

SCHACHT VALUE INVESTORS, LLC

Capital Management in the Graham and Dodd Tradition

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www.schachtvalue.com

Stock-ing Stuffer

Inspiration has come slowly to the stock market this year. Like 2004, the stock market did little or nothing in the first 9 months of this year. If not for the rally that started in November, the U.S. stock market would be flat to down year-to-date. Outside of the energy sector and other commodity-based businesses, investor conviction has been hard to find.

There are major disagreements within the financial community regarding the economy and the direction of the markets. The optimists have plenty to of ammunition. The economy is growing at a healthy rate. Unemployment and interest rates remain at historically low levels. Corporations are flush with cash and merger/acquisition activity is increasing. This backdrop has done little to assuage the fears of those who point to high energy costs, the cost of Katrina and other natural disasters, the global economy's reliance on an increasingly overextended American consumer, persistent trade deficits, and rising inflation fears.

On balance, we view the current economic environment positively. Despite dire predictions, the economy has shown remarkable resilience in the face of high energy prices and other challenges. Consumer spending remains strong and corporations show a willingness to expand and reinvest in their businesses. This is evidenced by strong technology spending. Furthermore, energy firms are responding to the incentive of higher prices by increasing exploration and production. All of these signs are encouraging.

In any case, Schacht Value continues to apply its value-oriented investment process in the search for undervalued opportunities. We calculate a firm's intrinsic value through an examination of underlying corporate assets, conservative estimates of ongoing free cash flow generation, and growth. Valuation discipline requires a discount to intrinsic value (margin of safety) of 40-60 percent to justify the purchase of a given security. Finally, we adhere to a sell discipline that is based on price targets set over a multi-year time horizon. Portfolio decisions are based on the ongoing fundamentals of each holding and a comparison to other investment alternatives that exist. It is important for us to be patient when short-term price movements go against us if the fundamentals of a company remain intact.

Despite the complex investing environment and a lack of energy and other commodity businesses, client portfolios have outperformed the broader market averages this year.

The overall approach has been successful, but we have experienced several self-inflicted "wounds" in recent months. **Delphi (DPH)** and **General Motors (GM)** are the most obvious examples. Shortly after touting them in the last newsletter, it became increasingly obvious that business conditions were deteriorating and that legacy costs were weighing more heavily than originally thought. The negative news led to lower prices and we felt justified in holding the shares because the price/value disparity seemed to remain attractive. The pattern of disappointment only repeated itself. We continue to hold GM since we still have conviction about the value of its underlying assets (especially GMAC), but we exited Delphi long before its troubles resulted in bankruptcy.

Our experience in the pharmaceutical sector was not much different. We eliminated our pharmaceutical holdings in recent months after a poor showing overall. While **Glaxo (GLX)** was a success, **Bristol**

Myers (BMY) and **Merck (MRK)** were sold as legal troubles and patent expirations continue to take their toll. Ultimately we found better opportunities elsewhere and we made room in the portfolio for these more attractive holdings.

In addition, we have made a number of other portfolio changes since the last newsletter.

Portfolio Changes (since February 20, 2005)

Additions

Arkansas Best Corp (ABFS)
Anglo American plc (AAUK)
ABN Amro Holding NV (ABN)
Cendant (CD)
Constellation Brands (STZ)
Directv Group (DTV)
Gannett Company (GCI)
Hewlett-Packard Company (HPQ)
Home Depot (HD)
Loews Corp (LTR)
McDonalds Corp (MCD)
Molson Coors (TAP)
Monaco Coach (MNC)
Neenah Paper (NP)
News Corp B (NWS)
Overnite Transportation (OVNT)
Sara Lee Corp (SLE)
Thor Industries (THO)
Timberland Co. A (TBL)
Tyson Foods A (TSN)
Whirlpool Corp (WHR)
Weyerhaeuser (WY)
Yellow Roadway (YELL)

