SCHACHT VALUE INVESTORS, LLC

Capital Management in the Graham and Dodd Tradition

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Rolling Stones

Schacht Value Investors delivered solid results in 2004, once again outperforming the broader market. Client portfolios saw an average annual increase of 12.3% after all fees. This compares with a 10.9% return for the S&P 500 index with fully 9.2% of the market's return coming the 4th Quarter alone. Our portfolio also showed little sustained progress until late in the year. The portfolio was up some 7% by the end of February, then down, back up, down, and finally up again.

The experience left us feeling like Sisyphus, a character out of Greek mythology. Sisyphus was a cunning man who betrayed the gods and was condemned to an eternity of hard labor. Specifically, he was to perpetually roll a huge stone up a steep hill. Upon nearing the top, the stone would tumble back down and the futile effort continued. From January through October, we got a small taste of this Greek tragedy.

Although we had to deal with a bipolar market, our stock selection process was quite productive overall. Holdings that increased more than 20% include: American Power Conversion (APCC), Apple Computer (AAPL), CBRL Group (CBRL), Fresh Del Monte (FDP), Freddie Mac (FRE), Hollinger (HLR), Jack in the Box (JBX), JC Penney (JCP), J&J Snack Foods (JJSF), Johnson Outdoors (JOUT), Lincoln Electric (LECO), Nautilus Group (NLS), Nokia (NOK), and Sears (S). In fact, several of these were up more than 30%. Enpro Industries (NPO), which was discussed in a previous letter, was up 112%.

Despite these successes, our pharmaceutical holdings, significant cash balances, and limited exposure to commodity stocks were a drag on performance. The fact that we overcame these issues and still had above average performance is very gratifying. With the benefit of 20/20 hindsight, we would have done things a bit differently, but let's review each factor in turn.

The purchase of certain drug stocks was made with the same value discipline that leads us to buy all our companies. Analysis can always be flawed, but just because a stock does not perform in the short-term doesn't automatically prove that a mistake was made. No question, these companies were out of favor last year, but that does not change our decision-making process.

Holding cash is never a goal. It's a byproduct of the investment process. As portfolio companies reach their price targets and are sold, cash balances increase. If new holdings do not immediately take their place, the cash remains and grows. Our goal is to be fully invested. Nonetheless, we will continue to buy and sell with the same discipline. If this leads to increased cash balances in the interim, then so be it. The low returns of cash are preferable to the high cost of making a poor investment decision. In short, we won't let client capital burn a hole in our proverbial pocket.

From gold to oil and steel to pork, commodity prices were on the rise in 2004. Companies connected with these commodities rose as well. These gains were major contributors to the overall market. Given their cyclical nature, we are cautious about committing money to these areas. In any case, we don't buy an oil company simply because the price of oil is high. It's a positive, but it's only one factor in the equation.

The biggest disappointment last year was the underperformance of our largest holdings, especially **Berkshire Hathaway (BRK.B)** and **The Topps Company (TOPP).** Both were over-weighted given the level of undervaluation and the perceived quality of each underlying business. A move designed to enhance returns actually achieved the opposite.

Given our desire to hold approximately 25 positions in the portfolio, one expects the average holding to account for 4 percent of the total. As stated above, our track record for picking those 25 or so companies has been good. Going forward we will be far more reticent to hold outsized positions, as we have been less successful at identifying the most promising 1 or 2 holdings within the larger portfolio. For this reason, Berkshire and Topps are being reduced to a more normal level. In addition to this move, there have been many interesting developments in the portfolio.

Portfolio Changes (since November 1, 2004)

Additions	*Eliminations*
Brown Shoe Company, Inc. (BWS)	CBRL Group, Inc. (CBRL)
Delphi Corporation (DPH)	Diageo plc ADR (DEO)
Fifth Third Bancorp (FITB)	Fresh Del Monte Produce (FDP)
Jones Apparel Group, Inc. (JNY)	J&J Snack Foods (JJSF)
Kellwood Company (KWD)	Pier 1 Imports, Inc. (PIR)
Reebok International Ltd (RBK)	Sears, Roebuck & Co (S)
Tribune Company (TRB)	
Union Pacific Corp (UNP)	

First, let's have a quick roundup of the companies that exited the portfolio since our last newsletter. **J&J Snack Foods** surpassed our price target in early November after being in the portfolio for 16 months. The last shares were sold at $47.25, resulting in a 40+ percent gain. The company has grown steadily in spite of the Atkins diet craze, completed a successful acquisition, started paying a dividend, and remained entirely debt free. Gerald Shreiber is a first class CEO and a disciplined steward of shareholder capital. At the right price, we'd be happy to own this company again.

