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## Letter to Clients – January 2003

Enclosed you will find the year-end 2002 analysis of your investment portfolio with Aldebaran Capital, LLC. Last year in our letter to clients for 2001, a year in which our investment performance exceeded the general stock market return, we stated “we would not expect to outperform the market by such a wide margin in the future.” To our surprise, in 2002 we were again able to appreciably outpace the widely followed indexes. For the year, the market averages put in their third down year in a row with the S&P 500 index losing –22.1%, the Dow Jones – 15.2%, and the NASDAQ –31.5%. In addition, according to Lipper, Inc., the average U.S. stock mutual fund lost 22.4% of its shareholder’s money in 2002.

At first glance, the calculated return on your portfolio might not spark too much excitement - with the conclusion being that it appears we spent much of the year running in place. Yet, upon closer inspection, we would underscore the importance of viewing your investment performance *relative* to the general experience of investors in the stock market. The reason for this is that we believe in the long run, investments made in American businesses will generate attractive rates of return. And if that is the case, by outperforming in a declining stock market (and preserving capital), we have positioned ourselves further ahead for the periods in which markets do advance.

### **Conservative or Conventional?**

The word “conservative” is probably one of the most overused words by investment professionals. Often the word is used as a surrogate for “diversification” or “asset allocation” of an investment portfolio, or even to describe a collection of high quality “blue chip” stocks. The presumed tenet is that by investing in a large variety of high-grade securities, you provide a safeguard for your portfolio.

Sellers of investment advice have gone to great lengths to stress these concepts as important to one’s overall financial health. Brokerage marketing material is bathed in colorful pie charts detailing the various asset categories to spread your investments: large stocks, small stocks, growth stocks, value stocks, international stocks, various bond investments, etc... Unfortunately, many in the investing public have discovered over the past three years that these “conservative” ideals did not provide them with the kind of protection that was advertised. Therefore, we feel it is a misnomer to attach the word “conservative” to these programs, and instead suggest the word “conventional” to better describe their widespread use.

Wouldn’t an appropriate test of conservative behavior be the investment results attained in a declining stock market? What could be a better definition than the preservation of capital in times of duress? If you accept this meaning then our investment behavior has clearly been conservative. Over the past 3 years, the market has lost a cumulative –37.6% and our aggregate portfolios (on average) have achieved a cumulative +25.1% return.

Yet what is ironic and perplexing to us, is that most of our industry peers would not classify our investment style as conservative. A key reason for this is that we do not follow their “conventional” methods of portfolio management. For example, we do not widely diversify our investments, instead preferring to hold 15 to 25 securities on average. When we find an undervalued situation that jumps out at us, we like to put a significant percentage of portfolio capital into it. Additionally, we don’t allocate specific percentages of our holdings across all the various economic sectors. Yet another blemish to our style *in the eyes of the conventional crowd*, is that we are

often invested in securities that are less widely followed by Wall Street (a feature you may be glad to hear after the Wall Street analyst debacles that have transpired recently.)

Contrary to the conventional thinking, we would argue that a widely diversified portfolio of blue chip stocks selling for 30 times their earnings, 3 times their sales and 4 times book value would fail our definition of conservative. Broad diversification, absent of any method to determine the value of the securities held, will not obtain a conservative profile for any investor. When presenting our arguments - critical of the over-diversification of portfolios - we point out that the best result these programs can hope to achieve is average performance – minus the large attendant fees that are associated with them. And if mediocrity is the ultimate goal, then why not employ the use of index funds as a simple way to attain diversification at a low cost?

If however, your quest is to achieve long-term results that are above average, you must do things significantly different than following the general credo. Your portfolio cannot be structured to mirror the market. We fully admit that much of this thinking is in direct opposition of conventional portfolio management theory. In other words it is “*unconventional.*” Most successful investors, and particularly those who we truly admire, *think independently.* They do their own analysis, reach their own conclusions (irrespective of the Wall Street crowd) and invest in a handful of carefully studied securities that are purchased at prices well below their underlying business values.

