Schacht Value Investors, LLC

Capital Management in the Graham and Dodd Tradition

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Oil Discovered on the Moon

For at least two years, investors have been preoccupied with energy prices. Proponents of the so-called Peak Oil Theory argue that the price of oil and gasoline will continue to go up because the planet's oil production has peaked and that world oil production will enter a terminal decline.

We've talked at length in these pages about the limits of forecasting. And the Peak Oil Theorists are having their share of disappointment. Just last month, a group led by Chevron (CVX) announced a discovery that may be as large as Prudhoe Bay, Alaska. The Gulf of Mexico find may boost domestic oil reserves by 50 percent. Ouch! Combine this with record oil inventories and fears that global economic growth may be slowing and you see why crude prices have dropped. In fact, the recent fall nullifies all of oil's 2006 gains.

Natural gas hasn't fared much better. Last year natural gas traded as high as $15 per million Btu. Naturally, analysts were predicting a continuing price increase to $20 or more and winter shortages. Less than a year later, natural gas inventories are now at record highs and pricing is around $6 per million Btu.

We've been skeptical about the price of commodities for some time. Our lack of commodity exposure was a limiting factor last year. Today, we don't look so stupid. Others were not so lucky. Mutual fund investors are typically seen as contrary indicators. Bloomberg reports that mutual fund investors were "captivated by oil's 88 percent appreciation" in the last two years and "increased their energy holdings in 2006 just in time to lose $4.5 billion." A total of $23.5 billion flowed into energy-related mutual funds in the year ending July 31, according to Financial Research Corp. So much for buying low and selling high.

Investors often don't appreciate the pivotal role that price plays. High energy prices are a powerful incentive. Consumers of energy look for ways to conserve and producers find a way to, well, produce. Forbes editor emeritus Jim Michaels illustrated the incentive of high prices by saying (and we paraphrase) that oil producers will drill for oil everywhere on earth with prices at $60-70 a barrel. And at $80 a barrel, they'll drill for oil on the moon! We are now seeing the power of these incentives.

> *"The most common cause of low prices is pessimism – sometimes pervasive, sometimes specific to a company or industry. We want to do business in such an environment, not because we like pessimism but because we like the prices it produces. It's optimism that is the enemy of the rational buyer."*
>
> *– Warren Buffett*

It's painful to watch a sector go up day after day when you are not participating. The urge to capitulate is extreme. Nonetheless, when a company or industry is priced for perfection, any disappointment results in a painful loss. It is fair to say that those who piled into energy stocks earlier this year (and Internet stocks in 2000) where driven by a fear of being left behind. Few considered what would happen if their assumption (that energy prices would continue going up) was wrong. The same soul searching is being done by many who invested in residential real estate in recent years.

Homebuilding companies are perfect examples of high expectations giving way to disappointment. A year ago, industry executives were uniformly bullish about the outlook for residential real estate. Today, they are hiding under their desks. Not coincidentally, Schacht Value had no interest in the homebuilding stocks when sentiment was riding high. Today is a different story.

The shares of America's largest homebuilders are 50 percent lower than they were at the beginning of the year. Is it a surprise that moods have changed in the executive suite? Irrational behavior in the hottest housing markets led to euphoria. The bursting bubbles have led to more sober thinking. The fact that homebuilding managers are chastened by their past exuberance is a comfort.

Homebuilders will no doubt have to suffer through a painful period of adjustment. Earnings estimates have fallen dramatically for the group and further earnings weakness is always possible. Nonetheless, this reality appears to be fully reflected in the lower stock prices. The homebuilders now trade at just 5-6 times revised 2007 earnings.

Schacht Value is using an exchange-traded fund (ETF) called the **Dow Jones U.S. Home Construction Index Fund (ITB**) to gain broad exposure to the industry. This ETF owns a cross-section of homebuilders including, **Pulte Homes (PHM), Lennar (LEN), DR Horton (DHI), Toll Brothers (TOL), Centex (CTX),** and **KB Home (KBH)**.

