



Value, Performance, & Service

From the desk of:
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Letter to Clients – October 1999

Enclosed are various reports to update you on your investment portfolio with Aldebaran Capital, LLC through September 30, 1999. We welcome any questions and would be glad to meet with you to go in greater detail on your account.

We will be the first to admit that the market environment for our style of investing has been difficult up to this point in 1999. The Wall Street Journal recently noted that about two-thirds of all stocks traded on the stock exchanges are down in value in 1999. Despite the current stock market's perception of our stock holdings, we are undeterred in our analysis of their investment merit. Our investment philosophy has always been that when we make an investment, we receive more in underlying business value versus the price we pay for a security. We are very comfortable that the stock positions you hold in your account meet this criterion.

At present, the market is infatuated with technology and select large-company growth stocks, particularly companies that are internet related. And while the natural temptation is to gravitate towards what is working today, we choose not to participate in this area of the market for a variety of reasons – namely overvaluation, speculative activity, and a general over-enthusiasm on behalf of investors for these stocks. One of our favorite expressions courtesy of Warren Buffett is that “you pay a very high price for a cheery consensus.” We believe that investors operating in these sectors of the market - though they don't know it yet, or even worse, choose to ignore it - are overpaying for the future results of these companies. This is nothing new. History has shown many a period where investors' enthusiasm for special market sectors has led to stock prices being pushed up to unsustainable levels that were followed by, at best, sub-par future returns, or at worst, severe market losses. For those who choose to buy these stocks at their current price levels, our advice is “caveat emptor” – let the buyer beware.

To illustrate an example of how we view present market conditions, consider these two truly divergent levels of valuation. Cisco Systems is currently one of the most desired stocks to own on Wall Street. It's about the closest thing to a “one-decision” stock (buy at any time regardless of price) around, and is a top holding of many mutual funds. Cisco supplies the network switching gear that is building the internet and is growing like a weed. It is by all measures an excellent company that dominates their industry. However, Cisco's current stock price not only reflects its present excellence, but also has already factored into the current stock price many years of *future* excellence. This *priced-to-perfection* phenomenon leaves little room for any disappointment or unforeseen change. That being said, what really caught our eye was a corporate purchase Cisco made about one month ago. In that transaction, Cisco bought a company by the name of Cerent Corp. and the purchase price – by any measure - was mind-boggling from a valuation standpoint. Cerent, which has only been in existence for 2 ½ years, makes digital gadgets that interact with network switching. During their short existence, Cerent had *aggregate* sales of \$10 million and, as is standard for internet related companies, is losing money (i.e. has no earnings). Cerent was planning on going public and raising \$100 million to fund their growth. Before the IPO offering could take place, Cisco came in and purchased Cerent for the astonishing price of **\$6.4 billion**. It is difficult for us to even contemplate a rational explanation for such a purchase price. Cisco's management “rationalized” the purchase price by pointing to the values being commanded in the stock market by similar companies. While Cisco managers are lionized on Wall Street, this acquisition caused us to seriously question their judgement. In any event, Wall Street analysts who follow Cisco weighed in with their predictable analysis. They had nothing but praise for the latest move by this well-loved company. Thus, according to these analysts, the fact that Cisco essentially took 3% (\$6.4

billion) of their shareholder's company and used it to buy a two-year old company that's losing money, and paid 64 times its sales, should be of no concern to Cisco shareholders. *It is this type of investor complacency that frightens us.*

So what is a rational investor to do? Remarkably, even in this period of extreme overvaluation in some sectors of the market, there are pockets of value. It's just that you won't find them in the area where most investors are enthusiastic.

For example, we point to one of our larger holdings – Standard Pacific (SPF). Here is a company that has real sales and earnings that are growing at an exceptional rate, and based upon our analysis, has a very positive outlook. The stock is trading at roughly 5 times 1999 est. earnings (a P/E of 5) and 10% below its book value (assets minus liabilities). Another way we look at an investment in SPF is the “earnings yield” which is the inverse of the P/E ratio. Using the numbers below, you can see that 1999 est. earnings of \$60 million represents 20% of the total Market Value of SPF. Thus, investors in SPF at these prices, receive a 20% *cash earnings* return on their investment. This makes Standard Pacific quite an attractive and rational investment to us, especially when compared to scenarios similar to Cerent Corp., where there is no cash earnings yield today, nor in the foreseeable future.

The following table is a side by side look at the valuation differences for these two companies:

	Cerent Corporation	Standard Pacific
Market Value (Price)	\$6,400 mill	\$300 mill
Estimated 1999 revenues	\$ 100 mill	\$1,000 mill
Estimated 1999 Earnings	\$ 0	\$ 60 mill
Price-Earnings ratio (P/E)	N/A	5
Earnings Yield (E/P)	0%	20%
Price to Sales ratio (P/S)	64	0.30

The above comparison illustrates why we find it amusing when we hear remarks about the market being “efficient” at valuing companies. Quite the contrary, market prices are often irrational. We are very content to exploit this undervaluation by purchasing shares of SPF and exercising the discipline and patience needed to wait for the market to recognize its mistake.

These days when you turn on the business news or pick up a financial publication, we regularly hear about the tremendous wealth that is being minted by all these technology companies that are going public. We hope that our discussion above provides you with some understanding as to why we do not operate in these highly publicized sectors of the stock market, and instead, choose to search for real values. As my partner Ed likes to say, “acquiring wealth in the stock market is not a sprint, it's a marathon.” Too many investors today believe they are running the 100-yard dash.

Sincerely,

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