Schacht Value Investors, LLC

Capital Management in the Graham and Dodd Tradition

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The Other Side of Panic

The S&P 500 index likes to make history in March. The index hit an all-time high of 1,552.87 on March 24, 2000. The Great Panic of 2008-2009 effectively came to an end on March 9, 2009 when the index hit 676.53. This multi-year low represented a 50-plus percent drop from two years earlier. As we approach the 2-year anniversary of that low point, it may be surprising that the 1,300 level for the S&P is in sight. Rip Van Winkle would hardly know anything happened!

The panic that once saw investors selling anything at any price in exchange for cash has come full circle. They are now doing the exact opposite. It's as if everyone suddenly realized it's hard to build wealth (or even maintain it) earning zero percent in a savings account. This is especially true when the value of the currency in question is also falling.

An obvious point? One would think so, but 2 years ago that caution went largely unheeded. The result: those who let emotion rule the day cost themselves dearly. And 2010 was no different.

The first 6 months of 2010 were replete with warnings of a double dip recession, the risk of bankrupt European states, the demise of the euro and perhaps the entire euro zone. Indeed there are plenty of reasons to be pessimistic. After all, the overall economic picture is quite bleak with high unemployment and moribund growth. Nonetheless, those who allowed this backdrop to invade their investment decisions were disappointed. The S&P 500 was up 15% in 2010.

We are proud to say that Schacht Value outpaced this figure quite handily. This is further proof (if any is still necessary) that company-by-company research ultimately matters more than macroeconomic forecasts.

Given current monetary policy, near-zero interest rates, and the corresponding returns on cash and bonds, it is hardly surprising that the prices of commodities of all types and equities are on the rise. The alternatives that investors face are few. Indeed, despite the market advance, the Schacht Value portfolio continues to look dramatically better than an equivalent amount in cash. It is a low bar to hurdle.

As we've discussed in part before, our performance in 2010 is directly attributable to buying oil related stocks during the BP oil spill, buying European multinationals during the euro crisis, buying retail companies despite unemployment fears, and buying drug/health-related firms during the healthcare reform debate.

Schacht Value compensated for a less than stellar experience with **BP** by owning oil driller **Ensco (ESV)**, which returned over 30%. Oil services/supply company **National Oilwell Varco (NOV)** rang up a 25% return. **ConocoPhillips (COP)** was the laggard of the group with a sub-20% return. It is the only one that remains in the portfolio as we expect more in the future.

In Europe, Schacht Value earned 20% on a stake in telecom giant **Vodafone (VOD)**, plus a massive (and growing) dividend. It's still undervalued. Patience wasn't necessary with Spain's **Banco Santander (STD)**. We earned over 30% in a couple of months following the first euro scare. We sold it and bought it back during a subsequent scare. This is one of the world's best situated and managed banks. A dividend of over 6% provides a clue. Our other European holdings include **Vivendi (VIV.PA)** and **Telefonica (TEF)**, which both yield more than 7%! How does that savings account look now?

In retail, the big winner was **Cato (CATO)**, our value-oriented women's store. The stock returned over 40% in 2010 and over 70% since our purchases in August/September 2009. It is all the more impressive considering a current dividend yield of 3%. Much maligned **Hot Topic (HOTT)** was a hot stock for us last year. We first bought it between November 2009 and January 2010 and sold out for a nearly 50% profit. In June we bought it again and netted another double digit return. Children's retailer **Gymboree (GYMB)** was another huge winner, up 27%.

The list of 2010 winners is lengthy. **Banco Latinamericano Comericio (BLX)**, **Dr. Pepper Snapple (DPS)**, **eBay (EBAY)**, **Lexmark (LXK)**, **LSI**, and **Sprint (S)** all gained 30% or more.

But the standout in 2010 was **Interdigital (IDCC)**, an intellectual property company that licenses patented technology to wireless companies. IDCC shares rose nearly 60% last year. And they are up another 17% in 2011. When Schacht Value first bought Interdigital, it had a $1 billion market value and zero debt. The corporate coffers were stuffed with over $500 million in cash and free cash flow was adding another $100 million (or more) per year. Clearly, IDCC was a low-risk proposition. The resulting return, however, puts other "safe" investments to shame.

It wasn't a perfect year. Mistakes were made. **Barnes & Noble (BKS)** and **Seahawk Drilling (HAWK)** are good examples. Happily the latter was already a small position in the portfolio before it got dramatically smaller. Other companies - like **BP** and **Weight Watchers (WTW)** – should not have been sold. In still more cases, our price targets were too conservative and/or we sold too early. Of course, this is a case of perfect hindsight and it always happens in a rising market. This is especially true for value investors with price discipline.

Schacht Value clients still enjoyed an excellent year, but it never feels good to leave money on the table. There will always be times when clients would have been better off if we'd taken an extended vacation.

More important for the road ahead, Schacht Value continues to uncover value. No, we're not lining up for the next Treasury auction or to buy a pile of gold bullion. We're not even trying to get in on the Facebook shares that Goldman Sachs has for sale. Unloved and undiscovered are preferable. A prime example: defense and aerospace companies.