The trucking industry is faced with similar investor pessimism. That may be changing. An article in the October 2006 issue of *Smart Money* magazine entitled "Time to Load Up on Trucking Stocks" accurately reflects our view of the industry. The article states: "All the risks to the sector – including record-high oil prices, a continuing driver shortage and an uncertain economy – have already been priced into the stocks, leaving plenty of room for upside as shipping demand stays strong." Megan Barnett solidifies her place as our favorite author by highlighting our 2 trucking holdings, **Arkansas Best (ABFS)** and **YRC Worldwide (YRCW)**, formerly known as **Yellow Roadway**, as top trucking stock picks. The office is being checked for listening devices and we are renewing the *Smart Money* subscription!

Our experience in the tobacco and insurance industries reinforces the benefit of contrarian thinking. Insurers **Berkshire Hathaway (BRK.b)** and **St. Paul Travelers (STA)** are trading near all-time highs after being laid low by Katrina fears a year ago. Pricing in the property casualty arena is phenomenal. Our tobacco holdings are also at record highs thanks to a clearing of the legal air and the increased possibility of consolidation. Our relatively new holding in **UST Inc. (UST)**, maker of Copenhagen and Skoal chewing tobacco, is up nearly 40 percent since our initial purchase in February. We would not be surprised to see UST acquired by **Altria (MO),** another portfolio holding.

Our international holdings also continue to perform well. Nearly 20% of the Schacht Value portfolio is invested in firms based outside the United States. That said, we're not keen on the emerging markets, which have attracted a lot of attention recently. We love Old Europe … at least their stocks! Most (but not all) of our international holdings are in Europe. Here are a couple of examples.

Anglo American plc (AAUK) is a highly diversified mining conglomerate which we have profiled before. It continues to be a great holding and an update is in order. We didn't buy AAUK because of its exposure to any particular commodity. Instead we were impressed by AAUK's management and their desire to simplify an Old World giant. The determination to maximize shareholders got our attention when we started acquiring shares in September 2005 around $13. The early results are more exciting than we could have hoped. Anglo's businesses (diamonds to platinum, cement to paper, coal to steel) are valuable and readily salable. With the streamlining process in full swing and strong overall businesses, the cash is flowing. Anglo increased its interim dividend by 18%, to 33 cents a share and is paying a 67 cent special dividend, amounting to $1 billion. The company increased its share repurchase program by $4 billion and has cut its debt to $2.7 billion from $5 billion since last year. Furthermore, AAUK is selling its paper business (Mondi) and continues to reduce an equity holding in **Anglo Gold Ashanti (AU)**. These ongoing activities continue to yield still more cash which will be reinvested or returned to shareholders. It gets better. Rumors are circulating that a group of mining companies might join forces to buy Anglo American. CEO Tony Trahar says that the process of transforming Anglo American will be largely complete in 2007 and he is slated to retire. We believe this is a prime catalyst for a buyout. In the meantime, AAUK trades at just 8 times 2007 earnings projections. Buyout or no, AAUK is a gem. No wonder the stock price is now over $20 a share.

Philips Electronics NV (PHG) is doing some pruning of its own and it remains a compelling purchase. Like many conglomerates, PHG got unwieldy with 5 divisions: Electronics, Medical Equipment & Healthcare, Lighting, Personal Care/Consumer Products, and Semiconductors. Philips did not have the scale or focus in many of its businesses to compete effectively. Investors have focused on this negative for years. The financial press rarely mentions PHG's $12 billion equity portfolio with a 16 percent stake in **Taiwan Semiconductor (TSM)**, worth $8 billion, as the centerpiece. Amazingly, Philips has been liquidating its portfolio for some time and it is still enormous. The proceeds from selling this portfolio and the non-core businesses will fund further investments in the remaining operations and higher dividends for shareholders. If you're going to have issues, these are first-class problems. Philips' management has recognized the possibilities and is seizing the moment. In a recent coup, an 80 percent stake in the Semiconductor business was sold in a transaction that valued the business at over $10 billion.

