Value, Performance, & Service

From the desk of:
Kenneth R. Skarbeck, CFA
ken@aldebarancapital.com
(317) 818-7827

* *The following is a reproduction of the letter sent to clients of Aldebaran Capital, LLC with their portfolio reports. Past performance is not a guarantee of future results. Nothing within these writings, directly or indirectly, should be construed as a solicitation of an offer to buy or sell any particular securities mentioned. While we stand by our commentary and opinions, readers should not view these writings as personal investment advice, and should individually determine whether anything we say is suitable for them.*

Letter to Clients - January 2004

We are pleased to present the following reports as of December 31, 2003, which summarize your investment account with Aldebaran Capital, LLC. The year 2003 marked the first out of the past three years, that the major stock indexes produced positive results - and the gains were impressive. The S&P 500 rose 29% and the NASDAQ returned a gaudy 50%. We also performed well, as the average Aldebaran client experienced results about midway between these two indexes. (See the enclosed Performance Report for a detailed review of your account percentage return.) Our results also compare favorably with the average equity mutual fund, which earned a 32% return, and hedge funds, which were only able to deliver a 16% return on average.

While we were not "chest-thumping bulls" throughout the year, we did own a number of securities that generated outsized returns for our portfolios. In last year's letter we noted that our flat performance in 2002, *as compared to the 22% decline for the S&P 500 index*, had positioned us well if the stock market were to improve. The premise being that when your net worth goes backwards, it becomes so much more difficult to regain that capital. As evidence of this, consider that the S&P 500 index (and certainly many investors as well) – over the prior two years - are just barely getting back to even. In contrast, our clients on average have attained a two-year cumulative return in excess of 35%.

Market Valuation: P/Es, E/Ps, and Interest Rates

The most widely used measure to value stocks is the P/E ratio. The P/E of a given stock is simply the **P**rice of the company's stock per share, divided by its **E**arnings per share. There are caveats to accepting the calculated P/E. The number will only reflect the company's earnings at a particular point in time. The "E" may be skewed higher (or lower) than normalized earnings due to a recent non-recurring gain (or loss) to earnings. Thus, the computed ratio should not be taken as gospel without an in-depth investigation into a company's earnings history. *We like to look at five or even ten-years of earnings* to ascertain the quality of the company's earnings per share at any given point in time.

Most investors have probably heard that all things being equal, a low P/E is more desirable than a high one. To show why this might be the case, we also calculate and consider the inverse of the P/E ratio - the E/P ratio, often called the *"earnings yield."* For example, a company whose stock sells for $10 per share and with earnings of $1 per share has a P/E ratio of 10 (10÷1), and an earnings yield of 10% (1÷10). The E/P tells us that the owners of this company (the shareholders) are receiving a 10% return on earnings at the current market price of the company. Likewise, a company whose stock is priced at $30 per share with $1 in earnings has a P/E of 30 (30÷1) and an earnings yield of 3.3% (1÷30). Thus, the earnings yield (E/P) puts into terms, perhaps more easily understood, that a lower P/E is desired over a high P/E - *a 10% accrual in earnings is intuitively superior to a 3.3% earnings accrual.*

Now, to throw a wrench into our discussion. The primary reason for companies having high P/Es vs. low P/Es, is the different growth rates investors expect in earnings. In our example above, the company with the higher P/E of 30 (and lower earnings yield of 3.3%) is generally *expected* to grow its earnings substantially faster than the 10 P/E company. Mathematics can show that a high growth rate, compounded over several years, will provide a larger total result in earnings for a high P/E company than a slower growing, low P/E company. Analysts using such

projections will calculate a "present value" of these future estimated earnings to justify the purchase of high growth stocks.