Eliminations

American Power Conversion (APCC)
Bristol Myers Squibb (BMY)
Brown Shoe Company, Inc. (BWS)
Cendant (CD)
Delphi Corporation (DPH)
Fifth Third Bancorp (FITB)
Friedman Billings Ramsey (FBR)
GlaxoSmithKline plc (GSK)
Janus Capital Group (JNS)
Kellwood Company (KWD)
Mattel (MAT)
McDonalds Corp (MCD)
Merck & Company (MRK)
Monaco Coach (MNC)
Overnite Transportation (OVNT)
Reebok International Ltd (RBK)
Sara Lee Corp (SLE)
SPX Corp (SPW)
Tribune Company (TRB)
Union Pacific Corp (UNP)

Our ownership of **Overnite Transportation (OVNT)** provides a nice counterpoint to the value traps mentioned above. We purchased Overnite in February at prices around \$30 a share. A one-time subsidiary of **Union Pacific (UNP)**, it was spun-off to form an independent company. Overnite quietly made progress, enjoying the dual benefit of low valuations and improving fundamentals. We got double-digit revenue growth and increasing profitability for just 9 times earnings. We weren't the only one's who saw the value. On May 15, 2005, UPS agreed to buy Overnite in a cash transaction valued at approximately \$1.25 billion or \$43.25 per share. We were pleased to see that our \$40 price target was so close to what UPS actually agreed to pay (about 14 times earnings). We don't pull price targets out of thin air and the OVNT transaction reinforced our valuation methods. The 40+ percent gain is nice too!

We invested the proceeds from Overnite in two more trucking companies, **Arkansas Best (ABF)** and **Yellow Roadway (YELL)**. The investment thesis remains the same: compelling valuations in a consolidating industry. Our transportation holdings have been very rewarding as a group thanks in part to fundamental changes. The trucking industry was once seen as hyper-cyclical. Business was only as good as the weakest competitor. In good times trucking firms would add capacity rapidly, thus killing pricing, and bringing about the next bust.

Today, pricing is high and capacity is tight, but unlike past cycles, trucking firms are reluctant to add capacity. In the words of Robert Young, CEO of ABF, “The dummies are all out of business.” And he should know. Mr. Young is an industry veteran, who owns nearly 10% of ABF, and runs a very tight operation. In fact, all ABF trucks have speed governors on the engine to save fuel and promote safety. The company is completely debt free and was selling at 8 times earnings when we started buying in May at \$32 a share. With 25,000,000 shares outstanding, ABF was valued at roughly \$800 million. The company has \$80+ million cash in the bank and it is on track to earn \$100 million this year. That is compelling! The company continues to expand its services, including a do-it-yourself moving service (UPack.com). The market is taking notice. Since our first purchase, Arkansas Best is up over 36 percent.

Another area that continues to yield interesting prospects is large conglomerates.

This fall we accumulated shares of London-based **Anglo American (AAUK)**. Anglo is the world’s second largest mining concern. It owns companies that mine gold, platinum, coal, copper, nickel, iron ore and more. Anglo American also owns Tarmac (concrete/aggregates), Copebras (phosphates), Mondi (paper/packaging), several steel companies, and 45% of DeBeers (diamonds). There’s more, but you get the idea. The company’s size and scope caught our eye initially. What got us excited was the change in strategic direction. Management announced that it had done a poor job in the past of creating shareholder value and that it was going to do something about it by slimming down and becoming more focused.

AAUK is in the process of reducing its gold exposure by reducing its 51% holding in **Anglo Gold Ashanti (AU)**. The paper, steel, and concrete businesses will most likely be divested one way or another. The result will be higher dividends for shareholders and a stronger mining business focused on diamonds, platinum, coal, iron and base metals. Another bonus is that AAUK is relatively unknown in the investment community and that is beginning to change. In less than 3 months, we are up almost 20 percent. We expect even more in the future. While you won’t find us in the commodity pits, we don’t mind doing a little mining in the stock market.