In the end, of course, we are not so naïve to acknowledge that there is a giant industry that depends on these sacred mantras to sell their wares. And no matter how much evidence is presented to challenge these mainstream ideals, investors will still be fed the verbiage, because the word conservative, and its derivatives like “diversification” and “asset allocation”, generate a whole lot of commissions and fees. In sum, the words of the great economist John Maynard Keynes tell it all, “*Most people would prefer to fail conventionally than to succeed unconventionally.*”

(Please see the Appendix to this letter where we discuss our investment in bankrupt Birmingham Steel. Talk about unconventional - we argue that this was a conservative investment.)

## **Corporate Governance**

Corporate governance can be thought of as a “code of ethics” used to guide the board of directors and managers of a company with respect to principles such as fair accounting, management compensation and their interaction with the company’s stakeholders – employees and shareholders (the owners). In general, the quality of corporate governance over the past decade has eroded.

Last year we wrote that the market was in the “rinse cycle” - in the process of purging the post-bubble excesses. More dirt came out in 2002, with accounting frauds at Worldcom, Tyco, and Adelphia to name a few. Also, New York attorney general Eliot Spitzer arrived on the scene and enlightened us with the Wall Street analyst scandals. Locally, the disastrous acquisition of IPALCO by AES Corp. and the bankruptcy of Consec have provided case studies of failed corporate governance.

To address this situation, the SEC and Congress have applied pressure with new accounting standards and laws such as Sarbanes-Oxley. Not that we are of the opinion that all regulation is good; yet, the powers-at-be recognize that action needs to be taken to restore integrity in the markets, which at present is fragile. The irony here is that for the past decade Congress shot down many of the reforms they are now, on their high road, proposing. During the 1990s, the SEC had an excellent chairman in Arthur Levitt who was a strong advocate for corporate reform. Yet Congress and a skillful business lobby stifled those efforts. For example, presidential candidate Joseph Lieberman led the charge to defeat an FASB proposal to expense stock options, which, as a consequence, contributed to the shenanigans that took place during the market bubble.

Perhaps a catalyst for change could come from large institutional shareholders, whose actions in proxy voting and dialogue with management will demand good governance policies. While a few may take on this challenge, the task is complicated by the fact that the average mutual fund buys and sells its entire portfolio in less than one year. This churning of portfolios has led Vanguard fund pioneer John Bogle to comment that institutions are just “renting” stocks. Stable owners are more likely to provide the kind of ongoing message that will prod corporate managers in the right direction.

In time, the best measures for reform may originate within the companies themselves. Recently, positive measures taken by Coca-Cola and a few others may serve as a model for future corporate governance. Coke announced it would start expensing stock options. Also, the company will no longer provide quarterly earnings guidance estimates to Wall Street analysts. This measure should help reduce the short-term focus on quarterly earnings and encourage investors to concentrate on the longer-term outlook of the business. It will also, to the dismay of analysts, force them to do their homework versus relying on corporate management to “guide” them towards an earnings number. Other measures such as independent directors, auditor independence, along with reform in executive compensation could help restore investor confidence.

### **Quality of Earnings**

Closely related to the decline in corporate governance, has been the deterioration in the quality of corporate earnings. In the midst of the market’s frenzy, it became common for companies who wished to paint a rosy picture, to report “Pro Forma” earnings. A few lone observers sarcastically described this as EBBS – Earnings Before the Bad Stuff. The manipulation of earnings reports helped obscure the true picture of corporate operations and fueled the unwarranted rise in stock prices. In the aftermath, considering the massive restructuring charges at companies like AOL Time Warner, Lucent, and JDS Uniphase, we would hope for this practice to soon end.

