

SCHACHT VALUE INVESTORS, LLC

Capital Management in the Graham and Dodd Tradition

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“Fear and Angst”

This is the headline on CNBC today as the Dow Jones Industrial Average has dropped below 10,000 yet again. At various times this year entire swaths of securities have been thrown on the ash heap thanks to shifting investor emotion.

Benjamin Graham, the father of value investing and security analysis, once wrote that he “embraced stoicism as a gospel sent to him from heaven,” an attribute he thought was essential to successful investing. Graham biographer, Jason Zweig, says that Graham’s success was instead due to an ability to invert (rather than deny) his emotions, “helping him see when markets had run to extremes.” Graham believed that investors should be pleased at languishing prices because of the prospect of putting money to work at favorable prices. Zweig quotes Graham (in part) when he says, “investors would be ‘enviably fortunate’ to benefit from the ‘advantages’ of a long bear market.”

By extension, if he were alive today, Professor Graham would probably be skeptical of buying Treasury securities after a 20 year bull market. This is especially true in light of record deficits and debt at all levels of government. Yet investors, foreign and domestic, continue to pile into US debt instruments. There was a time when residential property only went up in value too, remember?! The “fear and angst” (caused in part from that false belief) is such that many seem content to achieve a return OF, rather than a return ON, their money. Sadly, they are running away from one disaster and creating another.

The headlines provide ample reason to be uneasy. This week it was poor housing sales and durable goods numbers. Last week it was data showing persistently high unemployment (surprise, surprise!). But whether it’s low consumer confidence, currency crises, oil spills, or sun spots, the result is a search for safety. Unfortunately the assets being chosen provide safety in name and appearance, but not in fact.

Ironically, as one commentator recently said, Mr. Market has a habit of changing the labels without warning. Safe assets become risky and risky ones become safe. Given what we know, it is perverse that investors continue to look to government securities for the safety they desire. Most of the world’s governments can be described as profligate and perennially over-leveraged. Yet the line to lend them money (at ever lower rates) gets longer.

There are calls for caution. A report out of Morgan Stanley this week contains this blunt assessment:

Governments will impose a loss on some of their stakeholders. The question is not whether they will renege on their promises, but rather upon which of their promises they will renege, and what form this default will take. [The crisis] is

global and it is not over. Outright sovereign default in large advanced economies remains an extremely unlikely outcome...but current yields and break-even inflation rates provide very little protection against the credible threat of financial oppression...

We have ample evidence that government debt instruments are not risk free. But major warning signs have either been ignored or severely misinterpreted.

It wasn't long ago that Dubai was in the news with its sovereign debt woes, but UAE came to the rescue and the concern was soon forgotten. Greece became the most recent poster child for fiscal insanity. The Greek government apparently believed it could run staggering deficits forever. They did, until one day the lenders woke up. The panic that followed quickly spread to Portugal, Italy, Ireland and Spain (referred to as the PIIGS) as fiscal parallels were easy to see. The EU and the euro currency were the connective tissue tying everyone to Greece's problems. It turns out Greece was "too big to fail"!

April and May saw prices plunge as the effects of the debt crisis and subsequent bailouts were weighed. Pundits began to question the survival of the euro as a viable currency. Government debt instruments weren't the only securities affected. Every company unfortunate enough to do business in Europe was scrutinized (analysts scrambled to see how much of Coca-Cola's revenue came from Europe). Being based in the euro zone was a still greater sin. And then it was gone.

The euro never traded at parity with the dollar (1-to-1). It certainly didn't collapse. Instead it has rallied (to \$1.26) since the June low. Despite all the dire predictions, European nations seem to be addressing their fiscal woes or at least acknowledging the problem. (A recent *Financial Times* headline: Germany focuses on cutting spending.) If only this was a worldwide trend.

The "Greek tragedy" gave us an opportunity to buy a handful of leading European companies at very attractive prices. New holdings included telecom giants **Telefonica (TEF)** and **Vodafone (VOD)**, global financial powerhouse **Banco Santander (STD)**, and the evil BP. We also added to stakes in the media and telecom conglomerate **Vivendi (VVDY)** and the pharmaceutical firm of **Warner Chilcott (WCRX)**. Their headquarters reside in Spain and the UK. Vivendi had the misfortune of calling Paris home. And we're pretty sure Warner Chilcott rents a post office box in Ireland for tax purposes. With the exception of BP, these purchases have worked out well.

