Schacht Value Investors, LLC

Capital Management in the Graham and Dodd Tradition

September 24, 2007 www.schachtvalue.com

Liquidity Check

The third quarter was volatile for the overall stock market and for Schacht Value. Growing defaults in sub-prime loans caused borrowers and lenders across the credit markets to question their assumptions, Liquidity rapidly disappeared in many credit areas. Central banks, including the Federal Reserve, stepped in to provide relief. Nonetheless, contracting credit markets caused fear that economic growth will slow. And this spilled over into the equity markets.

As the weeks have passed, the sub-prime mess has become more well-defined. Investors, banks, and mortgage firms are swallowing the bitter pill of credit excess and are adjusting to a new reality. Loan portfolios are being revalued, failed mortgage operations are closing, and many leveraged buyouts are being renegotiated. The stock market has also recovered, but questions remain about the direction of the economy, the level of future growth, and market liquidity.

Ironically, prior to this credit crisis, financial markets were said to be awash in an ocean of endless liquidity. Like freedom, you appreciate liquidity most when it's gone. Mortgage lenders already hobbled by slowing mortgage demand learned this the hard way. A morbid website called the "Mortgage Lender Implode-O-Meter" keeps track of failed lenders. The count: 160 (and rising).

Number 111 is American Home Mortgage, whose shares opened 2007 at $34. The company declared a dividend as recently as June, but bad things can happen fast for sub-prime lenders. On August 8th, the company declared bankruptcy. AHM was dead without ready access to the capital markets. And if you think only ignorant investors got caught unaware, think again. Michael Strauss, Chairman and CEO of American Home got hammered. His 10% stake went from $160 million to zero in 8 months.

Billionaire Wilbur Ross made his fortune cleaning up messes in the steel industry, textiles, and auto parts. Lending will be his next stop. Asked about the business, he said:

> [Sub-prime mortgage lending is] a valid business. What's wrong with it is the way they did it. Weak credit should pay a premium, not a discount. You had the strange situation that while a normal, credit-worthy borrower might pay 5.5 or 6%, a sub-prime borrower would pay 1% for a year or two... It's silly to do that. And they often did it without verifying the person's financial information or appraising the property. It's one of the more extreme examples of the fact that risk went by the board in the credit markets. Instead of risk-adjusted rate of return, these people were dealing with risk-ignored rate of return.

Ironically, Mr. Ross is now trying to buy what's left of American Home Mortgage out of bankruptcy. Despite what he admits are "real issues in the mortgage industry", Ross sees the current turmoil as an opportunity to build a "big business" in lending. Thanks to investors like Ross, more rational lending practices, and the passage of time, the credit crisis will end. In the meantime, we believe the global economy is strong enough to weather the storm.

Despite many reasons for optimism, bad news was blown out of proportion in the last 3 months. Non-financial companies were treated as if they are issuers of sub-prime mortgages and solid financial firms were indiscriminately treated like the next American Home Mortgage.

Allied Irish Bank (AIB) is one example. Thanks to credit worries and concerns about European growth, AIB got battered. Investors ignored just how boring (in a good way) Allied Irish really is. The bank has a very clean operating structure. They take in deposits, issue loans, and make a living off the interest rate spread. AIB is also geographically diverse with a strong base in the UK, a valuable stake in M&T Bank here in the United States, and a rapidly growing business in Eastern Europe, particularly Poland. At less than 8 times earnings, AIB is a bargain, so we used recent weakness to buy more.

Schacht Value was able to seize many opportunities (like AIB) in the 3rd Quarter. This is thanks to liquidity, but not the kind being talked about on Wall Street. Being liquid can mean everything from having cash in the bank to being able to rapidly sell an asset. A liquid asset is one that can be sold rapidly, with minimum loss of value, and anytime within market hours. A liquid market is one where there are ready and willing buyers and sellers for an asset. This type of liquidity (*market liquidity*) is what disappeared in the credit markets. While the wider investing community periodically becomes obsessed with market liquidity, or the lack thereof, Schacht Value is always focused on the types of liquidity that directly impact client portfolios. It comes in several forms.

Our value discipline naturally generated cash as the market was hitting new highs in June. Positions approaching their price targets were reduced or sold completely. This is one contributor to general *portfolio liquidity.*

Whirlpool (WHR) is one such victim of its own success. Schacht Value made its first purchase of WHR shares in February 2005 at $63.50 a share. Throughout the spring and summer of 2007, we sold these shares at prices between $101 and $114. The final sale came in early July at $106 a share. As housing concerns mounted, we locked in a gain of 70% over the last 2 ½ years. This year alone, our Whirlpool shares gained nearly 30%. Who said appliances are boring?