In the coming year, we would expect two other accounting issues to take center stage: the treatment of stock options as an expense and the accounting for corporate pension plans. About 150 companies have announced that they would begin expensing stock options on their financial statements, although they are not presently required to do so. During the 1990s, the massive grants of stock options enticed corporate managers to engage in short-term maneuvers that were detrimental to intelligent long-term business decisions. Management became focused on the market price of the stock and not on the value of the business. Since stock options are a form of compensation, and since compensation is a corporate expense, it follows that a cost should be reflected on the income statement for their use. Investors rarely paid attention to the shareholder dilution that occurred at companies with large stock option programs. By properly accounting for options, shareholders will have better information to assess the true cost of these programs.

In the arcane world of pension accounting, companies choose an “assumed rate of return” that they expect the investments of the plan to achieve over the long-term. As long as this assumed rate is earned (along with funds contributed by the employer), the pension plan will have enough money to provide the financial benefits promised to retirees. During the 1990s, the bull market kept corporate pension plans well funded. Investment returns were good enough to allow companies to minimize their pension contributions.

However, the stock market’s decline over the past three years has altered this condition. Many pension plans are now underfunded and, in addition, continue to apply assumed rates of return as high as 9-10%. Most pension plans have a significant allocation to bonds, which at present yield anywhere from 4-7%. And considering the present environment in the stock market, it is difficult to make the case that stock returns will provide the boost to keep pension plans fully funded. To address this problem, some companies have begun to lower their “assumed rate of return,” and have quietly made large monetary contributions to shore up their pension plans. A few years back, companies were enjoying a tailwind in pension plan funding. Now, with the prospect of having to allocate significant monies to these plans, corporations face a further drag on their earnings prospects.

Standard & Poor’s has recently constructed a new measure of earnings, which they have dubbed “core earnings.” In this calculation, the three items we discussed above are used to arrive at an adjusted earnings figure. Restructuring charges are deducted from earnings, stock options are treated as an expense, and the effects of pension plan accounting are removed from the earnings figure. The difference between this core earnings calculation and the more commonly used “operating earnings” number is startling. For the trailing twelve months ending June 2002, the P/E (price earnings ratio) for the S&P 500 based on core earnings was 54, versus a P/E of 24 using operating earnings. The wide discrepancy between a conservative calculation for earnings (core earnings) and the more frequently used operating figure, demonstrates the decay in the quality of corporate earnings over the past decade. It also suggests that the widely held stocks, in aggregate, *are still richly priced*.

With respect to the earnings quality issue, we believe the most desirable outcome for long-term investors would be a movement by companies towards a more conservative accounting posture. We think it will happen, it’s just going to take time.

## Outlook

The perils of forecasting are many. To illustrate, we refer to a piece that Barron's recently ran on the predictive accuracy of the panelists that appear on Louis Rukeyser's Wall Street.

|             | Dow Jones Average        |              |            | NASDAQ                   |              |            |
|-------------|--------------------------|--------------|------------|--------------------------|--------------|------------|
|             | *Average Predicted Close | Actual Close | Difference | *Average predicted close | Actual close | Difference |
| <b>2001</b> | 12,173                   | 10,021       | -17%       | 3122                     | 1950         | -37%       |
| <b>2002</b> | 11,310                   | 8,342        | -26%       | 2279                     | 1336         | -41%       |

\* Average prediction of 22 panelists

So much for crystal ball reading. Throughout the past three years, Wall Street strategists have maintained a perpetual sunny view of the stock market, with the words "bear market" seemingly outside of their lexicon. We have been somewhat miffed by this bullish stance, particularly when any historical measurement of value indicated that the highly favored stocks were overpriced. However, their attitudes are perhaps better understood when you consider that most of these pundits represent firms with large sales forces, and a rosy outlook encourages more frequent transactions by investors. At present, most strategists believe that any military action in Iraq will be quick and once completed the markets will find their footing and move higher.

