SCHACHT VALUE INVESTORS, LLC

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The Fallacy of Growth

A great deal has happened since I last wrote to you in July, almost all positive. Our client accounts are currently sitting at the highs for the year. Obviously some of the portfolio gains are due to a surge in overall market values. That said, Schacht Value is comfortably outperforming most broad market averages. This is due to the attractive prices we paid for our portfolio companies and specific catalysts. Market values are beginning to more accurately reflect the underlying intrinsic value of our holdings.

In addition to progress on the investing front, I am pleased to announce the launch of our new online home, www.schachtvalue.com. It promises to be an important source of information about Schacht Value and our investing philosophy. Users will find recent client newsletters and an education page with resources for those wanting to learn more about investing. Soon anyone wanting to open a new account will be able to download the necessary agreements and forms online. There is a section answering our clients' frequently asked questions (FAQ) on issues such as transfers and withdrawals, State Street contacts, and important policies and procedures. This is part of our ongoing commitment to the client experience. If you have suggestions on how we can improve this vital link to Schacht Value, please pass them along.

Now back to business. What a difference a few months can make! Investors who hid in bonds and elsewhere this spring are feeling left behind and vulnerable now. Stocks are the place to be. Wall Street is enthusiastic and hopeful. Corporations are spending again (if not hiring). Everyone is hopping on the bandwagon because of the ever powerful and often misunderstood concept of growth.

To individual investors and corporate leaders alike, growth is seen as a panacea, a cure-all. Everything is great as long as a company is "growing." This simplistic view of growth has led to disastrous decision-making. But everyone loves a "growth story." You've heard the pitch, "Buy this stock now; its earnings are growing at over 30% a year!" The argument fails because just knowing that a company's earnings are growing at 30% or more a year is not a sufficient basis for a buy decision. Professional investment analysts are largely responsible for the unhealthy focus on growth that exists today.

Analysts often seem incapable of calculating the value of a company that isn't growing. In their minds, earnings growth drives valuation. With that reasoning, a company that isn't growing is worth zero. I'm being extreme, but just witness the sudden and massive stock declines suffered by firms when there's a hint that earnings growth has slowed. The value placed on "growth" is absurd and misplaced. Some of Schacht Value's best investments have been and continue to be no-growth, mature businesses bought at bargain prices.

On Wall Street, growth is everything and the more predictable the better. Corporate leaders are constantly bombarded with this "grow or die" message. With growth, you can do anything.

Without it, you are nothing. Consequently, managers often do anything to avoid the embarrassment of losing the "growth" label. Many conclude that the appearance of growth is better than nothing. In fact, the accounting scandals uncovered in the recent past are largely a result of corporate managers seeking to deliver earnings and/or revenue growth from businesses where no real growth existed. Ultimately, the charade is unsustainable and the house of cards collapses harder than ever. Those who perpetrate these frauds are not victims. Their actions are fueled by greed and the belief that growth begets value. They are not alone in this fallacy of growth.

To make matters worse, investors have been taught that there are two distinct investment strategies: growth and value. But growth is not an investment strategy. It is simply a variable in the value equation and a very troublesome variable at that. Extrapolating past growth rates out into the future is dangerous. Not all growth is created equal. Not all growth is profitable. In fact, the costs of growth (more inventory, more staff, etc.) can easily outweigh the benefits. Most importantly, growth is highly unpredictable and rarely sustainable over long periods of time.

Unfortunately, investors inevitably pay too much for growth (real and perceived) and perennially overestimate their growth forecasts. Simply put, buying a company because its earnings and/or sales are growing rapidly is a strategy that is doomed to failure.

Not infrequently, a company becomes a "growth stock" at precisely the wrong time. Growth has already started to slow. Compounding the problem, the title of "growth stock" brings with it a premium price. This often means a stock priced for perfection. In this case, no amount of future success is enough, the illusion fades, and investors pay the price.

Businesses are akin to living organisms. They are organizations made up of human beings, operating in dynamic and competitive environments. Like human behavior, corporate performance and earnings in particular can be erratic and not given to mathematical precision. This is why Schacht Value demands a margin of safety when investing. We want to buy a dollar's worth of value for 50 cents rather than 90 cents. This protects our capital from valuation errors and fluctuations in intrinsic value, while providing the possibility of attractive returns over time. A firm's earnings do not have to proceed upwards in stair-step fashion to be worthy of investment.

Our investment decisions are not built on growth projections going years into the future. In fact, we refuse to pay a hefty price for earnings and revenue growth, preferring instead to base our decisions on more predictable variables in the value equation. If profitable growth occurs it's a bonus, but not a necessity. A company does not have to be growing for it to be a good investment.

There is a lot to be happy about in today's marketplace, including the improving economic outlook. We will not, however, let the stock market or the emotions of its participants dictate our actions. All this newfound enthusiasm, the "return of growth", and the corresponding market advance have not changed our investment approach. We often remind ourselves of the wisdom of an old stock market axiom: *Be greedy when others are fearful and fearful when others are greedy.* Schacht Value Investors has been active on both sides of the equation.

For example, take **Cooper Industries (CBE)**, maker of electrical products, tools, and hardware. On August 22, a Banc of America analyst raised the investment rating to "buy" with CBE trading at $50 a share. Subsequently, Cooper announced an impressive earnings report showing a 12 percent increase in earnings year over year. Its shares traded as high as $54. Growth is back, Wall Street is happy, but the real money has already been made. Where were the analysts last year when investors could buy Cooper shares for less than $30 per share?