Philips' market value is currently $42 billion ($35 a share x 1.2 billion shares). By subtracting the $12 billion value of the investment portfolio and the $10 billion Semiconductor division, we arrive at a value of $20 billon for the remaining businesses. Bear in mind that Semiconductors were the most inconsistent business under the Philips umbrella. If it is worth $10 billion, then it is laughable that the four remaining (and superior) businesses are worth only twice as much. The Lighting segment is a world leader and is about to ride a wave of demand for LED lighting products. Flat-screen TV's are a booming business for the Electronics division. And Philips has invested heavily in its Medical & Health businesses, making it an industry stalwart. Philips makes everything from portable defibrillators to massive imaging systems.

Philips should generate profits of over $2 billion in 2007. Free cash flow should be even higher. And we haven't even mentioned the $4 billion of cash Philips has on-hand. PHG is trading at less than 10 times next year's earnings. We're hoping more investors see the light.

Domestically, the Dow Jones Industrial Average is at all-time highs. Since the last high, **Altria (MO)** is the best performing Dow component. **Intel (INTC)** is the worst. It is the ultimate dog of the Dow, having fallen from a high of $75 a share in 2000 to its current price of $20.75. We bought INTC in August at $18 a share, 70% below its all-time high. It seems appropriate that we're buying Intel today. At $75 a share everyone loved Intel and it turned out to be a lousy investment. Today, investors are so jaded by Intel's price drop that they have missed the obvious. Today, the price is right. Intel generates amazing amounts of cash and is the industry leader in microprocessors, regardless of all the talk about the ascension of **Advanced Micro (AMD).** New products and a commitment to becoming more efficient are the catalysts that have been lacking. Intel is trading at 13 times 2007 earnings (or less), far below the market average. Intel is not an average company and the returns from this investment shouldn't be either.

Neenah Paper (NP) is certainly smaller than Intel, but it is no less interesting. It's been a laggard in our portfolio, but that is changing. **Kimberly Clark (KMB)** distributed Neenah shares to its shareholders via a spin-off in November 2004. Schacht Value started buying in mid-2005 after Neenah fell off most investors' radar screen. Some investors were simply content to move on. Neenah's fine & technical paper business was (and is) solid, but pulp manufacturing was a drain. At the time of the spin-off, the company also owned 1 million acres of Nova Scotia timberland. The accounting value of this property was reflected on the balance sheet at just $5 million. Yes, $5 an acre. Needless to say, the balance sheet was understated, which is certainly better than the alternative. We estimated the land's true economic value was $300 million. The market value of the entire company was $450 million. The land value was going unnoticed and/or investors were placing a heavy discount on the pulp business.

Neenah's management has addressed both issues to the benefit of shareholders. This year half of the timber property was sold for $140 million and the bulk of the pulp business has been sold or discontinued. The cash is being reinvested in the core paper business and the stock is finally responding (up over 25% year-to-date). Neenah is an example of a mundane business unlocking shareholder value through a thoughtful, but dramatic transformation. If not for pessimism, this opportunity would never have arisen.

Portfolio Changes (since December 20, 2005)

Additions	*Eliminations*
Cemex S.A.B de C.V. ADR (CX)	Constellation Brands (STZ)
Dow Chemical Company (DOW)	Directv Group (DTV)
DJ US Home Construction Index Fund (ITB)	Freddie Mac (FRE)
Ingram Micro (IM)	Gannett Company (GCI)
Intel Corp. (INTC)	General Motors (GM)
Pfizer Inc. (PFE)	Hewlett-Packard Co. (HPQ)
SPDR Homebuilding ETF (XHB)	Jones Apparel Group (JNY)
UST Inc. (UST)	SPDR Homebuilding ETF (XHB)
Wabash National Corp. (WNC)	Topps Company (TOPP)
Xerox Corp. (XRX)	Tyson Foods A (TSN)
	Utah Medical Products (UTMD)

We continue to look at companies large and small, foreign and domestic for value where a clear margin of safety exists. We have illustrated several situations where "hidden" assets and low expectations have provided a very positive investment environment. The Schacht Value portfolio is performing well in absolute and relative terms thanks to a host of these compelling investments. Furthermore, the flow of new ideas is good. Geopolitics, energy prices, and interest rates may be the focal point on any given day, but we try to filter out the noise and continue to evaluate each company based on its fundamentals.

This discipline has served us well and it will continue to do so in the days ahead.

All the best,

Henry W. Schacht, CFA
President and Chief Investment Officer