Either way, penalizing these multinationals for being based in Europe is vaguely like saying **Disney (DIS)** isn't worthy of investment because it is based in California, not exactly a shining example of economic prosperity or fiscal responsibility. Or how about **Boeing (BA)**, which is headquartered in near-bankrupt Illinois? Simply put, the prospects of our Euro holdings aren't inexorably tied to a specific country or continent. By virtue of their businesses, these companies transcend geography.

Companies like Telefonica were making money before the euro ever existed. If the euro falls/goes to zero/ceases to exist, TEF will still be in business, collecting revenue in the prevailing currency. It is flawed logic to conclude that excessive spending and borrowing by European governments means European companies are untouchable.

The question of price is just one factor being ignored. Based on our purchase price, all our European holdings were purchased with free cash flow yields in excess of 15 percent. They also generate significant portions of their revenue from outside Europe. Besides the diversification benefits, it can be argued that a weak euro is actually beneficial.

Japan is another interesting case, home to multinational corporations like **Honda (HMC)** and **Nintendo (NTDOY)** and one of the worst fiscal situations on Earth. In fact, government debt in the Land of the Rising Sun equals 196 percent of GDP. An astonishing number when compared to spendthrifts like Greece (101 percent) and the USA (71 percent).

Despite this, Japan's private sector is replete with examples of parsimony and success, like Nintendo, a company with a cash horde of around \$12 billion in excess of ALL debt. Nintendo is persistently and significantly profitable, pays a healthy dividend, and sells its gaming gear around the globe. The decision to own this company is clearly not dependent on Japan's public finances. The country of origin is just one data point.

As such, Schacht Value built a position in Nintendo between August and December 2009 at prices from \$28 a share to \$32 a share. We sold those shares in March at \$42 a share. Japanese government debt levels played no role in the decision to buy (or sell) these shares. Renewed pessimism regarding Japan has driven Nintendo shares back to \$34. If they go much lower, we'll be interested again. As for Japanese government bonds, no thank you.

So where is the real risk these days? Private companies have adjusted to economic reality. Governments act as if they are immune to it. In good times governments spend because they can afford to (sharing the fruits of prosperity), while in bad times they spend because they can't afford not to (stimulus and benefits). Whatever the excuse, it won't end well. Schacht Value doesn't intend to compound the pain all citizens will feel by investing in the securities that represent this debt, which currently offer return-free risk.

So if not Treasuries and other government bonds, what about cash? Cash balances are at all time highs. Don't want that money put into a risky asset like stocks, right? But wait, aren't the Federal Reserve and other central banks running the virtual printing presses at full tilt, debasing the world's major currencies at a record pace? Just because this activity isn't as explicit as a stock quote doesn't make the loss of value any less real.

Municipal bonds? Yields are at 40 year lows and state and local finances have arguably never been in worse shape. All these points were underlined by **Loews (L)** CEO Jim Tisch who said in an interview:

There are equities that are rather intriguing, especially when compared to fixed income. When I look at what we're earning on T bills and round it to the closest whole number, it's zero, [but] we're in the insurance business, and like it or not we have to have a fixed-income portfolio... We're actually investing in stocks, in large cap, good dividend-paying stocks. Who would have thought five or 10 years ago that a 3 percent yield on a stock would be a good yield? But actually today

it's a very good yield... Municipal bonds yield just over 2 percent and, man, I think some of the credits could have some trouble. When you look at the state of some of the state and city finances it sort of makes Greece look like it's a solid credit.

Ouch.

We agree with Mr. Tisch. Carefully selected equities offer the best combination of safety and return. One of these happens to be Loews itself. Tisch is a wonderful steward of our capital. He and his family invest alongside us and are the largest shareholders in Loews. We appreciate managers who think and act like owners. It doesn't hurt that Tisch is an avowed value investor with an eye towards intrinsic value.

