

SCHACHT VALUE INVESTORS

Capital Management in the Graham and Dodd Tradition

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A View from the Cheap Seats

Major League Baseball is finding it difficult to face the new economic reality. Fans are facing higher unemployment, lower disposable incomes, and higher gas prices. But unlike other businesses, MLB is not that nimble. Some of the issues are structural. Player contracts don't get adjusted easily. And productivity doesn't increase with fewer players. Make do without a shortstop? 2 outfielders instead of 3? Not likely.

Empty seats behind home plate are an embarrassing trend for League officials, but a bigger worry is that those attending baseball games are more likely than ever to choose the cheap seats. Hot dogs and cold beer apparently taste good regardless of where one sits.

As investors, we appreciate this search for value. But while people's leisure spending habits are changing, behavior in the investing world hasn't. Memories are short. It's chase the story, ignore the fundamentals.

In fact, recent events conjure images of the 1990s Internet Bubble. Today, social networking companies fuel the imagination. **Netflix (NFLX)** with its legions of affinity shareholders have no idea what the company is worth, knowing only that they like the product.

Another recent example is the initial public offering (IPO) of social networking firm **LinkedIn Corp (LNKD)**, a sort of professional version of Facebook. The company sold a limited number of shares to the public in May to great fanfare. Huge demand plus a scarce amount of shares resulted in a meteoric rise on the first trading day. At one point, the shares were up 170%, which only reinforced the hype. The high price for the day was \$122 a share, but the shares closed at \$94.25. These prices valued the company at roughly \$10 billion.

Not a bad sale for insiders. After all, the company is thought to be unprofitable. Worse yet, most users would be hard-pressed to say how the company generates revenues. So reality is pretty sobering for LNKD, but early buyers clearly didn't care. Just 3 weeks since the IPO, however, the hubris is wearing off. LNKD shares are now valued at "only" \$72 a share or \$7 billion. We'll let others take this bet.

The LinkedIn story is not unique. Based on recent private stock sales Facebook supposedly has a market value of around \$60 billion to \$100 billion according to recent reports. Once again, there is open debate over whether or not the company is profitable and even over how it will make money. Yet Facebook shareholders are content in their belief that this enormous network of people will ultimately be worth any price. For them, it is only a question of when...not how.

Those tripping over themselves to buy the current crop of New Age darlings should study history and meditate on the law of big numbers. For those too old to remember the Tulip Bulb mania,

there is the Nifty Fifty era and the Internet Bubble. Speaking of which, we found the following post-mortem by Scott McNealy to be instructive. McNealy was the CEO of a beloved technology company (is there any other kind?) during the go-go days of the 1990's. In the April 2002 edition of *Business Week*, he said:

But two years ago we were selling at 10 times revenues when we were at \$64. At 10 times revenues, to give you a 10-year payback, I have to pay you 100% of revenues for 10 straight years in dividends. That assumes I can get that by my shareholders. That assumes I have zero cost of goods sold, which is very hard for a computer company. That assumes zero expenses, which is really hard with 39,000 employees. That assumes I pay no taxes, which is very hard. And that assumes you pay no taxes on your dividends, which is kind of illegal. And that assumes with zero R&D for the next 10 years, I can maintain the current revenue run rate. Now, having done that, would any of you like to buy my stock at \$64? Do you realize how ridiculous those basic assumptions are? You don't need any transparency. You don't need any footnotes. What were you thinking?

The company in question is Sun Microsystems and its market value topped out at \$200 billion in the year 2000. Reported earnings that year were \$1.7 billion, a substantial profit except when compared to the purchase price being assigned by investors. At the price of \$200 billion (\$64.70 a share x 3.1 billion shares), Sun Micro was valued at over 100x earnings. Buyers at this price were accepting an earnings yield of less than 1%, believing the company would grow forever and ultimately justify its gold-plated price.

No company can live up to assumptions so grand...and Sun Micro was no exception.

