SCHACHT VALUE INVESTORS, LLC

Capital Management in the Graham and Dodd Tradition

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Red Light, Green Light

Ask most investors what they seek and two words often come to mind – "safety" and "growth". The view is that these are diametrically opposed goals. You can have one or the other, but not both. The only way to get high returns is to take on additional risk. To keep your money safe, investors must sacrifice return. With bank deposits and bonds yielding nothing or next to nothing, the "low return = safe" impression is reinforced. Just the same, a volatile stock market gives them the impression that investing in anything not backed by the full faith and credit of some governmental body is akin to a financial bungee-jump.

Despite this pitiful logic, a casual glance at the first five months of 2012 would not dissuade anyone from these entrenched views. From January through April, the market went up by double-digits. The green flag was out and everyone piled into the water. By May the red flag was out and it seemed there was a shark behind every wave.

Depending on the news of the day, investors vacillate between two extremes. The financial world has come to refer to this dichotomy as "risk on, risk off". Bad economic news? Everybody out! Prospect of a government bailout? All's clear! GDP growth lags expectations? Run for your life! More quantitative easing? Break out the champagne!

2012 has been a year of such extremes. In 4 short months, the market shot to double-digit gains only to have them disappear in the month of May. Our portfolio has mirrored this general trend. Frustrating, yes, but even more so because current perceptions of safety and growth are absurd. Worse yet, they are dangerous.

By coincidence, a number of recent events serve to perfectly illustrate recent investor behavior and both ends of the "risk on, risk off" spectrum. The contrast with our approach and portfolio could not be starker.

The first event was the new record low interest rates for German 10-year bonds. So high was the demand at auction, that Germany paid the lowest rate in its history to borrow for 10 years, just 1.47 %. After all, these bonds are "the gold standard of eurozone debt". They better be considering a yield of only 1.7% on the country's 30-year government bond.

Schacht Value sees a gold-plated price on these securities, but precious little room for error and no margin of safety. Germany may be among the best credit risks in Europe, but that is not a beauty contest worth winning.

By contrast, **Siemens (SI)** is a hugely profitable multinational corporation that just happens to be based in Germany. And, yes, they do a fair amount of business in Europe. Unlike German sovereign debt, SI is priced for calamity. The stock has fallen over 40% in the last year from a high of $138 a share to a recent $82 a share. The dividend yield is around 5% and the company's shares trade at 9 times earnings. The company is conservatively financed and has a modest pension liability. Siemens is a world leader in energy, healthcare, infrastructure, and more. At this price, SI seems a vastly safer investment than the sovereign bonds of its country of origin. We also see the possibility of substantial capital gains. Safety and growth? The best of both worlds.

Japan is another country with massive (and growing) debts. It has an aging population and a stagnant economy. Count those among a number of other reasons that Schacht Value has no interest in Japanese government bonds. Our conviction grows exponentially due to the current prices and resulting yields on Japan's debt. A 10 year bond yielding less than 1%? How about a 30 year bond with a yield of 1.84%? No thanks.

Schacht Value sold nearly all our Japanese holdings for a tidy (though not exciting) profit in the Spring. Since its peak of 10,255 in late March, the Nikkei has slid to 8,500, a loss approaching 20%. The falling Japanese market means bargains and so **Nintendo (NTDOY)** has returned to the portfolio after a 50% drop in the last year. At the current price, Nintendo has a market value of approximately $14.5 billion. On the surface, many investors say that is a hefty price given Nintendo's troubles of late, and a strong yen is only making matters worse. Only those who don't read financial statements can hold such beliefs.

Nintendo's management certainly has not gotten the memo about impending irrelevance. They are forecasting a solid profit for this year and a return to dividend payments. But the real beauty of Nintendo is on its balance sheet. For our purchase price of $14.5 billion, we get a company with $13 billion in cash and investments and NO debt. Simply put, the market is so pessimistic that it is assigning a near ZERO value to Nintendo's business, name, or any future earnings. Furthermore, Nintendo is selling at a significant discount to its $16+ billion book value. For us, the business, the people, and the price of Nintendo define safety.

