SCHACHT VALUE INVESTORS, LLC

Capital Management in the Graham and Dodd Tradition

July 25, 2008 www.schachtvalue.com

Energized

For investors, this year's Fourth of July fireworks celebrated both the birth of our nation and the end to one of the worst 6 month periods in market history. Continued worries about energy prices, housing, and credit and their combined effect on economic growth and corporate profits contributed to the crescendo of selling. Throughout this period, conventional wisdom was that anything commodity-oriented – particularly gold, oil and natural gas – was investment worthy to the exclusion of everything else. After all, global demand for metals and petroleum will ensure prices perpetually move higher, right? Memories are short.

With crude oil and gasoline at (or near) all time highs, it is only natural that this is a topic on everyone's mind. Where will the price go? What will the short and long term effects be? How much is out there? Can we find it? The questions and speculations are never ending. At the risk of piling on, we will add our (brief) perspective.

Forecasting the price of oil has become a game of "pick a number, any number". Morgan Stanley said oil would hit \$150 a barrel by July 4th. They were only off by a few dollars. Goldman Sachs sees \$200 a barrel within 18 months. The CEO of Russia's oil giant Gazprom said oil will hit \$250 a barrel next year. Not to be outdone, oilman and hedge fund operator, Boone Pickens, told a Congressional panel to expect oil to cost \$300 a barrel in ten years or less. Ironically, the higher the prediction, the more credibility it is given by the media. Contrary voices are drowned out.

In a sense, many of these predictions seem to be self-fulfilling in the short-run. OPEC holds that "non-fundamental factors" (factors other than supply and demand) have driven prices to current levels. Factors like speculation and the falling dollar. One OPEC official said that while oil at \$200 per barrel is possible, there is no supply shortage, so prices *should* be much lower. Their position is that oil should trade between \$80 and \$110 given current fundamentals. They are not alone in believing that prices are unsustainably high. Peter Sutherland, head of BP, says predictions like the ones above are apocalyptic and just plain wrong.

It is precisely *because* anything is possible that the wildest speculation exists. Despite all the prognosticating, nobody really <u>knows</u> where the price of oil will go or what the ultimate derivative effects <u>will</u> be. The frenzy surrounding energy and commodities is reminiscent of the Internet bubble some ten years ago. Residential real estate saw similar conditions until last year. In both instances, these sectors were "the place to be". It is a lesson that many continue to pay dearly to learn. Let's not forget the house flippers of the recent past. House prices were going up forever, right?! Oops.

There are fundamental reasons why energy prices should be higher now than in years past (i.e, rising emerging market demand). Nonetheless, a trend based on solid facts can still lead to a severe overreaction. Clearly, the longer a situation persists, the more normal it appears. The longer energy prices stay at elevated levels, the more they will be viewed as permanent, not a temporary anomaly.

This resignation leads to changes in behavior, which leads to changes in demand and ultimately to changes in prices. This process is happening now.

Case in point: General Motors announced that it is shifting production towards small cars, closing four truck plants, and perhaps dropping or selling the Hummer brand. CEO Rick Wagoner said that high gasoline prices are "a structural change, not just a cyclical change". Only time will tell. We wouldn't exactly count on GM for accurate predictions and foresight. Within a week of GM's announcement oil prices dropped some $15 a barrel.

Investors must not forget that oil production is a cyclical business with enormous capital requirements. It is not unusual for oil and natural gas firms to reinvest more than 100% of their annual profits in order to maintain their reserve base. This is in sharp contrast to Schacht Value holdings like **Brown Shoe (BWS)**, **Dr. Pepper Snapple Group (DPS)**, **J&J Snack Foods (JJSF)**, and **Altria (MO)**, which do not require heavy capital spending. Oil companies are constantly searching for that next barrel of oil just to stay in business. Companies that make shoes, soda, snacks, and cigarettes don't have these concerns. Because of the structure of the petroleum industry, dislocations like the one we are currently experiencing can be violent. Corrections can be equally so.

Schacht Value does not have an opinion about where oil prices will go from here, but piling into commodities is not an investing panacea. We fully appreciate the inherent dangers of long-term forecasting and therefore we don't want investment success to depend on the price of a particular commodity – be it oil, gold, or corn – going in one direction or another. Schacht Value instead makes an appraisal of a firm's fundamental value and invests accordingly.

Contrary to the inferiority complex that has invaded our national consciousness, Schacht Value has confidence in the ability of the American economy and its participants (consumers and businesses alike) to adjust to structural and cyclical changes of all kinds. Just witness the rapid shifts in consumer purchases. Look no further than May's auto sales which showed Honda with a 15.6% sales increase. The Big 3 declined by double-digits.