While we wouldn't be surprised to see a positive spurt for stocks (assuming a short and successful conflict) *we remain very selective in our investments*. We have always required a significant "margin of safety" before we commit money to an idea. In other words, we feel it is essential that an investor receive more in business value than the price he must pay. This test has served us well through three tough years in the market and we aren't about to abandon it for a more freewheeling investment style. Aside from the war concerns, we think that the stock prices of many companies still need to adjust for the earnings quality issues that we discussed above.

Lastly, we hear from some corners that a "buy and hold" investment strategy is ineffective in the current market environment. This propaganda is based on the notion that in a volatile market, where hedge funds swing in and out of stocks on the latest whim, that it is no longer possible to confidently invest longer term. We think nothing could be further from the truth. *We are* in a bear market, but there is one huge benefit for long term investors in periods like this – stock prices get cheaper. And as they decline, some prices will drop below the value of the businesses they represent. *A smart investor* once said that you make your best investments (and the most money) in a bear market – it's just that you don't know it at the time. And finally, as Ben Graham once said, "*Uncertainty is the friend of the buyer of long term values.*"

Thank you for your continued confidence in our investment philosophy. Please feel free to contact Ed or myself at any time. We would be glad to schedule a personal meeting with you or, if you prefer, discuss any questions you may have over the phone. We look forward to another interesting year in the markets.

Sincerely,

Kenneth R. Skarbeck, CFA

Edward A. Skarbeck

## APPENDIX

### **Blair Corporation (AMEX: BL \$22/share):** A current holding in portfolios

Founded in 1910, last month Blair Corp. celebrated its 75<sup>th</sup> anniversary trading on the American Stock Exchange (the second oldest listing of the AMEX's 575 companies.) Blair sells a broad range of women's and men's apparel via catalog and e-commerce on their website [www.blair.com](http://www.blair.com) (whoever said we aren't tech investors?) With sales in excess of \$580 million, Blair is the 8<sup>th</sup> largest consumer cataloger in the U.S. Actress Jane Seymour has partnered with the company as a fashion designer. The company's offerings are targeted to the 40-to-60, low-to-moderate income market.

Our investment in Blair Corporation embodies many of the attributes that we desire in an investment, yet the stock is virtually ignored by Wall Street. The company's financial position is exceptional, possessing no long term debt and \$55 million in cash (\$6.89 per share). We first became interested in Blair using an investment tool Ben Graham described in his first edition of Security Analysis (1934). Graham used to invest in companies selling for prices at 2/3rds of their Net Current Assets (Current Assets – All Liabilities). He suggested that with a stock selling at one-third below net liquid assets, an investor was essentially getting the company's fixed assets for free, providing a significant margin of safety for an investor. At present, Blair's net current asset value is \$195.7 million, compared to a market capitalization of \$176.5 million.

Blair will soon report 2002 results and we expect earnings near \$2.40 per share for a P/E ratio of just 9. In addition, the company pays a dividend of 2.7%. Blair has recently struck deals with Amazon.com and ShopNBC to feature their *Crossing Pointe* line of women's apparel. While we already hold a fairly large position in the stock (our average purchase price is \$17.50 per share), we will continue to add to our holdings on any weakness.

### **Arbitrage Investments**

*Arbitrage:* Our method of arbitrage involves purchasing the stock of a company that is the object of a takeover offer, and to profit from the discrepancy between an announced takeover price and the market price for the security. We typically only invest in mergers where cash will be paid for our shares (seldom in stock mergers.) Below we highlight two arbitrage investments we made in 2002.

### **Birmingham Steel:** Initially purchased in June 2002 and completed in December 2002

The following outlines our rationale for our arbitrage investment in Birmingham Steel in June 2002. The notion that this investment would even be considered conservative violates just about any "conventional" definition of the word. First, we bought the common stock of a bankrupt company, and second, with the stock selling for less than a dollar it carried the negative connotation of a "penny stock." Yet, after a methodical analysis of the probabilities for a successful outcome, we determined that the risk of loss was low and the potential to realize a 20% return in six months was high. We therefore committed significant capital to this investment.