Another conglomerate that goes relatively unnoticed is **Loews Corp (LTR)**. This holding company contains a truly odd mixture of diverse businesses. LTR owns stakes in **Boardwalk Pipeline (BWP)** – oil/gas transmission; Loews hotels; **Diamond Offshore (DO)** – offshore oil/gas drilling; **CNA Financial (CNA)** – insurance; and Bulova Corporation – watches. Loews also owns Lorillard, maker of Newport cigarettes, but this business trades separately as **The Carolina Group (CG)**.

The decision to own Loews is not based on a pending restructuring. Rather, it is a bet on management, the underlying businesses they control, and their ability to buy/sell companies in the future. We are currently waiting for some cash to be put to work. Proceeds from recent asset sales are nearly \$3 billion, but the Loews is not in any rush. We’re not going anywhere either. If you add up the value of Loews’ holdings and its cash balance, it is pretty clear that LTR is selling at a discount to the value of its assets. The gap has narrowed a bit recently, however, as LTR is up 15% since August.

In our continuing quest to be on the cutting edge, Schacht Value committed a significant amount of capital to...the shoe industry. Clearly, shoes don’t capture the imagination like biotech or the Internet, but our returns in this mundane business are something to get excited about. In our last newsletter, we wrote about **Reebok International (RBK)** and how it was making huge strides (pun intended) and selling at a very reasonable valuation of 12-13 times earnings with solid growth prospects. We built a position in RBK and the stock flat-lined around \$40 a share for months. On August 3, 2005, that changed when Adidas-Salomon AG announced that it would acquire Reebok for \$59.00 a share in cash. The offer

price represented a premium of 34.2% over the previous closing price and valued Reebok at nearly \$4 billion. The new combined firm hopes to have the size and strength to take on Nike. It promises to be an interesting battle to watch from the sidelines. We made more than 40 percent on our Reebok shares in less than a year. If that's boring, then so be it!

Brown Shoe (BWS) was also discussed in the last newsletter. This shoe company was selling at a very compelling valuation and its Famous Footwear division was delivering solid results. After the company hit our price target, we sold the position for a 20+ percent gain, but it is clear now that we were overly conservative in our valuation of BWS. It would be nice to own Brown Shoe again if the price drops from current levels.

In the meantime, Schacht Value is building a position in **Timberland (TBL)**, the latest addition to our string of shoe holdings. Worries about growth have knocked Timberland's stock price down from a July high of \$41 a share into the low \$30's. At the current quotation, Timberland has a market value of around \$2 billion. That is too low. TBL is conservatively financed with zero debt and \$200 million cash on hand. The company generates loads of cash and is selling for just 13 times 2006 earnings. This is a recipe that's worked well in the past, so we're trying it again.

Next time you're in a shoe store, spend freely.

Looking ahead, we continue to find investment opportunities that will play out well into 2006.

In addition to the holdings already discussed, we continue to like large financial companies, especially those with international exposure, low multiples, and solid dividends. **Citigroup (C)** fits this description and thus remains in the portfolio. **ABN Amro (ABN)** was added for the same reasons. It has a presence in 60 countries and is expanding aggressively in China. This Dutch financial conglomerate trades at only 10-11 times earnings and sports a dividend yield of over 4 percent. What's not to like?

The continuing pessimism that surrounds large media conglomerates is overdone. Investors fear that changing technology and competition from the Internet will render them obsolete. Such predictions may make for great headlines, but we still find value on both the content and distribution sides of the media business. For this reason, **News Corp (NWS)**, **Directv Group (DTV)**, and **Gannett (GCI)** remain in the portfolio. We'll plan on adding to these positions going forward.

Our next newsletter will provide a final wrap-up of 2005 and a look ahead.

Until then, have a Merry Christmas and a Happy New Year!

All the best from my family to yours,

Henry W. Schacht, CFA
President and Chief Investment Officer