Investors who buy stocks based on high projected growth rates must take extreme care for a number of reasons. First of all, the earnings growth rates in these calculations are only <u>forecasts.</u> There is risk in relying on forecasts, as no one can accurately estimate the future with certainty - and we all know that analysts have been overly optimistic in their growth assumptions in the past. Also, corporate earnings do not grow in the regular procession that these models assume; *very few companies have been able to sustain high growth rates for an extended period of time. If the growth rate slows, the investor is left with an overpriced stock susceptible to a large decline in value.*

The stock market, at present, is valued with a P/E ratio of about 24 – *much higher* than historical market averages - and an earnings yield of 4.2%, which is about the same yield as the (risk-free) 10-year Treasury bond. It seems unrealistic that the risk of owning stocks is comparable to owning a government guaranteed security. In addition, what is most telling from this relationship between earnings yields and interest rates, is that *if interest rates were to rise, lower stock valuations would be the result.*

In conclusion, our point throughout this section is that we see an inadequate "margin of safety" in the market at present. With the average public company (many of them mediocre businesses) valued at P/E ratios in excess of 20 (and earnings yields below 5%), we believe that today's active buyer of these common stocks will find their future investment returns, at best, unexciting.

"If I Were a Tech Stock"

Our discussion of P/Es shows how extreme anomalies can occur in the stock market based on investor's expectations between various stocks. At present, no greater valuation discrepancy exists than that between the *(once again)* favored technology stocks and the stocks of homebuilding companies. We have mentioned here before that one of our larger holdings is Standard Pacific (SPF), a homebuilder with large operations in California and Florida, amongst other states. SPF, like most of the homebuilders, has experienced a multi-year boom. Our original purchases of the stock began 7 years ago in the fall of 1996. Consider this outstanding financial performance since then:

Standard Pacific (SPF)	7-Year Annual Rate of Change
Earnings Growth	52%
Revenue Growth	28%
Book Value Growth	19%
Return on Equity	18% average

This is a business performance that is the envy of any tech company. Yet, look how investors in the stock market are valuing SPF versus the average tech stock. SPF has a current P/E of 8, whereas the average NASDAQ tech stock is valued with a P/E of 40. In terms of our above discussion, SPF has an earnings yield of 12.5% versus a 2.5% earnings yield for the average NASDAQ stock. One has to wonder if the investment world woke up tomorrow and was told that SPF was in the technology industry, would the stock move up to $250 per share (40 x $6.08 2003 earnings) instead of the $48 it sells for today? Of course, we would never suggest that SPF should sell for 40 times earnings, and likewise we don't think tech stocks should trade at 40 P/Es either.

Mutual Funds – A Good Thing Gone Bad

During 2003, regulators turned their attention to misdeeds in the mutual funds industry. Their initial focus centered on charges of "late trading and market timing" in various funds. We won't go into the details (much has been written on this already), but essentially these transgressions involved a number of market operators skimming some profits that should have accrued to long-term fund investors. Worse, a great deal of the mischief occurred with the blessing of the mutual fund's management. This breach of fiduciary duty and the recognition of a host of other unpalatable practices within the fund industry, such as payments to brokerage firms to favor certain funds for sale to clients, has led regulators to consider sweeping mutual fund reforms.

While reform of the fund industry is long over due - in our opinion - what has been more injurious to a mutual fund investor's long term net worth, is the poor performance and high fees charged by the typical mutual fund. Over the past five years (according to the Wall Street Journal), the average US stock mutual fund has returned a cumulative 13.8%, for a 2.62% annual return. In dollar terms, a $100,000 investment made in the average stock fund five years ago, would have a current value of approximately $113,800. Considering that mutual funds charge an annual fee of about 1.5%, this means that investors have shared about 36% of their pre-fee return with their mutual fund company. Further, investors often work through an advisor who selects a basket of mutual funds and who charges an additional fee, often 1%, to oversee the portfolio. Under this arrangement, an investor who has received the average stock fund return over the past five years has earned roughly 1.62% annually and paid about 2.5% in fees each year. *In comparison, over the past five years, the average Aldebaran Capital client earned a cumulative 62.6% return net of all fees, or a 10.2% average annual return. An Aldebaran client who invested $100,000 with us 5 years ago (and attained the average results) would now have roughly $162,600.*

While high fees and poor management negatively impact performance, another glaring mistake (made by both individuals and advisors) is the tendency to invest *after* stocks have risen in value. As evidence, a recent study by Dalbar, a financial research firm, estimates that over the past *19 years* - because of this propensity to "buy high" - the average equity fund investor has earned a paltry 2.57% annually. This number is not only drastically below the S&P 500 annual return of 12.22%, but is also shy of the rate of inflation, which averaged 3.14% for the same period.