Birmingham Steel entered into a prepackaged bankruptcy on June 1, 2002. At the time of the filing, the company announced that it had reached a definitive agreement with Nucor (a large and financially healthy steel company) to acquire the company's assets for \$615 million. As part of the agreement, the common stockholders of Birmingham Steel were slated to receive \$15 million, which worked out to about \$.47 per share. With the shares of Birmingham trading at a price of about \$.39 in June 2002, the potential for a 20% return sparked our interest.

An item of note - takeover offers for cash occur with some regularity. We are usually reviewing at least one or more offers all the time. However, more often than not there is a reason for us to pass on these deals. Several factors must be weighed, for example, does the buyer really have the ability to finance the acquisition? Sometimes there are anti-trust concerns that could scuttle a takeover. Also, the length of time needed to complete the transaction can have a significant effect on the return of the investment.

In assessing the validity of Nucor's offer, we noted that earlier in the spring of 2002, when Birmingham's financial situation had become dire, Nucor had made a \$500 million bid that was rejected by Birmingham's board as too low. Three months later, after increasing their original offer over 20%, it was clear Nucor was seriously

interested in Birmingham's assets and that they had the financial strength to complete it. The \$615 million offer was a "definitive agreement", meaning both companies had agreed to the terms of the deal.

The next step in our analysis was complicated by Birmingham's bankruptcy filing. The secured creditors (banks and bondholders whose debts were secured by Birmingham's assets) were slated to be paid in full. Unsecured creditors were to receive less than 100 cents on the dollar for their claims (these were entities such as suppliers and leaseholders). What was unusual in this agreement was the \$15 million to be allocated to stockholders. Typically the common stockholders in a bankruptcy do not receive any payments until after secured and unsecured creditors are paid off in whole.

Several points raised our confidence that the court would approve the shareholder payment. First, management of Birmingham was to receive \$17 million of the Nucor proceeds. At first blush, such a large allocation to the executives of a failed business turned our stomach. However, the current Birmingham management had, over the prior two years, poured personal funds into the business in an attempt to turnaround the company. That effort failed and the \$17 million was to compensate them for the lost investment. We reasoned that if management was successful in convincing the court that they should receive this payment, then it would be hard to deny shareholders their \$15 million slice. Further, Birmingham's executives owned 12% of the company's stock and Birmingham's employees also owned 12% via the company's 401K plan. We felt it would be difficult for the court to allow management to be paid any amount of money and then to turn around and shaft the employee's retirement plan.

Next we wanted to assess the probability that the deal would pass anti-trust review, since this involved two large steel companies getting together. Here we felt the chances were excellent. Back in the spring of 2002, the Bush administration had enacted a slew of tariffs on imported steel. They were put in place partly for political reasons and also to try and save the struggling domestic steel industry. In effect the President was encouraging the steel companies to consolidate, hence we felt it would be difficult for the bankruptcy court to disagree with this policy. Also at this time the bankruptcy courts were jammed with cases involving Worldcom, Global Crossing and other huge business failures. Here they had a case where nearly everyone agreed on terms, which would certainly be refreshing to any overburdened judge.

When we put it all together we felt the probability was high that the transaction would go through and that the shareholders would receive the \$15 million. In addition we believed Nucor's stated objective of consummating the transaction by year-end. If so, our return for the six months would be in the neighborhood of 20%, or an annualized gain of 44%. On December 27, 2002 we received \$.4675 per share for our holdings in Birmingham Steel.

Lastly, it's useful to contrast our Birmingham investment with alternative investments available at the time. We can persuasively argue that in June of 2002, our confidence in the probability of realizing a 20% return in bankrupt Birmingham Steel shares, far outweighed our level of certainty for a similar gain via the purchase of most stocks in the S&P 500. While this was certainly an unconventional investment (one of the most unusual I've made in twenty years), we also believe it was a rational, perhaps even a "conservative" investment.