Honda Motor (HMC) was a solid company before rising gasoline prices. The current environment is a magnifying influence. While we were well aware of Honda's fuel efficient line-up of vehicles when we purchased the shares in September, it was not the primary reason for our investment. A solid balance sheet ($9+ billion in cash), a solid/growing dividend, a cheap valuation (about 10 times earnings), and large investments in research and development were more important. Gas prices may fall, but these more permanent factors will ensure that Honda will be able to manage its business from a position of strength in the years ahead.

Honda's price fell to attractive levels because analysts are preoccupied with the company's heavy exposure to the US market and the dollar. We take a longer-term view. Despite worries about the strength of American consumers, cars eventually get replaced. Honda's competitors are helping too. Ford, GM, and Chrysler are facing the same headwinds without any of its strengths. Profits are non-existent and the most profitable vehicles for the Big 3 are the ones nobody wants, namely trucks and SUV's. Meanwhile Honda consistently makes money and does so selling smaller vehicles on average. As buyers shift in this direction, Honda benefits disproportionately. To be clear, Honda met our criteria before gasoline spiked to current levels. $4 gasoline is a definite tailwind. We think Honda will continue to grow at the expense of its competitors and to the benefit of its shareholders.

A more direct participant in the energy complex is **ConocoPhillips (COP),** another Schacht Value company benefiting from current energy prices. Nonetheless, we did not purchase Conoco because of a particular attitude toward energy prices. Conoco traded at a single digit price-to-earnings multiple before oil rose to current levels and this is still the case. Company management is committed to holding the line on spending and to returning "excess" cash to shareholders via higher dividends and share repurchases. If that's a windfall profit, we'll take it.

We've discussed **Loews (L)** many times in these pages. We are so happy with this holding, it's worth mentioning again! The conglomerate has several businesses that throw off piles of cash, including investments in **Diamond Offshore (DO)**, **Boardwalk Pipelines (BWP)**, and **High Mount Exploration** that are doing especially well in the current environment. Our investment thesis is based on the fact that Loews' $22 billion market value is substantially below the value of the firm's asset value. Management's proven track record of superior capital allocation and a $4.4 billion cash horde doesn't hurt. Despite all of its merits, investors continue to ignore Loews' beauty. We will wait.

Portfolio Changes (since September 24, 2007)

Additions	*Eliminations*
Acuity Brands (AYI)	**ABN Amro Holding NV ADR (ABN)**
Ashland, Inc. (ASH)	Arkansas Best (ABFS)
Barclays plc ADR (BCS)	Ashland, Inc. (ASH)
Children's Place (PLCE)	Best Buy Co. (BBY)
Cooper Industries (CBE)	Children's Place (PLCE)
Dr. Pepper Snapple Group (DPS)	Citigroup (C)
EMC Corporation (EMC)	Cooper Industries (CBE)
LM Ericsson Telephone Co ADR (ERIC)	**Electronic Data Systems (EDS)**
Honda Motor ADR (HMC)	Imperial Tobacco Group plc ADR (ITY)
GlaxoSmithKline plc ADR (GSK)	Ingram Micro (IM)
ING Groep NV ADR (ING)	Jones Apparel Group (JNY)
Jones Apparel Group (JNY)	**Kellwood (KWD)**
Lincoln Electric Holdings (LECO)	Lincoln Electric (LECO)
Kellwood (KWD)	**Lyondell Chemical (LYO)**
Mohawk Industries (MHK)	Mohawk Industries (MHK)
Navteq Corp (NVT)	**Navteq Corp (NVT)**
Nvidia Corp (NVDA)	Nortel Networks (NT)
Sotheby's Holdings (BID)	Palm (PALM)
Swire Pacific Ltd. (SWRAY)	Progressive (PGR)
Taiwan Semiconductor Mfg Ltd ADR (TSM)	Real Networks (RNWK)
Tractor Supply Company (TSCO)	Sprint Nextel Corp (S)
Whirlpool Corporation (WHR)	Taiwan Semi Mfg Ltd ADR (TSM)
Wyndham Worldwide (WYN)	Travelers Companies (TRV)
	Wyndham Worldwide (WYN)

BLUE indicates that this holding was bought out by another firm

Despite the current myopia, there is plenty of action outside of energy prices. Probably the most interesting development for us was the buyout of **Electronic Data Systems (EDS)** by **Hewlett Packard (HPQ)**. As a long-term holder of EDS shares, we were pleased to see this transaction, but not thrilled. In truth, Hewlett got a bargain.

Ironically, we seem to be in the minority with this opinion. Much of the financial press and the analyst community greeted this transaction with skepticism saying that EDS is an inferior, slow growth company and the price was too high. There is a grain of truth in this characterization of EDS, but this is a case of missing the forest for the trees.

The stellar track record of HP CEO Mark Hurd should give critics reason to pause and reflect. Buying EDS was a courageous move for HP, one that should pay off handsomely. There is no question, however, that EDS is a business in transition. EDS is an outsourcer of data management, running computer networks for corporate and governmental clients. The industry is shifting overseas to places like India. In short, the outsourcers are being outsourced! EDS has been busy changing the way it does business. While the process has been painful, it has not been a failure. The HP buyout is proof.