It appears to us that a large number of mutual fund groups lost their way in the 1990's. They became sales-driven asset-gatherers more interested in collecting fees, than maintaining or seeking quality investment management. These shortfalls can be traced to the culture advocated by the directors and management in the fund industry.

Warren Buffett discussed the failings of the mutual fund industry in his 2002 annual letter to Berkshire Hathaway shareholders:

> *"[Mutual fund directors]...have only two important responsibilities: obtaining the best possible investment manager and negotiating with that manager for the lowest possible fee. When you are seeking investment help yourself, those two goals are the only ones that count....*
>
> *Many thousands of investment-company boards meet annually to carry out the vital job of selecting who will manage the savings of the millions of owners they represent. Year after year the directors of Fund A select manager A, Fund B directors select manager B, etc... in a zombie-like process that makes a mockery of stewardship. Very occasionally, a board will revolt. But for the most part, a monkey will type out a Shakespeare play before an "independent" mutual-fund director will suggest that his fund look at other managers, even if the incumbent manager has persistently delivered substandard performance. When they are handling their own money, of course, directors will look to alternative advisors – but it never enters their minds to do so when they are acting as fiduciaries for others."*

The shakeup in the mutual fund industry is in its early stages, and over time, fund investors and the firms that sell them will see positive changes. Regardless; of the more than 7,000 actively managed mutual funds, there are *only a handful* that we think are run by *outstanding investors* - and they are not funds you find in the large mutual fund complexes or "in-house" brokerages.

Outside of "actively managed" funds, there are plenty of low cost alternatives in the fund arena such as index funds and Exchange Traded Funds (ETFs), that often outperform actively managed funds. We highly recommend them for investors who want to achieve overall market returns. And since they are simple-decision investments, you don't need to pay anyone -including us - a fee to invest in them. Another criticism we have of the fund industry is that many mutual fund managers intentionally construct their portfolios to closely resemble an index (like the S&P 500), knowing that they will always turn in performance close to the market average. They do this for fear that investors will withdraw their account if they (the manager) stray too far from the average market return.

Unlike this protect-the-franchise-mentality, we are aware that the only way to outperform the index is to build a portfolio of investments that does not mimic the index. We do not do this via mutual funds. Rather, we prefer to purchase a relatively few, carefully selected stocks that we feel are selling below the "intrinsic value" of the business. We are fully aware that at times we may be out of sync with overall market performance. Yet, our study of value investors throughout history demonstrates that over the long term, this investment philosophy outperforms

– something that our long-term track record also bears out. *We like to think that, in essence, we are constructing for our clients their own personal mutual fund, whose goal is to incrementally outperform the market averages over time.*

Outlook

A recent article in Barrons noted that there are fewer undervalued stocks in the market today, than in March 2000 - *at the peak of the bubble*. We concur, for back then it was really only the technology and large capitalization companies that were trading at excessive valuations. Then, we were buying stocks that were cheap and ignored– they just weren't the stocks everyone else was buying. Today, the broad range of stocks - both large and small, growth and value - have had large run-ups in price. Small company stocks, where we found a lot of value in recent years, are no longer cheap. The Russell 2000 index (an index of 2000 small stocks) has almost regained the level it reached at its peak in March 2000. Needless to say, we are struggling to find stocks available for purchase at discounted values. *In our opinion, buying mediocre companies at P/E ratios in excess of 20, is a recipe for poor returns.*

In addition to unattractive valuations, another concern we have is that *speculation in the market is alive and well.* A few months ago, I came across the following statement by a mutual fund manager:

> "…*We are seeing a desire for greater risk-taking by equity investors. Such clients are tailor made for our fund, which employs an earnings-momentum-driven approach and invests without much regard to valuations."*

We are baffled that investors have entrusted this fund with millions of dollars.

