

SCHACHT VALUE INVESTORS, LLC

October 9, 2008

Dear Friends,

Normally, my newsletters are written in the third person, but this communication will dispense with the normal formalities. These are not normal times. Despite appearances, this company and what it does will always be a very personal endeavor. This company is a reflection of me and my values. I literally invest your money as if it was my own. My capital is alongside yours and I am personally and professionally invested in the outcome. If that were not enough, most, if not all, of you have become personal friends.

Today as I started writing this letter, the Dow Jones Industrial Average lost 678 points or nearly 7.5%. This one day drop caps off over a year of selling, which has resulted in the market retracing all of the progress it has made in the last 5 years.

To mark the occasion, President Bush is scheduled to speak tomorrow about the federal government's actions to stabilize our financial system. He is the latest in a string of political leaders to talk about our government's response. Congressional leaders, Fed Chairman Bernanke, and Treasury Secretary Paulson are all trying to "do something" to fix the problem that started with a housing price bubble and morphed into something bigger.

I don't think it is a coincidence that every time our leaders speak, the markets take a turn lower. The psychology is, "we must really be in bad shape if (insert name) is talking about it." And some constituency is always disappointed that the action being discussed is "not enough." Capital infusions, rescue packages, mortgage relief, global intervention, and interest rate cuts have only seen markets drop more day after day.

The government can't prevent our economy from dealing with consequences of a bubble in real estate prices any more than it can force people to live within their means. That does not, however, mean the current sell-off in the stock market is rational. The bad news is more than priced in, but a wave of negative sentiment that swept up the innocent along with the guilty. My job is to sort through the emotion.

Personally, I am in favor of Uncle Sam taking a back seat and allowing the capitalist system to work. This is not a Main Street vs. Wall Street problem. Many institutions on Wall Street got drunk on cheap money. (Thank you, Alan Greenspan!) Freddie Mac and Fannie Mae used their government charters recklessly and made it easy for banks to make sloppy loans and then effectively sell them to taxpayers. Ironically, everyone paid the price in the end. In short, easy money makes for dumb decisions.

To point to politicians, particular institutions, or groups of people as the sole culprit is (admittedly) too easy. The best thing we can hope for is that the current pain is an opportunity to get our financial house in order. If that involves some painful choices, then so be it. More cheap money and a further holiday from reality won't fix things.

It is also not a coincidence that this turmoil is happening within the context of a political cycle. There are many politicians scoring points by proclaiming the American economy dead and dancing on its grave. To make matters even worse, the mainstream media and the financial media are magnifying the situation and playing on the public's fears and ignorance. But ratings are good?!?!?

This is not to say that our economy does not face serious challenges. It does. But what we are currently experiencing is panic, pure and simple.

The fact that Johnson and Johnson, a company that makes band-aids and shampoo, was down 10% today should speak to the paranoia that exists. J&J wasn't undervalued before this drop, but it certainly did not deserve a 10% haircut in one day! Conoco Philips which is currently trading at around 4-5 times earnings lost nearly 14% of its market value today as well. Did we invent a replacement for oil that I'm not aware of?

My response to all this turmoil has been to stick to my philosophy: to buy companies I understand at prices I find attractive. That said, at this point in time, every purchase made in the last year (with few exceptions) looks stupid and every sale looks brilliant. The truth is somewhere in the middle.

The calls I have received in recent weeks tell me that the fear for many is overwhelming. I've been asked if I would start pulling money out of banks and if gold buried in the backyard is a legitimate exercise these days. The people asking the questions were not joking. I understand the emotions you feel. I feel them too. I've lost money and my company is getting less profitable with every tick down in our account balances.

Your September statements looked horrible, as did mine. The October statements will be worse, barring a sustained change in sentiment. The question is: What do we do now?

I have chosen to acknowledge the panic, but I refuse to give in to it. I will not throw away good companies simply because their stock prices may go down tomorrow. The assumption of most investors is that I will sell today because the prices of what I own will be lower tomorrow.

In some ways, it would be easier to throw in the towel and say, "I'm done!"

This would be irresponsible. The selling caused by this attitude leads to an adverse feedback loop that must be broken. It won't be broken if everyone continues to fuel the panic. While the selling process is self-fulfilling in the short-term, it will end.

In the meantime, valuations are already absurd, but we are in an environment where few investors care about valuations. Warren Buffett has put over \$25 billion to work in the last 6 months. If he is buying, I don't want to be selling. In the current environment, I want to be a buyer. If cash isn't available, the next best thing is to just not sell. This is a very real alternative in times like this.

I have done a top-to-bottom review of our portfolio at least three (3) times in the last six months. This review has resulted in a number of changes. The below companies have been SOLD since the last newsletter for the reasons listed:

Barclays (BCS) – turmoil in UK banking
Brown Shoe (BWS) – hit our price target
EMC Corporation (EMC) – declining value of VMW stake
Honda Motor (HMC) – too much money flowing into finance unit
J&J Snack Foods (JJSF) – hit our price target
Thor Industries (THO) – declining fundamentals
Tractor Supply Company (TSCO) – hit our price target
Whirlpool (WHR) – hit our price target

I have added to many existing positions as prices have declined and trimmed others on price jumps that have been few and far between. The following companies are NEW to the portfolio since our last newsletter:

Arkansas Best (ABFS) – see below
Cooper Industries (CBE) – industrial electrical equipment/grid upgrades
Forest Labs (FRX) – see below
Gannett (GCI) – less than 5 times free cash flow
Kyocera (KYO) – see below
Meredith (MDP) – high dividends and cash flow
Mohawk (MHK) – industry leader in flooring, valued as if it is liquidating
News Corp (NWS.a) – lots of cash, low multiples
Nucor (NUE) – solid dividend, less than 5 times free cash flow
United Rentals – restructuring to focus on core business, generating cash

Despite these opportunities, fear reigns...