Another example of the so-called "flight to safety" is the United Kingdom's rock bottom yields with 10 year government bonds yielding 1.66% and 30 years at 2.95%. Buyers of gilts at these levels have a very strange idea of safety. They better hope that inflation and currency risks are dead. We suspect not.

Either way, we prefer UK-based retailer **Halford's Group (HLFDY)**. To understand this unique company, think about what would happen if Dick's Sporting Goods (Dks) adopted the Pep Boys (PBY). Halfords can set you up with camping gear, bicycles, or fix your car's brakes and tyres. The UK economy has been tough, but the company still managed to generate £70.4m ($110m) in free cash flow last year (fiscal 2012). They also returned £106.5 million to investors through a combination of stock repurchases and dividends.

Because of a weak outlook, investors have punished Halford's shares. The stock trades near a 52 week low, valuing the company at only £475m (or $735m). At this price, the dividend yield stands at over 9%. Once again, this is a conservatively financed company. Even if operating results suffer in the short-run, the price more than compensates. We believe Halford's is a compelling investment. We are celebrating the Queen's diamond jubilee by investing in with Her Majesty's commoners and avoiding the lordly prices on offer for her government's paper.

Closer to home, Americans are painfully aware of our growing national debt and deficits. There is, however, a severe disconnect between this reality and their investing behavior. With 10 year Treasury securities yielding 1.57% and 30 year ones at 2.64%, one would hardly guess that our Uncle Sam was not running monstrous surpluses. The CBO recently forecast a doubling in national debt in just 15 years, but investors demand nothing in return for the risks they bear.

Not everyone is whistling past the graveyard. James Tisch, the chief executive officer of **Loews Corp (L)**, one of our largest holdings, echoed our sentiments recently. He said Treasury bonds should be called "certificates of confiscation" with yields at record lows. Indeed, at these levels, lending money at such rates (with all the associated risks) constitutes a massive wealth transfer from the lender to the borrower. But such is the level of fear in the markets.

Buying has begotten more buying as investors pile into the bonds mentioned above. In fact, if we had purchased any of the bonds above, Schacht Value would likely be reflecting capital gains on each one since January 1st. This is the financial equivalent of a game of chicken that we won't play with your capital or ours. Nonetheless, legions still cling to Treasuries and other sovereign debts despite negative inflation-adjusted returns.

Ironically only upon the IPO of Facebook did millions of investors decided to abandon the cozy embrace of their zero interest rate savings accounts. Why? Because Facebook is the definition of a GROWTH story. Just like the perception of safety has been warped, so has the concept of growth.

The lesson Facebook shareholders are now learning (besides never to buy an IPO issue) is that growth in sales and profits doesn't necessarily translate into shareholder value. The lynchpin is price. If the price you pay is astronomical, even torrid revenue growth won't help.

By now everyone on earth knows that **Facebook (FB)** finally became a public company last week. Those who satisfied their itch to own FB shares paid dearly for the privilege of being in that not-so-select group. Investors-turned-speculators formed a virtual line to get shares even while headlines like "Facebook Insiders Sell Bigger Stakes" flashed on their trading screens.

Aswath Damodaran, professor at Stern Business School at New York University and author of many books on corporate finance and company valuation gave this timely warning: "It's exceedingly dangerous to pay a $100 billion valuation for a company that hasn't figured out a way to make money." Facebook fans were undeterred.

The thought process goes something like this: I use Facebook, everyone I know uses Facebook, therefore I will buy stock in Facebook. Hey, I'm buying what I know! Social networking companies and other online services are especially susceptible to this type of thinking. While it may be a good starting point, it is hardly sufficient for an investment decision. As Facebook insiders were selling ever larger stakes in the company, prospective investors were assuming the service they use and enjoy is a great business and taking yet another leap that this business will be a wonderful investment.

