Schacht Value Investors, LLC

Capital Management in the Graham and Dodd Tradition

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The Lesser of Two Evils

Thanks to a suggestion from a client, we are introducing an executive summary of sorts to our newsletter. The chart below illustrates the major portfolio changes that have taken place since our last communiqué. Not every decision reflected in this summary will be discussed, but it should provide a basis for discussion. So for all the *Reader's Digest* lovers, we present:

Portfolio Changes (since March 1, 2004)

Additions	*Eliminations*
American Power Conversion Corp (APCC)	Hollinger International (HLR)
Fresh Del Monte Produce, Inc. (FDP)	J. C. Penney Company (JCP)
Friedman Billings Ramsey Group (FBR)	Johnson Outdoors (JOUT)
Mattel, Inc. (MAT)	Lincoln Electric Holdings (LECO)
	Tenet Healthcare Corp (THC)

At first glance the chart above looks fairly balanced with "buys" roughly equaling "sells", but this would not be a correct conclusion. In reality, we have been net sellers in recent months. Old positions have been successfully harvested while new purchases have been small. Attractive ideas are harder to find as the overall market has risen. The result: more cash than we would like.

Client accounts currently hold 20-25% cash on average. Obviously it would be preferable to be fully invested in undervalued securities that meet our criteria. Those are hard to find, however, and we will not forfeit our long-term discipline to play the momentum game. The short-term opportunity cost of holding cash far outweighs the cost of making a mistake. We are not alone in this belief.

Seth Klarman of the Baupost Group summed up what many value-oriented firms have been saying recently. His firm's investment partnership held approximately 50% cash at year-end. In a letter to clients, he framed the issue this way:

> Perhaps some of you will soon be asking why you are paying us a management fee to hold so much cash. Let us preempt you by saying that you are not. You're paying us to decide when to hold onto cash and when to invest it – to determine when the expected return from a prospective investment justifies the risk involved and when it does not. In the short-term…earning next to nothing on cash creates a compulsion to invest even when all investment alternatives appear overvalued.
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> Choosing their poison, most investors prefer to hope that something expensive becomes even more expensive, especially when it has recently been doing exactly that. Holding cash, which they find barely tolerable when markets are falling, is anathema when markets are rising.

> Cash…is a way of safely doing nothing until a compelling investment opportunity arises…. Every investment must be compared to the alternative of holding cash…. Note that the investment is made not because cash is bad, but because the investment is good. Exiting cash for any other reason involves dangerous thinking and greatly heightened risk.

I couldn't say it any better myself. So where has all of the cash come from?

Several of our holdings saw their market values increase, meeting or exceeding our estimates of intrinsic value. This is true of **Hollinger International (HLR)**, **J. C. Penney (JCP)**, **Johnson Outdoors (JOUT)**, and **Lincoln Electric (LECO)**. Not bad for a few months!

Hollinger Int'l was Topic A in our last newsletter. At that point, the company was soliciting bids for its most prized assets and/or the whole company. Having already reduced our position, we sold our remaining shares at $18 a share after bids were tendered for HLR's *Daily Telegraph*. We had hoped that someone would bid for the entire firm, but that did not happen. Given the ongoing uncertainty in the company and its fight with Conrad Black, we decided to lock in a very healthy return. Hollinger is fairly valued at this point. Clients who have been with us since November 2002 experienced an 80+% total return from this holding.

J. C. Penney has also been discussed in these pages before. J. C. Penney created an enormous amount of shareholder wealth in recent months due to healthy earnings and a solution to the Eckerd Drug situation. The chain of drugstores was sold for $4.5 billion in cash. We believe the good news was fully reflected in the stock price when we sold our last shares at $32 a share. At that point, JCP shares took up permanent residence on the New High list, topping out at around $39. Wall Street was falling in love. How times change! One year ago, the shares were trading below $16. We love to buy cheap and sell dear.

Investors are also clamoring for shares of **Lincoln Electric**, our favorite welding equipment and supply company. We first purchased shares in February of 2003 at $20 each. Our estimate of intrinsic value was $30 from the beginning. Last month, we sold the bulk of our clients' shares between $30.00 and $31.50. Indeed, Lincoln has been on fire. First quarter earnings blew away Wall Street expectations, and rapid international expansion and growth continues. Nonetheless, the current quote for LECO fully reflects the good news.

We'd love to own Lincoln Electric again at the right price. This is not necessarily the case with **Johnson Outdoors**, which also was shown the door. We're very pleased, having sold our remaining shares at over $19 a share. Another happy ending, but it was a wild ride.

Not all of our holdings have worked out so well. Late last year we started buying shares of **Tenet Healthcare (THC)** at $12 a share. This hospital operator's stock had been hammered for a variety of reasons, especially weak earnings and legal troubles. Seeing opportunity, we did our homework and started buying. As the stock rose, so did the buying. Encouraged by positive developments and a reassuring *Barron's* review, THC shares spiked as high as $17. This should have been our cue to sell. Instead, it took an eye-opening first quarter earnings report. Operating and legal problems were far worse than we thought. Our research was clearly inadequate. As the stock price dropped, we sold the entire position between $9 and $10 a share. While painful, it was the right decision.