Earlier this week, I received an email from a friend asking if he should worry about a mutual fund and if I would recommend selling. Here is part of my response (with some minor editing):

The fact that other mutual fund investors are selling is the very reason your balance keeps falling.

People are redeeming their mutual fund shares across the country. So mutual funds are selling assets to fund withdrawals. That selling leads to a falling market. A falling market leads to more redemptions. And the cycle goes on and on and on.

Those who resist the urge to sell feel dumber by the day until the urge to sell is too much and they cave in. At some point, we reach the end and we find a bottom.

But this is to say nothing of what the mutual fund or its holdings are actually worth.

Would you sell a \$20 bill for \$10? No. The disparity between market value (\$10) and intrinsic value (\$20) is obvious in this example. This calculation is not as easy with a company's stock or a mutual fund. The intrinsic value is not obvious to a casual observer.

The only measure most people see is market prices. When they drop every day, the assumption is that I better sell today or I will have less tomorrow. The question is: Are the assets owned by your mutual fund worth more or less (economically) than the current price?

We sold Whirlpool three weeks ago at \$89+ and it closed today at \$67.

Do you think Whirlpool is worth 25% less today than it was just 21 days ago?

I don't. Our decision to sell looks smart, because of the subsequent price drop. Nonetheless, we sold based on our view of intrinsic value. We thought that Whirlpool was fairly valued at \$90 or so a share. The timing (of our sale) was dumb luck.

The point of the email is that in the current environment, nobody cares what Whirlpool or anything else is worth. The fixation is on not wanting to see the stock fall any further. Consumers are certainly deferring purchases of appliances, but this does not make Whirlpool a dying company. To the contrary, the company is well capitalized, a leader in its industry and benefits from falling energy, plastic, and steel prices.

Is Whirlpool a \$20 bill being sold for \$10? Probably, but the same people who only months ago were saying oil prices were going ever higher, now say stock prices are going ever lower.

There is a reason we own **Lincoln Electric (LECO)**, which makes welding equipment and supplies. There is a reason we do NOT own **General Electric (GE)**. There is a reason we own **ING**, the Dutch insurer, and NOT the now infamous **AIG**.

By any measure, the stocks in our portfolio are ridiculously cheap, but in a panic nobody stops to ask for directions. Nonetheless, here are a few signposts that our portfolio is worth keeping.

At the close today, Pfizer's annual dividend payments of \$1.28 equal a dividend yield of over 8%. This is to say nothing of PFE's rock-solid balance sheet with nearly \$30 billion in cash on hand. You get 4% loaning money to Uncle Sam when you buy a 30 year Treasury. With the risk profile of the government increasing every day, Pfizer is the better deal.

The majority of the companies in our portfolio have very modest levels of debt. Our favorite trucking firm, **Arkansas Best (ABFS)**, has nearly \$250 million in cash. The company has no

debt and a market value of \$750 million. So at current prices, one third of our purchase price is sitting in ABFS' bank account. The company is profitable too, earning \$16 million in the last quarter. ABF will survive this turmoil and be the better for it. Some trucking companies will not survive and Arkansas Best will pick up the slack.

One of our newer holdings is **Kyocera (KYO)**. The company sports a balance sheet like few I've seen in my career. The company has a market value of around \$12 billion. The company owns \$6 billion in cash and short-term securities along with nearly \$5 billion worth of long-term investments. Buying KYO at current levels means that we are essentially getting the operating company for free! It is a business that generated \$1 billion in free cash flow last year, so I can comfortably say it is worth more than zero.

Forest Laboratories (FRX) is a pharmaceutical firm with a market value of about \$7 billion. They have zero debt, \$2.6 billion in cash and securities on hand and should earn \$700-800 million this year. Adjusted for cash, that's 6 times earnings.

Ternium (TX), our South American steel producer, is currently valued at roughly \$2.5 billion by this market. But net income for the first 6 months of the year was \$982 million. Income will certainly come down with a drop in steel prices, but even if TX doesn't make another dime all year, it is trading at less than 3 times earnings.

I could go on to write similar comments about every company in the portfolio, but you get the idea. If your pain tolerance has been exceeded, please call me. I am more than happy to discuss the situation with the markets and what to do with your portfolio.

If you think the current market valuations are absurd and that investing is still worthwhile, I am happy to continue to work on your behalf. We will navigate these tumultuous times together.

I want to extend a special "thank you" to all who have added to their accounts in recent days and weeks. I feel confident that your convictions will be rewarded.

In the meantime, let's stop looking to Washington for all the answers. This country is resilient and our economy will recover. The capitalist system can and will work by eventually weeding out the weak companies and creating new ones. What we need is a determination to succeed.

We, as investors, have it in our power to be part of the solution. Responding to facts instead of emotions is a good start.

All the best,

Henry W. Schacht

"Whether You Think You Can or Can't, You're Right" -- Henry Ford

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