At one point on opening day, the masses bid FB shares up to $45 a share, valuing the company at around $125 billion. That's when the "greater fool theory" was satisfied and the greatest fool got his fill of the hottest IPO in history and the stock began to fall. Despite investment banks trying to "support" the stock and CNBC's breathless 24 hour coverage, Facebook has not seen these heights again. The stock closed today at $33 a share, valuing the company at a mere $90 billion.

To put these numbers in perspective, $125 billion is enough to buy **Boeing (BA)**, **Target (TGT)**, and **Kimberly Clark (KMB)** with enough left over to throw one heck of a party. While jumbo jets, Super Target stores, and giant rolls of toilet paper don't stir the imagination like social networking, they may be more profitable. These companies combined for nearly $9 billion in 2011 profits. Today's $90 billion Facebook is roughly the same market value as McDonald's **(MCD)**. No bargain at this price, MCD at least raked in over $5 billion in 2011 earnings.

Fortune writer, Scott Cendrowski, outlined the Facebook fundamentals in his *"Facebook's Stock by the Numbers"* article. He puts the company's annual revenue at $3.7 billion and profits at roughly $1 billion. Both are obviously expected to grow rapidly, which explains a price-to-earnings ratio of 90-120 times. But that is the quandary. According to research Cendrowski illustrates, the implied growth already reflected in FB shares means the company will need $68 billion in sales by 2022 (or 34% annual revenue growth) while maintaining profit margins at nearly 30%. And that, just to justify its current price. Fully 90% of the current value of FB is predicated on future growth. Investors can't afford any downward revision. In fact, for investors to make money, Facebook must handily <u>beat</u> these expectations. We say, "Good luck".

Ask most Facebook buyers why they wanted the stock and we suspect they would say that they know and love the company and its product. This is a company that is intertwined in the daily lives of millions around the world, the makings of a solid shareholder base. The trouble is that "buying what you know" is not sufficient to guarantee a good investment…or even a well-reasoned one. Investors must compare the fundamentals of the company with the price they are paying. Few FB investors have looked beyond the stock quote or the size of their "friends" list.

It is no surprise that Facebook shares have faltered. Once all the buyers were satisfied and the hype died down, the stock had nowhere to go but down. That said, we didn't expect sentiment to shift so dramatically and so quickly. Weeks ago it was all buy orders and thumbs up for those participating in the Facebook phenomenon. Now, it's lawsuits and, well, another finger entirely. A far cry from the optimism that preceded the IPO, we now see headlines like: ***"How Facebook could destroy the U.S. economy"***. Hyperbole works both ways.

A friend recently said he likens these companies to the "FREE BEER (tomorrow)" signs that are common in bars. Or so he tells me! Every day you go back and the sign still says tomorrow, the forever unfulfilled promise.

We prefer our beer…or perhaps a **Dr Pepper /Snapple (DPS)** to be free today.

It is not a surprise that so many people have lost faith in stocks. So-called professionals talk in another language. Their approach to investing in companies is unrelated to logic and how businesses are valued. There is a short-term, trading focus that exacerbates volatility and raises fees, which gives rise to a casino mentality.

Chief among these problems is what we've started to call the "death of absolute numbers". In a recent speech to the University of Notre Dame Finance Club, I used **Pandora Radio (P)** as a prime example. When the company reported its annual results on March 6th, they touted a lot of relative statistics in large bold print: 99% year over year growth in revenue, 109% growth in listener hours, 69.8% share of the internet radio market, and a 62% increase in active users. Impressive numbers to be sure, but casual readers of the press release may have missed that Pandora lost $16 million versus a $1.7m loss the year before. Free cash flow was also negative and shares outstanding galloped higher thanks to employee stock options. It seems the bigger Pandora grows, the more money it loses. Yet Pandora has a market value of nearly $2 billion!

We are reminded of what the CEO of **Zillow (Z)**, a real estate internet sensation, said recently in an interview : "We're in revenue generation mode. We're not in profit maximization mode, just yet." Zillow has a market value near $1 billion. That's 12 times revenue and the company is only flirting with profitability. **LinkedIn (LNKD)** is another internet favorite with little in profits (about $16 million in the last year), but it sports a market value of nearly $10 billion! But just wait for tomorrow!

