



Value, Performance, & Service

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Letter to Clients - January 2001

We are pleased to provide the enclosed year-end 2000 portfolio reports on your Aldebaran Capital, LLC investment account. The year 2000 was, by any measure, a great success for our investment accounts as we significantly outperformed the market averages. These results can largely be attributed to the massive revaluation of company stock prices, where most of the overpriced technology stocks (which we avoided) dropped significantly and many stocks selling at discounts to corporate value were marked up in price.

A year ago, we constantly read and heard why sound investment principles, such as those set out by Benjamin Graham and others that had served investors so well over time, no longer applied. In this new economy, there was a different set of valuation techniques or "metrics" (to coin the phrase of the day) upon which an investor could rely on to buy stocks. Thirty something brokerage analysts were tripping over themselves to get on TV and inform the world why XYZ tech stock was not just going to double, it was going from \$100 to \$1000.

Throughout this speculative mania, we often consulted the classic text Security Analysis, written by Ben Graham and David Dodd in **1934**. Interestingly, the book has a chapter entitled "The New-Era Theory." (Imagine that, there have been periods described as new era's or new economy's in the past.) We thought it might be appropriate to quote a few passages here. What's eerie is that these words sound like they could have been written yesterday.

From Graham & Dodd's Security Analysis: (published in 1934)

The Factor of Human Nature

One of the striking features of the past five years has been the domination of the financial scene by purely psychological elements. In previous bull markets the rise in stock prices remained in fairly close relationship with the improvement in business during the greater part of the cycle; it was only in its invariably short-lived culminating phase that quotations were forced to disproportionate heights by the unbridled optimism of the speculative contingent. But in the 1921-1933 cycle this "culminating phase" lasted for years instead of months, and it drew its support not from a group of speculators but from the entire financial community. The "new-era" doctrine – that "good" stocks were sound investments regardless of how high the price paid for them – was at bottom only a means of rationalizing under the title of "investment" the well-nigh universal capitulation to the gambling fever.

The advance of security analysis proceeded uninterrupted until about 1927, covering a long period in which increasing attention was paid on all sides to financial reports and statistical data. But the "new era" commencing in 1928 involved at bottom the abandonment of the analytical approach; and while emphasis was still seemingly placed on facts and figures, these were manipulated by a sort of pseudo-analysis to support the delusions of the period. The market collapse in October 1929 was no surprise to such analysts that had kept their heads...

The New-Era Theory

The notion that the desirability of a common stock was entirely independent of its price seems incredibly absurd. Yet the new-era theory led directly to this thesis. If a public-utility stock was selling at 35 times its *maximum* recorded earnings, instead of 10 times its *average* earnings, which was the pre-boom standard, the conclusion to be drawn was not that the stock was now too high but merely that the standard of value had been raised. Instead of judging the market price by established standards of value, the new era based its standards of value upon the market price. Hence all upper limits disappeared, not only upon the price at which a stock *could* sell, but even upon the price at which it would *deserve* to sell. This fantastic reasoning actually led to the purchase for investment at \$100 per share of common stocks earning \$2.50 per share. The identical reasoning would support the purchase of these same shares at \$200, at \$1,000, or at any conceivable price.

An alluring corollary of this principle was that making money in the stock market was now the easiest thing in the world. It was only necessary to buy "good" stocks, regardless of price, and then to let nature take her upward course. The results of such a doctrine could not fail to be tragic. Countless people asked themselves, "Why work for a living when a fortune can be made in Wall Street without working?"

The new-era investment theory was conspicuously reticent on the mathematical side. The relationship between price and earnings, or price and trend of earnings was anything that the market pleased to make it.

And finally, from Graham's The Intelligent Investor: (published in 1949)

"Somewhere in the middle of the Bull market the first common-stock flotations (IPO's) make their appearance. These are priced not unattractively, and some large profits are made by the buyers of the early issues. As the market rise continues, this brand of financing grows more frequent; the quality of the companies becomes steadily poorer; the prices asked and obtained verge on exorbitant. One fairly dependable sign of the approaching end of a bull swing is the fact that new common stocks of small nondescript companies are offered at prices somewhat higher than the current level for many medium-sized companies with a long market history. The heedlessness of the public and the willingness of the selling organization to sell whatever may be profitably sold can have only one result – price collapse."

An unanswered question at this point is - where do we go from here? We are somewhat disturbed by the majority of pundits predicting that we will have a short period of "volatility" and then it's back to buying technology stocks. In fact, knowing that old habits die hard, we would not at all be surprised to see the NASDAQ make a good run sometime in the next several months. The argument has now become, that with many "good" quality stocks having come so far down in price, it's time to go bargain shopping for tech stocks. Yet when we look at many of the stocks so frequently mentioned, we still find many of them selling for lofty prices in spite of their extensive declines.

Instead, we will continue to focus our efforts on identifying investments that offer value in excess of the price we must pay. We will do this by applying simple concepts that make so much sense to us, i.e. the idea of buying \$1 worth of value for 50 cents. Purchasing an asset at a discount to its "intrinsic value" provides you with a Margin of Safety: protection against downside risk, while offering attractive upside potential.

It might seem that we would be eager to take on an "I told you so" attitude considering how things have transpired during the past year in the stock market. Yet, in this letter we chose to leave that task to Ben Graham. His message has been available for all to see for over 66 years.

In closing we think the following quote from Warren Buffett addresses the irony of how value investing makes sense, is simple in concept, yet most choose to ignore it to their peril.

"I can only tell you that the secret has been out for 50 years, ever since Ben Graham and David Dodd wrote Security Analysis, yet I have seen no trend toward value investing in the 35 years I've practiced it. There seems to be some perverse human characteristic that likes to make easy things difficult. The academic world, if anything, has actually backed away from the teaching of value investing over the last 30 years. It's likely to continue that way. Ships will sail around the world but the Flat Earth Society will flourish. There will continue to be wide discrepancies between price and value in the marketplace, and those who read their Graham & Dodd will continue to prosper."

Warren Buffett, Speech to Columbia Business School, 1984

We appreciate your business and, as always, please feel free to call us anytime you have a question or would like to discuss your account in more detail.

Sincerely,

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