Last year the market gave us the opportunity to buy Cooper at very attractive prices. Schacht Value determined its intrinsic value was closer to $5 billion than $3 billion. This was a good company operating in a difficult business environment. Cash flow was good and improving. The top-notch management team remained committed to running a tight ship, but earnings weren't growing and Wall Street yawned. Now they are awake, but it's probably too late. Wall Street is often late to the party because of their single-minded focus on growth. At the current share price, the market value of Cooper Industries is $5 billion. There may be more upside, but it is limited compared to what we have experienced so far. We've started selling.

The same can be said of **Apple Computer (AAPL)** and **Sears Roebuck (S)**. We purchased these holdings when the wider investing community gave both up for dead. After all, Apple is doomed in the Microsoft world, right? Maybe, but we bought the company at a value only slightly higher than the $4.5 billion in cash sitting in its coffers. Cash flow was positive and after factoring in values for Apple's brand name, customer loyalty, positive cash flow, and history of innovative products, we concluded that Apple was dramatically undervalued. Admittedly, none of the latter factors has a clear-cut value, but we knew the numbers were significant and positive.

Today Apple is looking healthier, and is even the subject of some hype. The new computer line is selling well. The company's online music service is getting a lot of press and generating increased sales of the iPod music player. The operating business now carries a healthy valuation and the cash still sits there. Apple could create far more wealth for its shareholders, but it refuses to do anything with its excess cash. That said, the company appears fully valued at these prices.

We've discussed Sears at length before. It's one of those mature companies that doesn't excite investors. Sears generated an enormous amount of shareholder wealth when it sold its credit card business to **Citigroup (C)**. Wall Street was completely caught off-guard by the magnitude of this catalyst. The company seems ready to return a huge amount of cash to stockholders and to use the rest to bolster its retail business. In any case, most (if not all) of this good news is reflected in the current stock price.

Apple and Sears have experienced amazing price increases this year, up 61 percent and 123 percent respectively. The important point is that their market values now meet or exceed our estimates of intrinsic value. Our margin of safety has disappeared and the capital can be better employed elsewhere.

Despite the general rise of equity prices, we continue to find exciting opportunities that meet our strict value criteria. Our new holdings include **Nautilus Group (NLS)**, maker of a wide range of fitness equipment. The company, with a stable of brands including Bowflex, Schwinn, TrimLine, and Stairmaster, is a fallen "growth" angel.

In early 2002, NLS shares hit $45 a share, valuing the company at almost $1.5 billion ($45 x 33 million shares). Sales had increased from $200+ million in 2000 to almost $600 million in 2002. Profits were soaring too, $40 to $100 million (round numbers) in the same period. This was a growth stock. Time to buy? Hardly. Investors who bought NLS after it was anointed with the "growth stock" label regretted it. Nautilus shares fell from $45 to $10 a share by this summer.

The profits and growth generated by Nautilus were an advertisement for opportunistic competition. Firms with copycat products emerged and profits suffered. Some would say this is the beauty of capitalism, a kind of creative destruction. Someone will always try to steal your business by trying to do things better, faster, and cheaper. Nautilus managers had grown complacent. The company's growth projections were aggressive to say the least. Using this faulty view of the future, managers invested and expanded precisely when the competition was taking hold. Prices came under pressure and profits followed. Earnings didn't grow; they fell. This year Nautilus should make around $35 million, which is quite a drop. NLS learned the hard way that trees do not grow to the sky.

Schacht Value started accumulating shares of Nautilus Group in September at $12.10-$12.35 a share. The value of Nautilus was around $400 million. Not bad for a company with no debt, $60 million in cash in the bank, and a great portfolio of brands. Competition is still an issue, but Nautilus leaders have learned some hard lessons and they do not intend to repeat them. The company returns $13 million to shareholders each year in dividends, about a 3% yield. The company seems stabilized and the stock has been as high as $16 in recent weeks. All in all, we feel very happy with the price we paid for this holding.

For those of you who will say that a fitness company like Nautilus is outside my circle of competence, here's something you know I understand… **J&J Snack Foods (JJSF)**. The name speaks for itself. J&J makes frozen beverages (ICEE and Arctic Blast), frozen desserts (Luigi's, Minute Maid, and Hi-C), pretzels (Super Pretzel), and a variety of pastries, cakes, and cookies.

The story of J&J Snack Foods is not a dramatic growth story with a sad ending, but rather a company neglected by Wall Street, flying below the radar. JJSF is a well-run company generating copious amounts of cash and selling at an attractive price. Our investment in the company started in July at around $33 a share or a market value of $285 million. This company also has no debt and is repurchasing and retiring shares with its excess cash. Cash is still accumulating as cash-on-hand currently stands at $23 million. The company generated over $30 million in excess cash last year and we expect a similar performance this year. With the change in the dividend tax laws, we believe that a dividend could be forthcoming in the near future as well. We could not be happier about adding this company to the portfolio.

Super Pretzels and Stair Masters… Now that's what I call diversification and the start of a Christmas list!

My best wishes for a happy Holiday Season and a prosperous New Year,

Henry W. Schacht, CFA
President and Chief Investment Officer