Revenue is a prime value driver. Indeed, it is difficult to create lasting equity value if your company has no sales. But sales alone don't guarantee success. Plenty of firms learn that it is easier to generate sales than it is to turn them into profits.

And this is the biggest gulf in the markets these days, the valuation difference between companies that are growing (read: COOL) and those that are not growing (read: NOT COOL).

We offer **L-3 Communications (LLL)** as an example of quiet, and (as yet) unrealized value creation. LLL is the antithesis of a well-known brand. It operates behind the scenes in areas from Command & Control, Intelligence and Surveillance to Aircraft Maintenance/Modernization and Electronic Systems. Are you asleep yet?

Well, L-3 generated nearly $1 billion in profits in the last year. Take a minute to compare this to the profit numbers immediately above. Cash flow generation was even higher. The company paid out $200 million in dividends and repurchased $890 million worth of its shares. So powerful was this buyback, that the total number of shares of LLL dropped by almost 10%. Add this to the dividend yield of 3% and our total yield on this holding was 13%. Our ownership stake in the company increased without us having to purchase another share. More amazing is that the company is forecasting a repeat performance this year.

For all this, LLL shares are valued at less than $7 billion. If L-3 repeats its performance from last year, investors will receive a yield of 16% on this investment. So what does Mr. Market hate about LLL? Well, it's not growing. Translation: revenue and profits (regardless of size) are stagnant. And the growth in shareholder value is ignored, disregarded in a market obsessed with headline names and in which nobody seems to read financial statements.

LLL may be completely unknown by the public and the vast majority of investors, but this is a track record we find comforting. Better still, the mathematics is stacked in our favor. This is our version of safety and it also holds out the hope for substantial growth in shareholder value.

L-3 is only too happy to showcase its earnings power via its substantial dividend and buybacks, but it is not alone. New or increased dividends have come from companies like **Cato, Dr Pepper Snapple, SAIC, Lexmark, Lear, Vodafone, Northrop Grumman,** and more. Substantial share repurchases have been done by **AstraZeneca, Loews, Foster Wheeler, Lear, SAIC** and more. These are not accounting gimmicks or one-time attempts to attract attention, but sustained efforts to build shareholder wealth. Nearly each one of the companies mentioned here could warrant a section like LLL.

In any case, Schacht Value can't control whether or not the market will recognize these activities today or tomorrow. We will attempt to take advantage of volatility: selling when our holdings reach fair value or more and buying when valuations become attractive. As long as the math makes sense, we will ignore the crowd and hold companies like these in the portfolio. And we will continue to avoid hype and overvaluation even if it is the "flavor of the month".

It is no accident that the world's richest man is Mexican businessman Carlos Slim. Some years ago, he told an interviewer that "buying well is a discipline." It can be emotionally difficult to buy well, because others are running away from cheap assets in favor of greener pastures. For a time, those green pastures go up in price confirming the trend. Mr. Slim is a value investor and is frequently buying what others don't want. Interestingly, he's been buying newspapers (via a stake in the New York Times) and trying to purchase mobile telecom assets (in Europe). "I like numbers," he said. "Words speak to some people; to others of us its numbers." No doubt, for Slim, the numbers often scream "buy me" when most people were running the other way.

Schacht Value likes the numbers we see out of our portfolio holdings. We hope the above illustrations are instructive and compelling. The laws of finance are as immutable as the law of gravity. They can be defied, but only in the short-run. The absurdly high prices investors pay for certain securities never ceases to amaze us. On the flipside, plenty of babies get thrown out with the bathwater. As famed investor Jeremy Grantham said, "The short term will always be exaggerated, and the fact that a corporation's future value stretches far into the future will be ignored." Ultimately, the market will get it right.

If something cannot go on forever, it will stop. ~ economist Herbert Stein

Thank you for the opportunity to invest on your behalf. We will continue to strive every day to warrant the trust you place in us.

Henry W. Schacht, CFA