Conservative calculations of intrinsic value for each of our holdings prevents us from flying blind, buying and selling at the whim of the market. It allows for informed decision-making in times of turbulence and uncertainty. Our value estimates provide the basis for confident buying when times are tough and/or prices are low and the confidence to sell when happy times are back and companies becomes fully or over-valued. We hope Ben Graham would approve.

We applied these principles from December 2009 through April 2010 when the Nikkei index rose from 9,000 to 11,000. During the upturn, Schacht Value sold most of our Japanese holdings. **Takeda Pharmaceuticals (TKPHY)** was the lone exception. Over the past 4 months the Japanese equity index is back where it started, offering us a chance to buy again.

One recent addition is **Kyocera (KYO)**, a company we've owned successfully in the past. At \$84 a share, this company's market value equals \$15 billion. For this price, we get a company that has nearly \$6 billion in cash, essentially no debt, a securities portfolio worth around \$4 billion, and an underlying business that generated \$1 billion in cash last fiscal year. Besides looking like a giant Japanese mutual fund, Kyocera makes everything from cell phones to solar panels and semiconductors to ceramic knives. Any way you slice it (pun intended), Kyocera owns a mountain of assets that trade at a mole hill price. Fair value is around \$110 a share.

Europe and Japan aren't the only places we've been able to capitalize on massive changes in investor sentiment. During the BP oil spill and its aftermath, we added to our position in Loews, which has extensive energy holdings. We also picked up **ConocoPhillips (COP)** and offshore driller **Ensco International (ESV)**. COP pays a 4+ percent dividend and trades at less than 10 times earnings. ESV is a \$6 billion company with \$1 billion in excess cash and a 3+ percent dividend yield. Both are significantly undervalued because their prices fell as investors sold in response to the BP oil spill.

But Schacht Value isn't alone in the belief that our portfolio holdings are undervalued. The managers of the companies themselves are weighing in as well, taking a variety of steps to highlight their respective company's value and to reward shareholders.

Portfolio companies from **Dr Pepper Snapple (DPS)** to **Northrop Grumman (NOC)** have announced significant increases in dividends. **Ternium (TX)** started paying a dividend again after coming through the steel downturn in fine fashion.

Significant special (one-time) dividends are also becoming more prevalent. In addition to instituting a significant regular dividend, Hot Topic paid a \$1.00 a share dividend to shareholders in April. Not bad for a company that was trading around \$6 a share before the announcement. Investors who were not able to invert their emotions piled into the stock and drove the price above \$9 a share. Schacht Value sold our stake at that point. In June we started building a position again around \$5 a share.

The aforementioned Warner Chilcott is also paying a large special dividend. The company is recapitalizing itself by borrowing a significant sum and paying out the proceeds as a dividend. The company believes its shares are cheap and that it can borrow money advantageously, so this is one way to capitalize on both. We should receive \$8.50 a share from WCRX in a few days.

Those who are in love with cash and Treasuries won't get pleasant surprises like the ones highlighted here. The US Treasury doesn't pay more than the contracted rate and the bank won't surprise you with a little holiday bonus on that CD. In fact, given the fiscal and monetary trends, nasty surprises are more likely. This will seem like a cruel joke to those who think they are in the safest of all securities.

In short, price determines the safety of any investment. Fixed income (especially government debt) and cash seem overpriced for the risks being assumed. "Risky assets" like equities are generally not. Indeed, the private sector is de-leveraging after gorging on record levels of debt. With jobs less secure and home prices falling (and not rising by the day), individuals realize that consumption levels have to change. Businesses concerned about demand, the regulatory environment, tax changes, etc. are being more prudent with their capital spending.

Schacht Value owns a portfolio of such companies. They are intelligent allocators of capital, conservatively financed, and underleveraged. The list of governments who can claim such adjectives is short. So we'll let others rely on the full faith and credit of these institutions and pay record prices for the privilege.

We will continue to take advantage of whatever this market offers us. In general, you can expect us to do so with companies that live on a budget, generate profits, and are reasonably priced.

Risk truly is in the eye of the beholder.

Henry W. Schacht, CFA

The object of life is not to be on the side of the majority, but to escape finding oneself in the ranks of the insane. ~ Marcus Aurelius

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