Sun's fall from grace was more swift than most. Just two years after its peak value and profit was reached, Sun was losing money. Investor hopes were dashed. The company never regained its former (and brief) glory or the \$200 billion market value. In fact, the company was unceremoniously purchased by **Oracle Corporation (ORCL)** in 2010 for a mere \$7 billion. Buying at a moment of maximum optimism is very risky. Those who did so with Sun Micro and held on to the bitter end lost 96.5% of their investment. Many did worse.

The Sun Micro buyers of yesterday are probably the bond buyers of today. Burned in the stock market and worried about the economy, they happily buy bonds at nearly any yield because they are safe. The "at least I'll get my money back" mentality is being exploited by everyone from the US Treasury to Wall Street, who happily issue debt that has essentially a zero cost.

When asked by an analyst about his rationale for issuing debt, **Raytheon (RTN)** CEO William Swanson replied:

When you can get debt for five years at 1 5/8 (percent), even somebody that doesn't like debt has to look at it and sit there and say, can you make your balance sheet and your operations more efficient? And even an engineer like me can understand that one.

The opportunity is so great that companies with no obvious need for capital are issuing debt. In many cases they are using the proceeds to repurchase shares. Such cash-rich companies as **Google (GOOG)**, **Johnson & Johnson (JNJ)**, and **Microsoft (MSFT)** have all issued debt. Google sold 3, 5, and 10 year debt with yields of 1.25 percent, 2.125 percent, and 3.625 percent yields respectively. Despite such paltry sums, bond investors eagerly stand in line to buy debt instruments that offer little to no real return, certain are they in the belief that the future promises no inflation. Can you hear that next post mortem?

One respected investor said that buying bonds today is like picking up pennies in front of a steamroller...both have a messy ending.

Schacht Value prefers **Vivendi** (France), **Telstra** (Australia), **Telefonica** (Spain), and **Partner Communications** (Israel), especially when compared to bonds. These companies are reasonably priced, offer inflation protection, provide diversification away from the US dollar, and pay well-covered dividends of 7 percent or more based on current stock prices. These companies may not be the flavor-of-the-month, but they provide higher return potential with less risk than any of the stocks or bonds listed above.

The speculation in Internet companies and the search for yield are fueled by human nature. But the Federal Reserve's money pump gets a significant share of the blame as well. Call it QE (quantitative easing) version 1, 2, 3 or whatever, but the results are the same – a cheapening of the US dollar and artificially low interests rates.

This backdrop colors the markets by penalizing savers and encouraging speculation. Either way, emotion plays a greater role than arithmetic. But emotion works both ways. There is unbridled hubris in bonds and select stocks, while abject pessimism exists elsewhere. Look no further than a recent Bloomberg headline announcing that, *Americans Shun Cheapest Homes in 40 Years*.

Remember when buying a house was said to be risk free? Everyone who was anyone was buying spec houses with no money down. Yet despite (indeed because of) the hype, this was the most risky time to buy. Today, the risks are much lower. Risk is ultimately a function of price. But most investors can't fight their own psychology.

A renter featured in the Bloomberg article is quoted as saying, "I don't see myself purchasing, even with all the great prices I see...going to bed every night worrying about your home value doesn't sound like a good time to me."

No coincidence then that housing continues to suffer. Potential buyers are scared. And that creates the potential for value. In the meantime, the landlords rejoice.

<p>I [have] learned never to stand in line to buy an asset. You always want to go where nobody else is in line. ~ James Grant</p>
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Like all humans we seek validation. As investors we ultimately need validation in order to succeed. The unpopular must become relatively more popular if we are to realize value.

Schacht Value ranks each of its holdings based on a value-to-price ratio. Higher value-to-price ratios are at the top of the list. These are our most undervalued companies. We are buying a lot of value for the price we are paying. Schacht Value is predisposed to add to these holdings at the expense of those companies that have low value-to-price ratios.