Yes, the economy is on the mend. It has received a big boost from the monetary and fiscal policies being pursued by our politicians. However, there is a potential danger that election year politics are providing a short-term lift, at the expense of longer-term problems – namely large budget deficits. Low interest rates and tax cuts have kept consumer spending strong and have lured investors out of money market funds and into stocks and high yield bonds. Yet, a stronger economy suggests that interest rates would eventually need to rise - *and we are doubtful that most 20 plus P/E stocks will fare well in a rising interest rate environment.*

Thus, as always, we fall back on the same investment principles that have guided us through all kinds of market conditions. One of the key tenets is Ben Graham's *"margin of safety*" concept. As Warren Buffett described it: *"…You don't try to buy something for $80 million that you think is worth $83,400,000. You leave yourself an enormous margin of safety. You build a bridge that 30,000-pound trucks can go across and then you drive 10,000-pound trucks across it. That is the way I like to go across bridges."* We've sifted through large numbers of SEC filings - looking for an idea or two – and, more times than not, our analysis concludes that investors are not being adequately compensated for the risk in purchasing most stocks at these price levels.

Cash is the most unloved investment yet, under present market conditions, we feel it's prudent to maintain higher than normal levels. Some of the smartest investors we know have elevated cash positions: the Clipper Fund is 19% in cash, Weitz Value Fund 21%, Longleaf Partners Fund 14%, Sequoia Fund 21% and the granddaddy of them all, Warren Buffett has $27 billion or 32% of Berkshire Hathaway's investment portfolio *in cash*. Their common complaint is a lack of attractive investment opportunities in the stock market. In the past, we have engaged in arbitrage investments as a way to employ excess cash at higher returns. This approach dried up in 2003, namely because merger activity declined. For the deals that were announced, the returns to be earned were slim and, in our opinion, not worth the risk.

Patience is a virtue. We do like the positions we currently own – although, for the most part, we don't feel like they are at valuations that would spur us to make significant additions. And, while you haven't seen a whole lot of activity in your portfolio lately, we have been working harder than ever to uncover attractive investments. If we don't find compelling opportunities, the decision *not to invest,* is just as important (relative to successful long-term performance) as the decision to invest. It is a characteristic of our investment style – that we tend to be much more active when stock prices are cheap. Our experience tells us that now is a good time to exhibit patience, and

eventually opportunities to employ capital will surface. In the meantime, *we feel a defensive posture is warranted and careful stock selection is paramount.*

Welcome Rich Rockwood

Ed and I are proud to announce that Richard M. Rockwood has joined our firm. While we aren't keen on fancy titles, Rich will hold the position of Research Analyst. A graduate of Indiana University's Kelley School of Business, he comes to us after stints at Conseco and City Securities Corp. We originally met Rich about 2 years ago after learning of his intense interest in value investing and, in particular, the investment strategies of Benjamin Graham and Warren Buffett. He learned the craft much like I did; not from any academic program (they still don't teach value investing in schools) - but through devoted study of the investment tenets of history's most successful investors. Nothing thrills Rich more than to dig into the footnotes of a company's SEC 10K filing. He regularly attends the Berkshire Hathaway annual meeting in Omaha and has even written a book on the company's subsidiary GEICO, the direct seller of auto insurance.

For a sample of Rich's passion for investing, you can visit his excellent web site on value investing at www.focusinvestor.com. (Awarded one of the "Best of the Web" by Forbes in 2001.) Needless to say, he will be helping us to improve our website www.aldebarancapital.com in the near future. Rich is 33 years old, and lives in Fishers with his wife Julie and their new baby Kathryn.

As always, thank you for your business. Please feel free to give us or call or send us an email if you have *any* questions, or would like additional information concerning your account. For your convenience, we have included our personal contact information below.

Sincerely,

Kenneth R. Skarbeck, CFA Edward A. Skarbeck

To reach:

Ken – 317.818.7827, option 1
Ken@aldebarancapital.com

Ed – 317.818.7827, option 2
Ed@aldebarancapital.com

Rich – 317.818.7827, option 3
Rich@aldebarancapital.com

10291 North Meridian Street • Suite 150 • Indianapolis, Indiana 46290
PH 317-818-STAR (7827) • TOLL FREE 888-742-STAR (7827) • FAX 317-818-7830
E-MAIL info@aldebarancapital.com • www.aldebarancapital.com

Copyright ©2003 Aldebaran Capital, LLC. All Rights Reserved.