While HP is itself a player in the data management business, it ranks far behind industry leader IBM. Buying EDS will help Hewlett catch up. All US-based competitors are being forced to react to industry changes and scale matters. The skepticism surrounding the deal shows that Hewlett's management can think for itself and doesn't mind doubling down in a business it knows well.

Unfortunately this is not true of all companies. For proof, look no further than **General Electric (GE).** The company announced that it intends to sell its home appliance business. While many analysts applauded the move, we think it is a case of looking in the rear-view mirror. The most likely time to get the best price (as a buyer) is when even the owner of an asset doesn't want it. GE is proving this. The actions of Hewlett Packard and General Electric are case studies in action vs. reaction.

Problems in the home appliance business are well-known. Prices tend to overshoot fair value in both directions. Optimism leads to hubris and irrationally high prices, but the converse is also true. **Whirlpool (WHR)** is an example. We sold WHR last summer when the shares hit our price target around $105 a share. We mentioned that we would reinvest given a sufficient margin of safety and we have done so. Schacht Value started rebuilding our WHR stake in October shortly after CEO Jeff Fettig bought $1 million worth of stock for around $85 per share. Admittedly we were too early in our decision. In the market sell-off this year, Whirlpool traded into the low 60's thanks to demand concerns and cost pressures. Rather than panic, we continued to add to our position and our average cost per share is now in the mid 70's. And Whirlpool shares have recovered substantially.

Whirlpool remains the best company in its industry. And it appears that Whirlpool will continue to build on its lead thanks to the acquisition of Maytag and the fact that its remaining competitors are in chaos. Despite high steel, plastic, and energy costs, WHR expects to generate a minimum of $500 million in free cash flow this year! Compare that to the company's $5 billion market value and you get a compelling situation. If Whirlpool can earn this much under such pressures, then we like the upside potential. GE should take a look at Whirlpool. Instead, they seem intent on selling low. Many investors are making the same mistake with companies like Whirlpool and others.

While very real problems exist, our belief is that worries about the global economy are exaggerated. Price movements in these times may not be the best reference point for making decisions. We are careful not to let stock movements dictate our thinking.

With the Fed cutting rates, the real return on cash is essentially zero and may actually be negative when the effects of inflation are taken into account. As such, Schacht Value seeks to be fully invested. Finding opportunities for investment has thankfully not been hard. Negative investor sentiment has only helped by driving down prices. We are not alone in this belief.

Warren Buffett got a lot of press recently (more than usual) when he said recently that the US is "essentially" in a recession even though the technical definition for a recession has not been met. That said, Buffett has been a major buyer recently. It is telling that he is investing in equities, especially in light of his "recession" comments. **Berkshire Hathaway (BRK.b)** has added to holdings in drug stocks like **Glaxo SmithKline (GSK)** and financial stocks like **Wells Fargo (WFC)** and **US Bancorp (USB)**. Why would he do this if we are in a recession? Because, despite that possibility, the price is right. "Buy low, sell high" isn't just a saying for Buffett. He knows that successful investors must thrive on fear and irrationality. There is plenty of that to go around these days.

We are very happy to see Berkshire Hathaway put its cash to work. As shareholders, we have ample reasons to believe it will pay off handsomely in the future. If there were any doubt, Inbev's bid to take over **Anheuser Busch (BUD)** is proof. Berkshire is one of the largest owners of BUD shares. Buffett accumulated the shares years ago when they were passé. So much for following the crowd.

Financial stocks are currently the most hated among investors, many for good reason. That said, we continue to see value in select areas of the sector. **Legg Mason (LM)** is one example. This asset management firm has some $925 billion under management, but several of its mutual funds have fallen on hard times. This is especially true of Bill Miller's Legg Mason Value Trust, which is the flagship fund for the company. In addition, some of LM's money market funds got caught with some illiquid assets when the credit markets seized up and the parent company had to make several large investments to make shareholders whole. Nonetheless, Legg Mason has worked through these problems and is still one of the largest asset management firm's on the planet. Investors have fled the stock and left it for dead. Legg Mason trades for just 9 times earnings. This is compared to 20 times for another industry giant **T. Rowe Price (TROW)**. To put this in perspective, the market value of TROW is $15 billion and the firm manages $380 billion. Legg Mason's market value is $5 billion and it manages 2.5 times as much. Even adjusting for differences in their businesses, the value disparity is enormous. We think LM is worth at least $70 a share. Not bad, considering the current price of $37.

A special welcome to Ankur Rughani, our new summer intern. Ankur attended the University of Kansas and is working on his CFA charter. His work experience at the Federal Reserve and Moody's KMV are welcome additions to the firm. We will all benefit from his hard work and passion for investing.

Henry W. Schacht, CFA