SCHACHT VALUE INVESTORS, LLC

Capital Management in the Graham and Dodd Tradition

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Eat, Drink, and Be Merry

With the market sitting at lows for the year, it hardly feels like a time to party. In fact, most of you are probably muttering the rest of the phrase: "for tomorrow we may die".

Today's headlines provide plenty of reasons to be glum. Oil prices (and gasoline by extension) are rising on global demand (China), on terrorism fears (Iraq), on hurricanes, and on pure speculation. Job growth has been relatively slow. New York Attorney General Eliot Spitzer has a new target, the insurance industry, in the crosshairs and, yes, there's an election coming up! You get the idea.

Investor confidence is dropping by the day and confusion is abundant. Just witness the gyration of interest rates . . . down, up, and back down again in the span of a few months. Is the economic recovery stalled or non-existent? Recent economic data often contradicts itself and offers plenty of ammunition for those in both the bullish and bearish camps.

Confused? You're not alone. A few months ago, investors worried about the strong recovery leading to an overheated economy. The stock market dropped on the prospect of higher interest rates and inflation. When the economic picture grew less clear, the market dropped even more!

Schacht Value is quite comfortable in the current environment. A few simple economic facts . . . The Fed continues to raise short-term rates at a slow, but deliberate pace. The United States has the lowest unemployment rate in the industrialized world. GDP growth is strong. The recovery is a (bumpy) reality despite tepid job growth, which is always a lagging indicator. Our conclusion is that interest rates should rise to more normal levels and that the bond and real estate markets will not continue to outperform equities.

Nervous investors have jumped back into the bond market after a brief hiatus. Interest rates are again at levels not seen in 40 years. In fact, the 10 year Treasury now yields less than 4%. Are you willing to lend money to the US government for 10 years in return for a 4% yield? Jim Grant of *Grant's Interest Rate Observer* says the bond market offers "return-free risk". Nonetheless, we continue to hear stories of investors liquidating their equity portfolios in favor of bonds.

Real estate is another so-called "refuge", which is seeing its share of "irrational exuberance". A series of recent Fortune articles highlighted some interesting observations:

- The nationwide median home price has risen 47% since 1995.
- Economists Robert Shiller and Karl Case found that nearly 30% of homebuyers in Boston, LA, and San Francisco expected home prices to rise 20% a year for the next 10 years.
- Rule of thumb in Northern Virginia: If you don't buy now, prices will be 1% higher next month ($6,000 on a $600,000 house).
- The volume of house sales is 50% higher today than it was in the mid to late 1990s.

- Since the mid-1990s, home prices have risen 25% faster than rents on average.
- From 1975 to 2000, home prices remained at 2.7 to 2.9x median annual income.
- Today, the figure is 3.4x.

These figures are averages. Overheated markets on the coasts like San Diego (median home price: $559,000) are more than offsetting weakness in places like the Midwest - Indianapolis (median home price: $125,000). Could San Diego real estate be the Internet stock of 2004? Either way, buying high and selling higher doesn't seem like a sustainable long-term investment strategy. But this hasn't prevented thousands of Average Joes from becoming real estate speculators.

In this economic environment, we prefer to look for value in the stock market. Nonetheless, recent negative price pressure has been a two-edged sword, creating buying opportunities and hurting our short-term performance. It's a trade-off we're willing to make.

Portfolio Changes (since July 1, 2004)

Additions	*Eliminations*
CBRL (Cracker Barrel) Group, Inc. (CBRL)	Coastcast Corp (COCA)
Diageo plc ADR (DEO)	Jack in the Box, Inc. (JBX)
General Motors Corporation (GM)	The Nautilus Group (NLS)
Koninklijke Philips Electronics NV ADR (PHG)	
Nokia Corporation ADR (NOK)	
Pier One Imports, Inc. (PIR)	
PNC Financial Services (PNC)	
Sears, Roebuck & Company (S)	
SPX Corporation (SPW)	
Unilever NV ADR (UN)	

As discussed in the last newsletter, cash balances have been unusually high, so we are pleased to report progress in putting that cash to work. In response to increased volatility in the marketplace, new positions are of a smaller size (as a percentage of client accounts) than has been the case in the past. This increased diversification is temporary as we add to new positions on weakness and sell older positions that meet our price target. Cash, therefore, continues to represent a significant (albeit smaller) portion of our accounts.