Companies at the top of the list are new holdings or ones that have not performed. In either case, the stock price is low relative to our estimate of value. At the same time, stocks at the bottom of the list are those trading at (or above) our value estimate. We strive to sell that which is dear and to buy that which is cheap. In this case, to sell what is at the bottom of the value-to-price list and to buy what is at the top. It sounds easy until you assign names to the companies in question.

Invariably the companies that have fallen on your “most undervalued” list are ones that have performed well. It can be difficult to sell them. Fully valued or not, these companies are the “winners”. They have made us money so they practically glow.

An analogy appropriate to this time of year: selling our fairly valued holdings is akin to a teacher saying goodbye to a classroom full of students at the end of the school year. The task has been successfully completed and it is time for the kids to move on. Meanwhile the teacher gets a short break before the arrival of an unknown group of new raw recruits. There is comfort and familiarity in the current group, but there is nothing left to be done with them.

Harvesting money from the fully valued and successful portfolio holdings to buy new holdings is difficult. No matter how undervalued the new recruit may be, it does not conjure the same feelings as that last winning stock. But all this emotion needs to be set aside in favor of a cold analysis of intrinsic value and a comparison to current market values.

Setting all emotion aside, we sold a number of companies in the first half of 2011. **Interdigital (IDCC)** was the biggest winner of the group. Our final sale was in February at \$56 a share. At the time, IDCC shares were up nearly 35% in about 6 weeks. And up over 150% since our first purchase in September 2009. It didn't “feel” good to sell, but the mathematics dictated it. Interdigital had surged past our price target. And everyone was finally talking about a company we'd quietly purchased when it was unknown and unloved. It was fortuitous that we chose to ignore emotion. IDCC shares currently trade at \$36 a share. Once everyone is thoroughly disgusted with IDCC, it may be time to take a second look.

Other ugly ducklings that turned into beautiful swans are **H&R Block (HRB)**, **Big Lots (BIG)**, **Nomura (NMR)**, and **Sprint (S)**. The average return on this group was over 35% and the average holding period was less about 6 months. We didn't seek to sell so quickly but when our price target is reached, we have learned to sell.

In the case of Big Lots, there were news stories that the company was seeking to go private. Private equity firms were said to be interested in buying the company and (not surprisingly) the stock jumped. We purchased BIG in December around \$28 a share with a price target of \$38 a share. The aforementioned buyout rumors drove the stock price toward \$40 a share by early February. Rather than wait for a prospective deal, we took “the bird in the hand” and sold our shares for between \$39 and \$40 each. Yet, the price continued to climb above \$44. Our tidy

profit aside, leaving money on the table doesn't "feel" good. But our value estimate, not emotion, is what drives decisions. We have learned to trust calculators over the heart.

Once again selling Big Lots was a fortuitous decision. By May, it was obvious that any buyout offers were not meeting management's expectations. Nothing was made public, except the company's decision to stay public. That and a struggling retail environment have pressured Big Lots once again. Just two weeks ago, Schacht Value bought BIG shares again at just \$31.50 a share. If it goes back to \$28, we'll buy more.

May lightning strike twice at Big Lots! After all, this is a well-managed and attractively priced retailer and we're happy to own it again. Yet conventional wisdom is that retailers are dead in the water thanks to high unemployment. This is a superficial observation. The jobless numbers are more than reflected in the stock prices of most retailers. Realizing this in Big Lots helped Schacht Value clients realize a 40% return in less than 3 months.

If Schacht Value invested with tunnel vision, we never would have bought integrated oil giant **Conoco (COP)** when oil was trading at \$50 a barrel (August 2010). Things can change quickly and they have. Oil has since doubled. We recently sold Conoco for all tax-deferred accounts after a 40% gain. In hindsight, we should have ignored the tax consequences and sold all our COP shares. As it is, we're more apt to be buying Conoco at current levels.

Schacht Value did well early in the year by harvesting gains as the market rose. Now that the market has reversed course, we are finding plenty of opportunities in existing holdings and new ones. Nonetheless, none of our recent purchases look as inspired as our sales.

