SCHACHT VALUE INVESTORS, LLC

Capital Management in the Graham and Dodd Tradition

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Holding the Line

2006 was a good year for most world markets and Schacht Value participated in significant fashion. The danger after a year of solid double digit gains is to confuse a bull market for intelligence, but Schacht Value did make a number of smart moves last year. Avoiding mistakes was a key component. For instance, we didn't put one nickel of our assets in the Saudi Arabian stock market. It was a good move… the Saudi market lost 53% of its value last year! OK, Saudi Arabia was never even a consideration. In all seriousness, most of the investments we did make in 2006 paid off handsomely.

Our investment in residential housing (discussed in the last newsletter) earned nearly 20% in just the last few months of 2006. Our timing was not perfect, but housing stocks bottomed in July. **Berkshire Hathaway (BRK.b)**, our largest holding, was up 25%, which didn't hurt performance one bit. In fact, many of our over-weighted positions did well including: **Loews (LTR)** up more than 30%, **Altria (MO)** up nearly 20%, **Philips Electronics (PHG)** up over 20%, **St. Paul Travelers (STA)** up over 20%, **Enpro (NPO)** up 25%, and smokeless tobacco company **UST** returned over 50%. Media giant **News Corp (NWS)** was up nearly 35%. The Dutch financial firm **ABN Amro (ABN)** returned over 25%. **Neenah Paper (NP)** was up 27% and **Unilever (UN)** went up over 20%. Even **Citigroup (C)** returned 20%. You get the idea.

It is obvious that some of our winners were sold too early. This is the case with **DirecTV Group (DTV)** and **Molson Coors (TAP)**. We made a lot of money, but left more on the table. It is also true that we should have owned more shares of **Jo-Ann Stores (JAS).** It started as one of our smallest holdings, but gained nearly 100% in 9 months. Hindsight is 20/20.

Not everything went up in 2006. The stocks that underperformed generally had exposure to higher energy costs and/or the weak housing market in common. These include trucking firms **Arkansas Best (ABFS)** down 15% and **YRC Worldwide (YRCW)** down 15%. **Home Depot (HD)** and **Whirlpool (WHR)** were flat to down 1%. And **Furniture Brands (FBN)** was down 18%. FBN was particularly disheartening. The stock appeared cheap from the day we bought it through the day we sold it. It still appears cheap. This is the definition of a value trap. The stock price was simply discounting a persistent decline in the underlying fundamentals. We thought the furniture business would stabilize and it did not. Selling was a good decision. FBN is down another 15%.

We bought more shares of ABFS, YRCW, and WHR as their prices fell. The continued confidence is paying off. Last year's dogs are having their day in 2007. In just 5 weeks, Arkansas Best is up 12%. YRC Worldwide is up 17.5% and Whirlpool is up 11%. Having the discipline to invest more in these companies at significantly lower prices is having a very positive effect on the portfolio.

Schacht Value enters 2007 with a sense of cautious optimism. Relative to other asset classes, a carefully selected portfolio of stocks remains the place to be.

Portfolio Changes (since October 5, 2006)	
Additions	*Eliminations*
Barclays PLC ADR (BCS)	Furniture Brands (FBN)
Legg Mason, Inc. (LM)	Home Depot, Inc. (HD)
Lyondell Chemical (LYO)	Ingram Micro (IM)
Nortel Networks Corp. (NT)	Molson Coors (TAP)
Palm, Inc. (PALM)	The Timberland Company (TBL)
Patterson-UTI Energy Inc. (PTEN)	Weyerhauser (WY)
Sprint Nextel Corp (S)	

Schacht Value has added several new names to the portfolio since the last newsletter. Technology companies are well represented on the list. An example is telecommunications equipment maker **Nortel Networks (NT)**, which attracted our attention in late October. CEO Mike Zafirovski is restructuring Nortel to make it a more streamlined operator in an increasingly competitive environment. In the late 1990s, the company enjoyed a market value of over $200 billion. Today, the market values NT at just $11 billion. Times have changed. The company has never fully recovered from the bursting of the Internet Bubble. Nortel should be a stronger and more focused company when Mr. Z is done. The company has plenty of cash with $3.5 billion in the bank and improving cash flows. The telecom equipment industry continues to consolidate, as well, and Nortel could become an attractive buyout candidate. We can't be alone in this belief. Since our first purchase, Nortel is up 30% and we expect more good things in the future.