Our decision to sell Whirlpool was fortuitous in hindsight. Worries about the housing market are now weighing on WHR with the stock hitting $86 a share recently. The current sentiment is a case of investors shooting first and asking questions later. Demand for appliances is primarily governed by a well-defined replacement cycle. New home construction is not the driving force. In addition, the purchase and integration of Maytag is progressing well. Schacht Value sold WHR because our valuation of the company showed it was fully valued in the $105-$110 range. If the stock price continues to fall, we may have a sufficient margin of safety to reinvest. Stay tuned.

Schacht Value also sold shares of **Cemex (CX)** and **Xerox (XRX)** earlier this year based on valuation. CX was trading near $40 a share and XRX was over $20 a share. The fundamentals of both companies were and are very strong so we were selling opportunistically, not aggressively. For this reason, we still held shares of both companies as the market sold off in July and August. The selling in these two companies is now hugely overdone. For this reason, we repurchased all the shares we originally sold and at much lower prices. At $30 a share Cemex is a bargain and so is Xerox at $17. The magnitude of the declines in just 2 months shows how irrational the market can be.

Selling companies as they hit our price targets generates cash that we can reinvest. In addition to the above, we made a number of changes to the portfolio since the last newsletter.

Portfolio Changes (since April 19, 2007)

Additions	*Eliminations*
AEGON N.V. ADR (AEG)	Barclays plc ADR (BCS)
Best Buy Company (BBY)	Circuit City Stores (CC)
Brown Shoe Company (BWS)	Kraft Foods (KFT)
Circuit City Stores (CC)	Intel Corporation (INTC)
Conoco Phillips (COP)	Patterson-UTI Energy (PTEN)
J&J Snack Foods (JJSF)	PNC Financial Services Group (PNC)
Lions Gate Entertainment (LGF)	Whirlpool Corporation (WHR)
Northrop Grumman (NOC)	YRC Worldwide (YRCW)
Nucor Corporation (NUE)	
The Progressive Corporation of Ohio (PGR)	
Real Networks (RNWK)	

Client deposits also give a boost to portfolio liquidity at crucial times. It is impossible to overstate the benefits of your contributions and the flexibility it affords at crucial times. Money managers can't always count on client deposits when the market is uncertain. As the saying goes, the stock market is the only place nobody wants to buy when there is a sale. So thank you for your continued support!

Perhaps the most dramatic (and unpredictable) contributors to portfolio liquidity are corporate actions like buyouts or liquidations. Fortuitously, Schacht Value has a couple to report. In the last newsletter, we discussed **Lyondell Chemical (LYO)** as an exciting addition to the portfolio. We could not have predicted how quickly our thesis would be proved correct. LYO was purchased in January at around $26 a share. In July, the company agreed to be purchased by Basell, a division of Access Industries, for $48 a share in cash. That's an 80% return on our investment in just 8 months.

Another buyout that is reaching a conclusion is **Abn Amro (ABN)**. It appears the consortium led by Royal Bank of Scotland will win the battle to buy this Dutch financial giant. We should receive approximately $53 for each ABN share, or a 65% gain since January 1st. More liquidity!

Our portfolio also enjoys a higher than average dividend yield. Ongoing dividend payments provide a regular, reliable, and growing source of cash. And if regular dividends weren't enough, our portfolio has benefited from a host of special (one-time) dividends. **Progressive** ($2 a share), **Thor Industries** ($2 a share), and **Palm** ($9 a share) have declared and/or paid special dividends in recent weeks.

Of these, the most interesting situation is **Palm (PALM)**. In June the company announced that Elevation Partners, a private equity firm, will pay $325 million in exchange for a 25% stake in the company. As part of the deal, current shareholders (including Schacht Value clients) will receive a $940 million special dividend ($9 per-share). This is huge, as it represents over half of the pre-transaction value of Palm. Some of the cash will come from Palm's existing $504 million cash hoard, while the rest will come from Elevation and $400 million in new debt. The transaction is confirmation of two basic facts: Palm was (and is) undervalued in the market and the company was holding too much cash. These are the very reasons we bought the stock. Elevation Partners recognized these facts too. They crafted a transaction that addressed both issues and created the very catalyst we seek.

Palm isn't alone in returning excess capital to shareholders. Steelmaker **Nucor (NUE)** is a relatively new holding to the portfolio and they have a habit of paying special dividends. The payments are so frequent that one wonders if the word "special" still applies. In fact, Nucor has paid a special dividend every quarter for the past 2 years. The company also pays a regular quarterly dividend. The combined dividend payments give NUE a current dividend yield of over 4%. Now that is special!