We strayed out of our circle of competence and paid the price. Tenet shares have recovered recently and it may ultimately prove to be a winner, but we'll be watching from the sidelines. The hospital industry and Tenet's situation make estimating its intrinsic value an effort in futility in our humbled opinion. Any purchase of THC at this point would be purely speculative and we don't knowingly cross that line. This is one time I wish the dog ate my homework.

Mistakes happen in this business. The key is to recognize them and deal with them. We want our clients to know that these instances will be highlighted in the same manner (albeit with less enthusiasm) as our victories.

Developments among our current holdings are so numerous that we could never cover them all here. Nevertheless, there are a couple worth mentioning.

Utah Medical Products (UTMD) initiated a regular dividend of 15¢ per quarter. At the current price of $26.50 a share, this represents a 2.25% yield. This is becoming a welcome theme in our portfolio. After receiving a $24 million cash payment from Tyco thanks to a successful lawsuit, UTMD decided to share the wealth. Besides a nice dividend, the firm's stock price still has some room to grow. The firm's market value is now approximately $124 million. The balance sheet sports over $24 million in cash and zero debt. Excess cash generation is $7 million per year or more. No doubt we were happier buying at $19 a share, but this is a solid company with excellent, disciplined management. Look for UTMD to aggressively repurchase its own shares on any price weakness.

On the earnings front, the picture was mixed. Fast-food restaurateur **Jack in the Box (JBX)** earned $0.53 a share (or $19.6 million) versus the Wall Street consensus of just $0.43 per share, with quarterly revenue up 12% to $517 million. **Furniture Brands' (FBN)** shares have fallen dramatically after the firm lowered earnings estimates. The stock had jumped dramatically earlier in the year thanks to a bullish forecast. We took that opportunity to sell most of the holding. After the disappointing news, it was time to take a step back. Buying of FBN could resume if the stock price continues to fall. This company remains the class of the industry.

When a firm has a disappointing quarter, it can often create a buying opportunity. A further example is **American Power Conversion (APCC)**, a new position in our portfolios. This company was trading at almost $25 a share in late April, putting APCC's market value at roughly $5 billion (200 million shares x $25). At this level, the company was no bargain. And then (quietly) it happened. On April 29th, the maker of power protection systems announced earnings of $34.7 million for the first quarter. Only one problem: Wall Street analysts had been expecting $38.7 million. That $4 million difference cost dearly. In just 3 weeks, the market value of APCC dropped $1.6 BILLION as the stock dropped below $17 a share. We thought this was a tad extreme. After all, power failures don't seem to be on the decline these days and APCC owns the market for uninterruptible power supplies used by computer systems (PC's to supercomputers).

While some were upset with the earnings, context is important. One year ago, American Power had earned $30 million in the first quarter of 2003. So $34.7 million represented earnings growth of 15%. Sales had increased over 13% over the same period. Not bad! But APCC had "missed analysts' expectations", the cardinal sin. Instead of running away, we were intrigued. So much so, we started buying shares on May 20th at $16.95.

At $3.4 billion ($17 x 200 million shares), American Power Conversion looked like a good deal. The company was sitting on $800 million in cash. Debt, you ask? Zero! The company generates copious amounts of cash and should earn $200 million this year.

Within 3 weeks of dipping our collective toes into the water, American Power's management announced that they weren't going to let the cash sit idle. A 25% annual dividend increase (to $0.40 a share) and a $150 million stock repurchase was announced on June 14th. The stock has responded, up almost 13% since the first purchase to over $19 a share. Our price target is $23. This would represent a 35% gain (excluding dividends) at a price that is still below where APCC was trading before the troubles began. You've got to love that!

Toy manufacturer **Mattel (MAT)** was also added to client accounts recently. The owner of Fisher-Price, Barbie, American Girl, and Hot Wheels has fallen out of favor lately. Competition is a major factor and Mattel is the big kid on the block with nearly $5 billion in annual sales. Earnings have been lackluster and the stock has drifted. In fact, MAT shares are little changed since early 2001. CEO Bob Eckert is taking the operating challenges seriously and we are encouraged by the results. Between its brands and its financial acumen, Mattel has many strengths and it will likely weather the storm. The proof is in the numbers. Over the last 3 years, Mattel generated approximately $2.75 billion. In turn the company increased capital spending, paid off $800 million worth of debt, paid $200 million in dividends, repurchased $250 million worth of its stock, and increased cash on hand to almost $1 billion. We should all be in such "bad" shape!

We started buying Mattel shares at around $19 a share in March. The position is underwater at the moment as MAT is trading at $18 today. That said, we're happy with the direction of the company and our investment. With a market value of between $7 and $8 billion, there is considerable upside. Unlike Ken and Barbie, Schacht Value and Mattel won't be breaking up anytime soon.

2004 has been an interesting year so far, complicated a bit by all the volatility. Client accounts are up approximately 4% year-to-date. New accounts opened or just ramping up during the spring, however, are an exception. The Schacht Value portfolio hit its highs of the year (briefly) at the end of February. This caused a performance disparity for accounts that were buyers during that period. Time and disciplined buying will be the great equalizer.

We are pleased with our performance thus far, but not yet satisfied. We will be patient, but don't be surprised to see cash being put to work quickly when opportunities arise.

Happy Independence Day,

Henry W. Schacht, CFA
President and Chief Investment Officer

"Some see private enterprise as a predatory target to be shot, others as a cow to be milked, but few are those who see it as a sturdy horse pulling everyone's wagon."

- Winston Churchill