As we have attempted to show, Schacht Value likes to invest in situations where perception is at odds with reality. In past editions, we have discussed this many times, whether with oil/gas companies, defense/aerospace, or European companies during the euro crisis. Happily we've made money in each of these instances.

Today's cheap seats are increasingly being found in Japan. And it is a region that has garnered more of our research time since the earthquake and subsequent events. Those who are bearish on Japan point to these events, the government's fiscal issues, a strong yen, and other macroeconomic factors as reasons to avoid the Land of the Rising Sun. We prefer to look at individual companies and make judgments at that level.

Prior to the horrific earthquake and nuclear meltdown in Japan, our holdings in the region had dwindled to one company, **Takeda Pharmaceuticals (TKPYY)**, which just announced a massive acquisition of Swiss drug firm, Nycomed. Prior to this announcement, Takeda would have taken the prize for "most boring" stock in the Schacht Value portfolio. The company is awash in cash, has essentially zero debt, and pays a hefty 4.5% dividend yield.

With the exception of Takeda, many Japanese firms have seen their shares fall precipitously because of their country of origin's rolling disasters. Because of this reaction, Takeda is no longer our lone Japanese holding. **Kyocera (KYO)**, a name clients have seen before, is back. The company's operations saw little to no effect from the earthquake and aftermath. The

receding waters did not wash away Kyocera's fortress-like balance sheet. Over \$10 billion in cash and securities remain. Management has clearly been planning on a rainy day and they got it. Nonetheless, Kyocera is a multinational company that is thriving in the current environment.

Another returnee is Nomura. Just months ago, Schacht Value sold NMR shares for approximately \$6.60 each. Now the financial service firm is back. Fears about the Japanese economy sent Nomura below our original purchase price to \$4.85 a share. At this price, we are buyers. But Nomura is not the only financial company we like.

While many US investors debate which US bank to buy, we have avoided the debate entirely. Recent weakness has allowed Schacht Value to buy a mini-portfolio of 3 Japanese commercial banks – **Mitsubishi UFJ Financial (MTU)**, **Sumitomo Mitsui Financial (SMFG)**, and **Mizuho Financial (MFG)**. Individually these are small positions, but they collectively make up 5-6 percent of client portfolios. As a group, these banks trade at about a 50% discount to book value, at roughly 6 times earnings, and pay an average of a 4% dividend yield. Needless to say, we are more comfortable with this collection than **Bank of America (BAC)** or **Citigroup (C)**.

Yet most investors can't see past the short-term troubles in Japan. This is reflected in the press. This recent *Wall Street Journal* headline is typical – “*Large Question for Japan's Megabanks: The effect of the earthquake and tsunami on the companies' short-term results*”. And if it isn't the disasters, the focus is on Japan's decades-long decline and fiscal problems. At the risk of beating a dead horse, it is this skepticism that has created low prices and the opportunity for patient investors. We like the prices we see in Japan. And we are not alone.

This excerpt from Edward Chancellor's April 2011 piece (*After Tohoku: Do Investors Face Another Lost Decade from Japan?*) sums up our position pretty well:

Investors in Japan have lost money for more than two decades. But it's often overlooked that the main cause of these miserable returns has been the long decline in Japanese equity valuations from their absurdly inflated levels of the early 1990s. For the first time in the careers of many investors, the Japanese stock market is now no longer expensive. Yet instead of looking on the bright side, investors appear transfixed by Japan's poor demographics, fiscal deficits, continuing deflation, and low returns on equity.

It is for these reasons that our Japan exposure is approaching 15% of the portfolio. We don't need an excuse to buy \$20 worth of value for \$10. Hunting for value never goes out of style.

See you in the cheap seats,

Henry W. Schacht, CFA

<p>To buy when others are despondently selling and to sell when others are euphorically buying takes the greatest courage, but provides the greatest profit.</p> <p>~ Sir John Templeton</p>