Schacht Value bought Nucor this summer when global growth fears caused the stock to fall from a high of $70 a share. We built a position between $49 and $53 a share valuing Nucor at $16 billion. This is a compelling price for a company with $1 billion in net cash and over $1.6 billion of free cash flow. As for recent industry fears, steel inventories are moderating, imports are down, prices are improving, and the industry continues to consolidate.

Palm and Nucor are examples of the next level of liquidity built into the Schacht Value portfolio: *company-specific liquidity*. This is where our portfolio really flexes its muscles. We specifically look for companies that generate substantial and sustainable cash flow. Ideally we want companies that are self-funding, which need very little (if any) access to the capital markets.

The liquidity of the individual companies in our portfolio is truly remarkable. **Arkansas Best (ABFS),** a lowly trucking outfit, sports a balance sheet with nearly $150 million in cash and ZERO debt. **Nokia (NOK)** is up over 80% year-to-date, holds $11 billion in cash, and has essentially no debt. With so much extra capital, both are buying back shares. **Best Buy (BBY)** is taking share repurchases to the extreme. The company is so flush with cash that it is buying back 15% of its outstanding shares by early next year. Thanks to the wise use of this liquidity, our ownership in each of these companies is growing without buying 1 additional share. This is what building shareholder value is all about.

To say our companies are liquid is an understatement. Cash represents a significant portion of the overall market value of most of our holdings. **Berkshire Hathaway (BRK.b)** is particularly amazing as cash representing about 30% of its total market value. And this is not a small company! Berkshire holds over $50 billion in cash and Warren Buffett is showing an increased willingness to put capital to work. This is a powerful driver of value. Every 1% additional return on Berkshire's cash will generate $500 million for Berkshire shareholders. Not surprisingly, Berkshire now trades near its all-time high.

RealNetworks (RNWK) is making its debut in our portfolio. The digital media and software company owns the Rhapsody online music service, Real Player media software, and a collection of video game franchises. In addition to these businesses, Real has the most absurd cash-to-market value ratio in our portfolio. Thanks to the antitrust settlement it won against mighty Microsoft (MSFT), RealNetworks has over $600 million in the bank ($500 million after subtracting all debt). Cash makes up more than 50% of the market value of the company. It's not likely the credit crunch will have an effect on RealNetworks. They simply don't need access to the credit markets to fund operations.

Schacht Value is also buying **Lions Gate Entertainment (LGF)**, an independent studio. "Discipline" is the word most often associated with Lions Gate. They consistently generate cash. The company is known for making small pictures (lots of horror flicks) and for its ability to limit risk. Its crowned jewel is a film library containing over 5,500 titles, from *Rambo* and *Terminator* to *Dirty Dancing*. It may not be high brow fare, but the collection could easily be worth over $1 billion in a private sale. Yet Lions Gate's market value is just $1.1 billion. Buyout rumors have swirled around LGF for years. Speculation has only grown louder now that corporate raider Carl Icahn owns 4% of the studio. Lions Gate is an exciting investment either way. The cash is flowing and the library is growing. We think the shares are worth $13+ a share, up from $9.50 now. That's a storyline anyone should like.

We don't know where the overall market is going and we certainly can't control it. At Schacht Value, we can control what kinds of companies we buy and the prices we pay. For this reason, we remain focused on companies and their underlying fundamentals. This dictates returns.

It pays to ignore emotion and focus on fundamentals. Schacht Value has owned **Anglo American (AAUK)** since 2005. Intrinsic value has steadily grown and the trend continues. This year the mining giant has increased its dividend and is repurchasing a massive quantity of shares. AAUK is liquidity incarnate, but somebody forgot (momentarily)! Look at this 1 year stock chart of AAUK:

In July and August, the stock lost 25% of its value in just 6 weeks and we bought more shares. Daily stock prices are fickle and don't always reflect a company's true worth. We try to exploit these disparities. Not all of our holdings bounced back as quickly as AAUK, but the thinking is the same.

> **"We try to *price,* rather than *time,* purchases. In our view, it is folly to forego buying shares in an outstanding business whose long-term future is predictable, because of short-term worries about an economy or a stock market that we know to be unpredictable. Why scrap an informed decision because of an uninformed guess?"** *--Warren Buffett, 1994 Berkshire Hathaway Shareholder Letter*

We hope this letter illustrates why we are confident in our approach and in our portfolio.

Thank you for your continued confidence,

Henry W. Schacht, CFA

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