13.95, up over 50%. This year the company is up 44% year-to-date. That's right, a 44% return in only 60 days! Certainly this must be a sexy biotech firm working on a cure for cancer, right? Nope, try boring industrial products. Enpro Industries manufactures sealing products, bearings, air compressors, and heavy-duty diesel and natural gas engines. This is a business we can understand.

Enpro started life as an independent company after its spin-off from Goodrich Corporation (GR) in May 2002 with Goodrich shareholders receiving a total of 21 million NPO shares. The shares began to drop immediately, from $8.50 initially to $2.16 a share by October 2002. Schacht Value found the company at this point, but did not invest due to "a lack of information" (our words). We've been kicking ourselves ever since for not digging around more. To our credit, we did not let one mistake lead to another.

As time passed, more financial information became available and the stock more than tripled from its lows. Despite this, we realized that Enpro was still dramatically undervalued with a market value below $200 million. Certainly, the firm was not without its problems. A couple of Enpro subsidiaries faced a mountain of asbestos litigation. Asbestos had once been a component in the manufacturing of certain products. This opened the door for lawsuits from individuals arguing that they suffered from asbestos exposure (sick or not). As was the case with **Cooper Industries (CBE)**, a past holding of Schacht Value, the mere mention of asbestos is like screaming "Fire!" in a crowded theater. On the surface Enpro Industries was a hot potato. But we looked a little deeper.

At $9 a share or $180 million, we got a company with solid businesses that generated $709 million in 2002 sales. These subsidiaries operated in a variety of industries providing nice internal diversification. Enpro had $80 million cash in the bank and relatively modest debt levels. Despite the soft economy, things were going quite well, except for the specter of asbestos. Nearly all of NPO's excess cash was going out the door for asbestos settlements and litigation. These expenses caused reported earnings to be essentially zero. The good news was that all trends were positive. NPO was well covered with insurance for much (if not all) of its asbestos claims. The company even won a couple of cases that went to trial. Evidently, the particular asbestos in question has not been conclusively linked to cancer and/or the individuals were not sick. In any case, settlements were still the cheaper option, but new claims were dropping quickly. With or without intervention by Congress and various state governments, Enpro had the asbestos issue firmly under control.

Enpro Industries ended 2003 having generated $77 million cash before asbestos expenses ($42 million after) on revenues of $732 million. New asbestos claims continued to drop. With cash on hand at almost $100 million, the company remains well capitalized. Business continues to improve and management continues to invest in its business. They even completed the purchase of a firm specializing in seals for the oil and gas industry. All this, while still managing itself out of the asbestos problem with a high degree of success. If these trends are any indication of the future, Enpro is still reasonably priced. The shares currently trade at $20 a share, representing a market value of roughly $400 million. Our egos are still bruised for not buying sooner, but the subsequent profits have had a soothing effect.

One housekeeping issue: The Schacht Value Investors website (*www.schachtvalue.com*) continues to be expanded and updated. In particular, we have added a Links page that features a host of Internet resources, and our list of recommended books continues to grow on the Education page. Our company website continues to be a valuable point of contact for our firm. If you know someone searching for investment alternatives, please refer them to the website.

Despite our note of caution at the beginning of this letter, we are pleased with our portfolio and the outlook for the future. It is always healthy to keep expectations rational. The doom and gloom that pervaded the markets less than two years ago are gone (for now) and investors have "rediscovered" the stock market. While this means that there are fewer fat pitches being thrown across the plate, we are not having any trouble putting capital to work. Compelling opportunities continue to present themselves in this market environment.

With my Louisville Slugger in hand,

Henry W. Schacht, CFA
President and Chief Investment Officer