A casual observer will notice that several of our portfolio additions carry the suffix ADR. These American Depository Receipts are certificates issued by a U.S. bank and traded on a U.S. stock exchange. Each represents ownership of a specific number of shares in a foreign company. In this fashion, Schacht Value invested in four European firms in the past quarter. We believe that each offers considerable value.

In March of this year, **Nokia (NOK)** shares were riding high, trading as high as $23.50. This equates to a market value of $110 billion (4.7 billion shares x $23.50). The Finland-based cellular phone and networking company was hot! With nearly 35% of the cell phone market, fabulous earnings growth, essentially no debt, and free cash flow of over $3 billion a year, investors had a lot to be happy about and they were paying up. On April 5th, Nokia gave its fans a cold shower when it announced that it would miss first quarter revenue targets. Hot stocks don't handle bad news well.

Nokia shares dropped nearly 20% in one trading day, from $21 to $17 a share. Very quickly investors forgot about Nokia's beauty and focused on its warts.

The cell phone market is competitive and characterized by changing consumer demands. And at least in the short-term, Nokia was outmaneuvered. Motorola, Sony-Ericsson, Siemens, and Samsung seemed to be running on all cylinders with sexy clamshell style phones with built-in extras, like cameras. Nokia, on the other hand, was still dependant on the old candy bar style phones. Its new models were not coming to market fast enough. In addition, besides general price pressures, much of Nokia's growth was in Asia where low-end phones are more popular. All this weighed on NOK shares. By mid-August the stock hit a low of $10.89, an amazing 54% drop from top to bottom. Drops of this magnitude generally catch our attention!

Schacht Value bought Nokia shares in July at around $12. At this point, the market value of the company sat at $55 billion. Our research concluded that this was a good entry point. Life at Nokia was not as bleak as the headlines suggest.

Despite a market share drop to around 28-29%, NOK is still the largest cellular company on Earth. (#2 Motorola has less than 20% of the business.) The company has attractive prospects in China and its network business (installing the cellular infrastructure) is doing well. We believe the product pipeline issue is overblown. Nokia has a number of new products coming to market and is getting very aggressive with pricing. When it comes to pricing, Nokia is in the catbird seat. It can make money even at lower price points because of its sales volume. A firm selling fewer units can easily lose money while NOK remains comfortably in the black.

Indeed, Nokia boasted net income of $4+ billion last year. This year's profit should be in the same neighborhood. Factoring in essentially zero debt and over $15 billion in the bank, we find that Nokia can weather the competitive storms and still be in good fighting form. In fact, the company acknowledges that it has more work to do in returning excess cash to shareholders. We look for dividend increases and more share repurchases in the near future.

Schacht Value also took a small position in UK-based **Diageo plc (DEO),** a maker of alcoholic beverages (beer and wine), including brands like Guinness stout, Smirnoff vodka, Johnnie Walker Scotch whiskies, Baileys Original Irish Cream, J&B Scotch whisky, Captain Morgan rum, Tanqueray gin, and Cuervo tequila. The company was created when Grand Metropolitan plc and Guinness plc merged in 1997. Since that time, the combined firm has been building its portfolio of beverage brands while selling a host of non-beverage businesses. Pillsbury was sold to **General Mills (GIS)** in 2001. A year later, its fast food business, Burger King, was sent packing. As a result of these transactions, Diageo gained a healthy cash position and 79 million shares of General Mills stock (valued at over $3.5 billion). Diageo has been busy in recent months selling these GIS shares (now at 25 million shares). The added focus has led to a leaner operation and more predictable cash flow. In fact, at its annual meeting this week, the company announced that it would use half of the $2.26 billion proceeds from the sale of General Mills stock to repay debt and the other half to repurchase its own shares. The company stated: "We believe that the most appropriate mechanism by which to return surplus capital is through a combination of an on-market share buyback programme and dividend payments." We'll drink to that!

(**Note:** Diageo has **<u>not</u>** been included in portfolios with a "prohibition" on owning alcohol companies. If it has been placed in a portfolio where it is not wanted, please notify our office.)