Mobile device maker **Palm (PALM)** is another fallen angel. The buzz on Wall Street is that Apple's iPhone will do serious damage to Palm. A highly publicized patent lawsuit and the delayed launch of the Treo 750 phone didn't help Palm's case. That said, we think these issues are more than reflected in Palm's price. If you want proof that most investors pay little, if any, attention to a company's balance sheet, look no farther. Palm's balance sheet is a thing of beauty, showing over $500 million in cash and investments with essentially no debt. Free cash flow runs about $100 million a year. Not bad for a company with a market value of $1.5 billion.

If Nokia or Hewlett Packard decides to bulk up in the high-end mobile device business, Palm may be a target. Both companies are awash in cash. Speaking of **Nokia (NOK)**, the hype surrounding the iPhone pushed NOK shares from $21 to $19 a share in January. We added to our Nokia position and the shares currently trade at $22 after a strong quarterly earnings report. Nokia is the low-cost provider of cell phones and they can make money where others can't. NOK has 35% global market share. In China, Nokia has a 35% share of the cell phone business (Motorola has just 10%). NOK sports a 60% share in India compared to Motorola's 5%. Despite a nice move in the stock price, Nokia still makes sense at these levels. If current emerging market trends persist, NOK is worth $25-$30 a share.

We invested more in the energy sector as prices fell in recent months. It may sound counterintuitive, but we were not keen on buying when oil was close to $80 a barrel. Pundits were asking "How high will it go?" and many analysts were forecasting ever higher prices. As oil dropped to $50 a barrel, energy bulls got scared. $40 oil became a "distinct possibility" and energy company shares fell hard.

Schacht Value added to our stake in **Loews Corp (LTR)**, the diverse conglomerate that has been discussed in these pages before. Loews is a major stockholder of **Diamond Offshore (DO)**, a drilling company. Diamond is cheap and LTR has been buying more shares. Furthermore, Diamond Offshore declared a $4 special dividend last week, which will yield Loews a tidy $280 million. Needless to say, the intrinsic value of LTR continues to grow, yet it trades at a significant discount to its underlying asset value. LTR trades at $44 and is easily worth $50 a share.

We also started buying shares of **Patterson-UTI Energy (PTEN)**, one of the largest U.S. land drillers. The drilling business is attractive because of its long term contracts and high day rates for drilling rigs. PTEN shares dropped 17% in December alone as investors began to worry about falling oil and gas prices and the effect on drilling rates. Patterson is debt free and trades at just 6 times 2007 earnings so even if earnings fall precipitously it is too cheap to ignore. Company management must agree because they are currently repurchasing stock aggressively.

Lyondell Chemical Co. (LYO) is the third largest US chemical company with three major divisions focused on ethylene, propylene oxide, and titanium dioxide production. Lyondell's chemical products go into plastics, resins, coatings, etc. (Please don't yawn. It gets better.) The company was partners with Venezuela's Citgo Petroleum Corp. in a major Houston refinery until LYO bought out the remaining interest last year for about $2.1 billion. The result is a pile of debt, but also a very lucrative (wholly-owned) refinery operation. Lyondell should earn $4.00 a share this year. We paid $26.50 for Lyondell. That's a price to earnings multiple of just 6.5. Lyondell is in cyclical businesses, but that's cheap by any measure. Management is exploring the sale of the TiO2 business and is reducing debt. The company pays an annual dividend of 90 cents (3+% yield) and is up 14% in the two weeks since our purchase. Lucky timing, but we'll take it. Lyondell reported that 4th quarter earnings grew 62% thanks to increased output from its refinery last week. Our price target is $40, a 30% upside from here.

Barclays (BCS) is one of Britain's largest banks. It is also the latest addition to the international portion of our portfolio. Two days after our initial purchase rumors surfaced of a possible bid for Barclays by Bank of America. Nothing materialized, but it would not be surprising if BOA was interested. Barclays is a powerhouse in investment banking, asset management, international banking, and credit card businesses. Barclays is highly diversified with banking exposure in Asia and Africa. The company's asset management business has $1.7 TRILLION under management. This asset level is due, in part, to Barclay's market-leading role in the exchange traded fund (ETF) business. The best news is that we get all of this for just 10 times 2007 earnings and BCS pays a sizable 3.5% dividend.

Low interest rates have led to a world that is awash in cash. As this excess liquidity searches for a home, investors have lowered their standards to put assets to work. The result is that they accept little or no return premium for taking on significant risks. The investments above should illustrate that we will not let your money burn a hole in our pocket. Schacht Value continues to maintain our valuation discipline and we will only invest when a significant margin of safety is thought to exist.

Happy New Year,

Henry W. Schacht, CFA
President and Chief Investment Officer

Circle of Competence ○ Intrinsic Value ○ Margin of Safety ○ Catalysts ○ Active Ownership ○ Sell Discipline