**Dole Food (NYSE: DOL \$32.71/share):** A current holding in portfolios

On September 22, 2002, David Murdoch the Chairman of Dole Food and owner of 24% of the company's common stock, offered to acquire the remaining 76% of the company for \$29.50 per share, for a total of \$2.5 billion including the assumption of debt.

I quickly became interested in this deal because it reminded me of a similar transaction by Mr. Murdoch and the parallels were striking (Murdoch is a member of the Forbes 400 wealthiest Americans). In March 2000, Murdoch made a \$17 per share offer for the remaining 73% of Castle & Cooke that he did not control. Castle & Cooke's is a large owner of Hawaii real estate (Dole also has vast land holdings in Hawaii). The company's board began a review of the offer, while a group of vocal shareholders complained the offer was too low. In May, Murdoch increased his offer to \$18.50 a share. Undeterred, the shareholder group filed suit and in June Murdoch again raised his offer to \$19.25 per share and the acquisition was completed in July 2000.

Knowing this, we figured the Dole bid had a good chance of being increased. There were similar gripes from shareholders about a lowball offer (Dole is trading with a P/E ratio of 11 and it's future prospects look bright). So

last October we started buying the stock at prices around \$27.50 a share. As scripted, Murdoch raised his offer to \$33.50 per share on December 19<sup>th</sup>. We have continued to buy shares on any weakness. The acquisition should be completed by the end of March and in the meantime we will receive another \$.15 dividend. Our total return on our initial purchases will be in excess of 20% for the six-month period.

## Cash

We have had a few conversations with clients about the level of cash reserves in their portfolios, so we felt it was worth discussing our views on holding cash.

First some tongue in cheek comments. We are very familiar with the “conventional” view on cash. The premise is that investors should be fully invested at all times, otherwise you are trying to “time the market.” Most advisors anxiously share various studies that show market timing doesn’t work. Many of you may have seen the studies where if you were out of the market on the “X” number of largest positive market days, you would have missed 80% of the gains. [The cynic in us has always wondered why no one has ever bothered to go through this exercise for the “Y” number of largest losing market days]. In keeping with a fully invested creed, the average equity mutual fund is 96% invested in stocks. We would also note that in 2002 the average equity mutual fund lost more than 22%, while cash gained 1% or so.

Ideally we would like to be fully invested, and will do so only when we can find enough securities that meet our undervalued criteria. Under present market conditions, we are sensitive to how important it is to preserve capital. And we’re cognizant that the price we pay when acquiring new investments will in the end determine our future returns. Our investment style could never be mistaken for market timing, which we do agree is folly. But needless to say, we also disagree with the conventional view that investors must be fully invested at all times.

Back in November 1974, Warren Buffett wrote an article in Forbes magazine. In it he described the process of investing by using a baseball analogy. Buffett wrote:

*“I call investing the greatest business in the world because you never have to swing. You stand at the plate, the pitcher throws you General Motors at 47! U.S. Steel at 39! and nobody calls a strike on you. There’s no penalty except opportunity lost. All day you wait for the pitch you like; then when the fielders are asleep, you step up and hit it. But pity the pros at the investment institutions...It’s like Babe Ruth at bat with 50,000 fans yelling ‘Swing, you bum!’ and some guy is trying to pitch him an intentional walk. They know if they don’t take a swing at the next pitch, the guy will say, ‘Turn in your uniform.’”*

Some final Buffett wisdom from this article written 28 years ago in the midst of the last nasty bear market: *“stay dispassionate, be patient, and buy stocks that sell at ridiculously low prices.”*

Our patient approach and focus on undervalued securities have served us well over the past three years. At any given time we are studying scores of potential investment ideas. On most we will pass, yet we are certain that we will swing our bat at a few new ideas this year.

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