Unilever NV (UN) and **Koninklijke (Royal) Philips Electronics NV (PHG)** are similar stories. Both companies are selling at 10 to 12 times earnings, have compelling global brands, and are becoming more focused. The British-Dutch firm, Unilever has been selling off underperforming brands and refocusing on Food and Personal Care products. Food brands include: Birdseye, Hellmann's, Lipton, Breyer's, Good Humor, Ben & Jerry's, and Ragu. Personal care brands include: Dove, Pond's, and Surf. Philips Electronics is Europe's largest electronics company with its name plastered on everything from light bulbs and TV's to semiconductors and heart defibrillators. In addition, the firm holds a multi-billion dollar portfolio with investments in **Taiwan Semiconductor (TSM)** and **LG.Philips (LPL).** Philips has already unloaded stakes in **Vivendi (V)** and **JDS Uniphase (JDSU)** and continues to monetize such investments for the benefit of its shareholders. As Unilever and Philips slim down, the proceeds are used on a combination of debt repayments, increasing dividends, and stock buybacks. Sound familiar?

We also put some money to work in Lebanon . . . Lebanon, Tennessee that is. **CBRL Group (CBRL)**, owner of Cracker Barrel and Logan Roadhouse chains, earned a spot in the portfolio when its stock dropped below $32 a share in August. Since Cracker Barrel restaurants are located primarily along the Interstate Highway System, rising fuel costs got investors nervous. Higher food costs didn't help either. But results for CBRL remain good. The Logan's chain is growing nicely. Firm-wide earnings have advanced at 10+ percent a year and cash generation is impressive. Buying at just 12 times earnings, we should be well rewarded.

CBRL makes a nice replacement for **Jack in the Box (JBX)**. The fast food operator hit our price target of $30 a share in July and we subsequently sold our shares after a 41 percent gain year-to-date. The position was initiated in December amid the Mad Cow scare for around $21 a share. JBX's business was unaffected by publicity from Mad Cow. In fact, Jack in the Box made great strides in spurring growth, improving the customer experience, and (most importantly) increasing profitability. The stock reflected this progress faster than we anticipated. Not bad for 6 months!

Our position in fitness equipment firm **Nautilus (NLS),** which was discussed at length in a previous edition, was also liquidated after an 80 percent rise in its stock price. You may recall that we picked up NLS shares in September 2003 at $12.10-$12.35 a share after a major disappointment on profitability. The stock price fell from a high of $45 a share and was left for dead. Today, with new management and broader sales channels, the company is in full recovery mode. NLS still has zero debt and $100 million in cash, but competition in this field is fierce. The company must grow in order to maintain profits at current levels. Earnings of around $30 million a year is probably the norm for the foreseeable future. After blowing through our price target of $20, we sold our remaining NLS shares at $22 a share. This puts the market value of Nautilus at roughly $750 million. Even adjusted for the excess cash, that represents a valuation of 23x annual earnings. Nautilus is no longer undervalued by any measure and we'll be putting our capital elsewhere. Now that's the kind of workout we can get used to. Thanks for pumping us up, Nautilus!

Despite our newfound opportunities and success stories, this year has been humbling. Virtually every success has been offset by a decline elsewhere in the portfolio. Per usual, we plan to give equal time to the lowlights. This year our drug stock holdings have been the main area of disappointment. This sector is one of the worst performers (if not the worst) in the market this year. And they remain about as popular as **Halliburton (HAL)** in this election year.

Much of the investor apprehension is related to the issue of importing cheap drugs from Canada. The party line says that all our problems will be solved by simply buying cheaper pills from our friends north of the border. In a recent *Fortune* article entitled "Both candidates are on a drug trip to fantasyland", author Geoffrey Colvin puts the issue to rest this way:

> In economics the drug import situation is a common one, known as the free-rider problem. It arises anytime someone is able to consume a product or service without paying his or her fair share of the costs. For example, your public radio station is constantly haranguing you for money, but you can listen even if you don't donate. Others end up paying the bill, and you can ride along for free.
>
> In the world of prescription drugs, the U.S. market pays the stupendous costs of developing new products. It's not only the world's largest economy, it's also one in which drug companies are free to charge what the market will bear. As a result, the U.S. market brings forth most of the new, breakthrough medicines the rest of the world wants. Then the rest of the world - not just Canada but Western Europe and South Africa as well - free rides on this circumstance by mandating lower prices in their countries. As long as these prices are higher than the drug companies' marginal production costs, the companies will go ahead and sell to those countries. And as long as those countries can't send the drugs back into the U.S., the system works.
>
> Senator Kerry and the many others who want to legalize drug imports . . . believe they can achieve everyone's dream, getting something for nothing. By simply enacting a law, they think they can make the U.S. a free rider on itself. In fantasyland, no one would have to pay for drug development at all. Maybe these people are economic illiterates who believe in magic.