After a successful experience owning **Sears (S)** from 2002 through 2003, we got an unexpected opportunity to double dip. The company's shares fell from a high of $55 in late 2003 to $36 when we started acquiring shares in July 28, 2004 with a price target of $50. Just 3 ½ months later, on November 17th, Kmart (KMRT) and Sears agreed to merge. The deal calls for Sears' shareholders to receive ½ a share of Kmart stock or $50 cash. Wow, were we close or what!?!? It's rare for us to get that kind of positive reinforcement! Despite the terms, Sears' stock price spiked to nearly $56 after the announcement. Schacht Value elected to sell rather than wait 4 months for a lower price. Besides, 50 percent in 15 weeks isn't bad.

CBRL (Cracker Barrel) shares were purchased in August 2004 at $31.75. Several factors were depressing the stock price and made a purchase attractive. Wall Street worried that high gas prices would hurt customer traffic and that high food prices would lower profit margins. But Cracker Barrel has been very effective in passing along higher prices and encouraging customer traffic. In recognition of these facts, the stock has increased nearly 32 percent since our purchase. It's time to look elsewhere for value.

The same is true for fruit and vegetable provider **Fresh Del Monte Produce (FDP).** This is a very cyclical business, but because it was trading at 6-7 times 2003 earnings, practically debt free, and experiencing significant revenue growth, we concluded that it was absurdly cheap. When we sold the position earlier this month, the value had increased over 30 percent. Given the nature of the business, this company was on a short leash. As it turns out, the stock has dropped 10 percent since the sale. Both CBRL and FDP could return to the portfolio at the right price.

The sale of retailer **Pier 1 Imports (PIR)** and spirits firm **Diageo plc (DEO)** were not based on their having hit our price target. Both were sold due to concerns about competitions. PIR is cheap only if its problems are as temporary as management contends. We initially agreed that weak results were due to short term merchandising issues and ineffective advertising. Recent store data leads us to believe that the retailer's problems are more fundamental. Slower store traffic and sales are more likely the result of increasing competition from the likes of Bed Bath and Beyond, Crate & Barrel, Pottery Barn, Linens n' Things, and even Target and Wal-Mart. No one company is in direct competition with Pier 1, but as a group, these retailers are having a dramatic effect. Diageo is in a much better competitive situation thanks to its recognizable brands, but increasing consolidation and pricing pressure in the alcoholic beverage space led us to worry that earnings would be under pressure. Indeed, both sales and profits were down in the last 6 months. Despite an early exit, both holdings resulted in modestly positive returns.

New additions to the Schacht Value portfolio fall into several groups. The most obvious is shoes and apparel. **Brown Shoe (BWS)** is a footwear wholesaler and retailer. Stores operate under the Famous Footwear and Naturalizer names. Management has been doing a respectable job of revitalizing the company's brands, updating its merchandising strategy, and paying down debt. Selling at just 10 times free cash flow made Brown Shoe a perfect fit! While selling at a slightly higher valuation than BWS, we are building a position in **Reebok Int'l (RBK)** as well. The company is very well capitalized, with zero net debt. Sales and profit growth has also been impressive. RBK has introduced several new brands, entered the hockey market, and has established an impressive foothold (sorry) in China. Not a bad buy at 12-13 times earnings.

It's not Fashion Week here at Schacht Value, but we did acquire shares in both **Jones Apparel (JNY)** and **Kellwood (KWD)**. Kellwood is a manufacturer of "value priced" private label and branded apparel. This has been an area of weakness in the clothing business in recent years. Nonetheless, Kellwood is a diversified player selling to a variety of retailers. The company owns or licenses a wide range of brands including Gerber Onsies, Izod, Liz Claiborne, Calvin Klein, and Phat Farm. It also manufactures recreational products under names like Eddie Bauer, Slumberjack, and Sierra Designs. Kellwood announced disappointing earnings for 2004 and lowered its earning expectation for 2005. This news has been a drag on the stock price, but we believe the bad news is more than reflected in the current quote. KWD was cheap before the recent drop, so we've added to this holding at these more attractive levels.