Before September, **Northrop Grumman (NOC)** was our only exposure to this out-of-favor group. It wasn't long **before L-3 Communications (LLL)**, **Raytheon (RTN)**, and **SAIC (SAI)** joined the portfolio. As their prices fell, we continued to buy. What started as a small allocation to just one defense contractor became a significant mini-portfolio within the overall portfolio. At its peak, these 4 companies represented some 15% of our total holdings.

What gave us the confidence to make such a significant allocation of capital?

It was a combination of quality companies selling at historically cheap prices. Investors were singularly focused on the prospect of shrinking defense budgets and ignoring everything else.

Our thesis was (and is) that a shrinking defense spending pie may actually be good for investors in these industry leaders. Revenue pressures can often spur consolidation and aid strong companies at the expense of the weak. These are well-managed companies with healthy cash flows, low debt, and world-class capabilities – attributes that matter as much as (or more than) incremental changes in defense spending.

This month, many of the proposed Pentagon cuts were finally outlined and the sigh of relief from investors is palpable. Despite the significant cuts that are making headlines ($100 billion+), the individual effects are minor when spread across numerous companies. As a result, the industry has outperformed in 2011.

Since the calendar turned, Raytheon is up 11%. Northrop has advanced 6%. L-3 is up over 10% and SAIC has gained 5%. Not bad for just 3 weeks. Perhaps investors realize the negativity is overdone. Either way, Schacht Value clients are benefitting from this contrarian investment.

To be clear, our investment philosophy is not a matter of simply chasing pessimism. Value investing is about comparing what you pay with what you get. Even legitimate concerns can cause investors to overreact and drive individual stock prices to unwarranted levels.

In response to this phenomenon, the investment community always churns out a raft of articles enumerating last year's worst performing stocks. The idea is that last year's losers may become this year's winners. Such lists always feature a mish-mash of companies. Their only common thread is a host of problems and a falling stock price.

Unlike the high quality defense firms above, these are usually companies you don't take home to meet the parents. Their character is in question! It doesn't help that previous investment managers have paid dearly in both money and reputation by owning them.

Schacht Value searches the "new low" list nearly every day. Looking for the unloved companies is not a one-time ritual performed around January 1st for us. By year-end 2010, Schacht Value owned three (3) of the worst performing stocks of 2010, though not by design. Even we were a bit shocked to find so many attractive opportunities among the losers of last year.

Year-end window-dressing is real. Most investment managers are embarrassed to have clients see companies like these in their accounts. They fear negative reactions like, "Did they really buy that lousy company for me?" So they sell them (if owned) and avoid them otherwise, often making the opportunity even greater.

To be clear, Schacht Value did NOT own these companies on the way down. We bought them after their historic drops. The offenders in question are: **H&R Block (HRB)** – down 47% in 2010; **Dean Foods (DF)** – down 51%; and **Corinthian Colleges (COCO)** – down a whopping 62%. Is it any wonder investors who owned them wish to disavow any knowledge of it?

"Buying low" makes a nice slogan, but it's hard to do when the companies in question radiate pain. Without doing research, it is easy to assume that more troubles are lurking. But hard work and a full measure of conviction often pay off.

Having built a position in H&R Block near the lows of 2010, we are happy to report that the stock is a major outperformer in 2011, up over 9% so far this month. The company is not without its skeptics (including us), but at the current price, it is hard to pass up. HRB has been a serial disappointer in recent years. Not until recently did the price seem to justify owning HRB. It is the nature of our business that we are constantly being offered choices and that we say "no" far more often than we say "yes". We waited patiently and time will tell if we are correct.

All for-profit education companies were under a cloud of suspicion all last year with talk of new regulations and reduced federal funding. This hurt our **Washington Post (WPO)** holding due to its ownership of Kaplan, but we decided to add Corinthian shares to the portfolio in November. At $4.35 a share, we thought the point of "maximum pessimism" had been reached. COCO shares currently trade for $5.56. That's up 9% year-to-date and 30% since inception.

And last on the list is Dean Foods, a dairy products firm, which grew quickly by doing countless deals in a bid for greatness. This has been elusive, the resulting $4 billion of debt remains. Not good at a time of declining wholesale milk prices and rising costs. Nonetheless, despite its warts, DF was worth a shot, especially in light of a 50% price cut. Schacht Value bought DF shares at $7.31 on December 3rd with a $10 price target. On January 8th, hedge fund manager David Tepper announced a nearly 8% stake in Dean Foods, saying he too thought the shares were cheap. Such validation was welcome (and profitable). Dean Foods' shares jumped and we sold our shares shortly thereafter for $9.85 each. The result: a 35% profit in just 6 weeks.

We are proud of this recent performance. Rest assured it will not always look so easy.

The real lesson here is how quickly sentiment can change. This goes for the overall market as well. Investors who were once convinced that markets would fall forever now seem to feel otherwise. In many cases the buying has become indiscriminate. It seems that prices don't matter as much as the urge to exchange dollars for something else…anything else.

The fiscal and monetary situation in this (and most every) country is worrisome, but it does not justify throwing cash at anything that moves. We understand the emotion involved, but we will maintain our standards even in this rising tide.

Happy New Year,

Henry W. Schacht, CFA