Worried that American demand for Canadian drugs would throw a wrench into the price-control system has further complicated the issue. Last week, the *Financial Times* reported that over "30 Canadian internet pharmacies have decided not to accept bulk orders for prescription drugs" from the United States, because there is "growing concern in Canada that growing exports to the US could lead to rising prices and shortages north of the border." Indeed, Canada can't supply a significant number of Americans with bargain prescription drugs without threatening their system.

In the meantime, pharmaceutical firms are not sitting idle. In fact, **GlaxoSmithKline (GSK)**, another new holding, states on its website that "GSK Canada has begun to restrict shipments of prescription medicines to identified Internet pharmacies in Canada for export to the United States or elsewhere." And they highlight the core issue, estimating that "cross-border Internet sales of its products currently represents less than one day of its total U.S. sales." This is not enough to destroy Canadian price controls, but clearly a higher level is unsustainable.

It seems that Canadian taxpayers and the pharmaceutical industry have a common cause. The real solution to lowering drug prices is ending price controls in Canada and elsewhere, but don't hold your breath. In the meantime, this issue will continue to have a psychological effect on drug company valuations, but not (we think) on their intrinsic values.

On our list of pharmaceutical industry concerns, Canadian importation is near the bottom. Far more worrisome are the prevalence of patent expirations, a lack of new blockbuster drugs in the pipeline, the industry's dependence on big new ideas, and the increasingly hostile legal environment.

In December, **Merck (MRK)** was the poster child for everything wrong in the pharmaceutical industry. We started buying shares at around $43, because our thesis was that the bad news was already factored into the battered share price. Furthermore, we admire CEO Ray Gilmartin for resisting the urge to do the easy (and stupid) thing by simply merging with another large drug company to temporarily cover up the real problems that exist. Merck and its peers need to streamline the research process, speed time to market, and stop being so insulated. Competition and price pressures necessitate a dramatic cultural change since "lean and mean" is not an oft used term in this industry.

Merck was making good progress on these fronts when another shoe dropped. This month, the company withdrew its blockbuster pain reliever Vioxx from the market due to an increase of "cardiovascular events" in patients taking the drug for more than 18 months. This announcement and subsequent lawsuits have knocked $30 billion off of MRK's market value. The shares are currently trading at around $31 a share.

In light of recent developments, we are reviewing all of our drug company holdings. While all of our positions are reviewed at least quarterly, this is a special project. Having a big loser in the portfolio is a painful daily reminder of a poor decision. But we don't buy or sell based on emotion, feelings, or ego. For example, selling Merck now may be the worst possible reaction. The question is: Knowing what we know now, would Schacht Value buy Merck today at the current price? In short, is the price-to-value equation compelling? The preliminary answer is "yes".

Last year Merck announced it would eliminate 4,400 positions in response to patent expirations. It is ahead of schedule. Year to date, Merck has signed over 40 agreements with outside firms to fill the hole in its product pipeline. Internal research is also progressing at a measured pace. The firm has a healthy cash position and expects some $6 billion in free cash flow this year. The wildcard is the legal costs of Vioxx. We'll let you know what we decide.

Despite this drug-induced stumble, we feel good about the overall progress made this year. Like a man treading water, there's been a lot of movement below the surface, not much visible progress, but we aren't sinking! And considering the broad market performance this year, it could be worse.

Keep the faith. But if this market drives you to drink, may I suggest a pint of Guinness? Don't worry, the only pints on this end are Ben & Jerry's ice cream. Hmm . . . Cherry Garcia or Chunky Monkey? Decisions, decisions, decisions.

Until next time,

Henry W. Schacht, CFA
President and Chief Investment Officer