Jones Apparel also had a disappointing 2004. JNY is a manufacturer of branded apparel and shoes, which it sells through its own stores as well as a range of other retailers. Company brands include Jones New York, Gloria Vanderbilt, Nine West, Easy Spirit, Enzo Angiolini, and Anne Klein. Late last year the firm acquired retailer Barneys New York. Like Kellwood, Jones had a difficult 2004. It is now trading at a 52-week low or just 11-12 times this year's revised earnings estimate. At these levels, investors are awfully pessimistic. Downside risk seems limited at current prices.

Two other additions also fall into the "stocks investors love to hate" category. In the last few months Schacht Value has built positions in both **General Motors (GM)** and **Delphi Corporation (DPH)**. To date, both holdings are underwater. Keeping in mind that "being ahead of your time is indistinguishable from error", here is an outline of why we don't think we'll be wrong forever.

It's hard to find a kind word about GM in the business press today. Slow demand, high oil/steel prices, soaring health/pension costs, and labor issues are all well-known reasons to be wary of owning General Motors. Indeed, none of these issues should be ignored or underestimated. Actually, in this negative environment it's hard to focus on anything else! A recent *Forbes* column by Vahan Janjigian, entitled "The Price Makes the Stock", underlines the theme of our GM purchase and a major tenet of value investing. Mr. Janjigian says, "Cheap enough, any company is a buy… the trick is finding what a company is worth."

GM's current market value is $21 billion. To put this in context, Toyota sports a $140 billion market value! It's not a perfect apples-to-apples comparison, but it shows the level of contempt investors have for GM. We believe that GMAC, GM's finance subsidiary is worth at least $21 billion. GMAC does more than just provide financing for GM cars and trucks. It's a diversified financial services business offering mortgages, insurance, commercial loans, and more. They even own Ditech.com. You've seen the "Lost Another Loan to Ditech.com" TV ads, right? In any case, if this value for GMAC is correct, then the market is assigning a zero value to the rest of GM. Certainly GM's auto business has some dead wood (e.g., Saab), but its truck/SUV business is solidly profitable, Cadillac has been reinvented, and its Chinese business is booming. GM, with its Buick brand, is the #2 automaker in China after Volkswagen. While we wait for the market to revalue GM, we get paid a very nice $2 a share annual dividend. That works out to a yield of over 5 percent. We'll take it.

Delphi, a former GM subsidiary, is facing similar issues. Rising pension, health care, and commodity costs are taking their toll and the stock price reflects it. Nonetheless, with 2004 sales approached $29 billion and operating cash flow at $1.5 billion, Delphi's market value of only $4 billion looks absurd. Part of the problem is that GM and Delphi are still closely linked. Some 50 percent of Delphi's 2004 sales came from GM contracts. It's a huge and very costly legacy business. Since Delphi became independent in 1999, the GM portion of its business has gradually declined. This has many analysts nervous, but it's a healthy change and a small price to pay for being a separate company.

Delphi is an engineering firm with a world of opportunities that could not be fully explored while captive to GM. Management has worked overtime to reduce exposure to GM and the overall auto industry. The effort is paying off. Within the auto segment, non-GM sales were up 20 percent in 2004. GM's competitors weren't too keen on hiring Delphi when it was owned by the enemy. Today, DPH is making up for lost time! Ford is now the largest non-GM client. Delphi is exhibiting steady growth outside the automotive arena also. Non-auto revenue has grown 23 percent annually for the past 5 years. Medical systems are one reason, as Delphi technology is used in dialysis, infusion, patient monitoring, and respiratory devices. Consumer electronics is contributing as well. Delphi sold 4.5 million satellite radios last year. It may take some time, but we expect good things from Delphi.

Thank you for another successful year. It is a privilege to invest on your behalf and we will work hard every day to continue to earn the trust you have placed in us.

In the meantime, we'll put the Greek mythology books back on the shelf!

Henry W. Schacht, CFA
President and Chief Investment Officer