



Value, Performance, & Service

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2004 Annual Letter to Clients

We are pleased to present the following reports as of December 31, 2004, which summarize your investment account(s) with Aldebaran Capital, LLC. A year-end rally in the stock market rescued the most followed indexes for 2004, enabling the S&P 500 to rise 10.9% and the NASDAQ to advance 8.6%. In addition, the average equity mutual fund was able to nearly match the S&P 500 with a 10.7% return for the year. We are also pleased to note that the average Aldebaran Capital client achieved net-of-fee returns in excess of these market averages. (See the enclosed Performance Report for a detailed review of your account percentage return.)

Hedge funds, the private investment pools that in recent years have attracted large dollars and are heavily marketed as offering superior returns, saw their second year in a row of underperformance. The average hedge fund returned 9.5% in 2004, reinforcing our belief that too much money is flowing into these vehicles and that the money manager talent pool running them has decreased significantly. As an analogy, we view the current popularity of hedge funds as being a phenomenon eerily reminiscent of the IPO craze in the late 1990s.

During 2004, the stock market spent the first ten months of the year stuck in neutral while exhibiting remarkably low volatility. Then, following the presidential election in early November, stocks made an impressive two-month sprint to the end of the year. It seems odd to us to attribute this newfound optimism for stocks entirely to a George Bush victory. Instead, skepticism leads us wonder whether this stock rally was helped along by hedge fund manager's eager to achieve year-end bonuses. A suspicion (perhaps) confirmed by the market sell-off that has taken place since the first of the year.

A Few Issues for a Pricey Stock Market

Investors always face a litany of concerns about the future. When these uncertainties act as a depressant on stock prices, it often provides opportunity for an astute investor to acquire good businesses at bargain prices. On the other hand, *when businesses are valued at full or premium prices, much as conditions are today, it is worthwhile to be cautious, and attentive to a few of the issues which could derail the market.*

The U.S. economy appears to be in decent shape and corporate earnings have been respectable. Many companies took advantage of the low interest rate environment to strengthen their balance sheets. Yet, there still seems to be **a lingering hangover of economic capacity** from the excessive investments in technology and plant (by corporations) during the late 1990s. These investments have proven to be more than sufficient for businesses to run their present operations (i.e. no need for expansion). Additionally, the magnitude of excess has surfaced in many cases - one glaring example comes from the still devastated telecom industry. Tyco International recently sold its Global Network, an undersea telecommunications cable system that cost nearly \$3 billion to build, for a meager \$130 million.

On the acquisition front, some sizeable mergers have recently been announced, but the transactions are not at large premiums to market prices. In addition, their rationale appears to be based on taking costs out of the merged entities. Assets are brought together in these corporate marriages, but their “synergies” are achieved via cost reduction...i.e. significant layoffs of employees and the closing of facilities.

*The venue that may determine how well U.S. investors will fare in the coming years, could very well be determined by **developments in the global economy**.* The U.S. is running twin deficits, in both the federal budget and trade, leading to a decline in value of the U.S. dollar. China is growing rapidly and importing vast quantities of raw materials; commodities such as oil, steel, coal, soybeans, etc. Prices on some commodities have skyrocketed, creating pricing pressure in raw material prices around the world. Without question, China is a marvel of economic activity. Yet, the country still has tenuous political issues, a currency that is artificially undervalued, and an unsound banking system. *Anytime a huge “emerging” economy experiences hyper-growth, it is wise to guard against an economic “dislocation” that could send a tremor throughout world markets.* At a minimum, it seems that China’s vast demand for resources will eventually translate into inflationary pressures, leading to higher global interest rates.

While the government debates the future of Social Security in the headlines these days, the issue of **retirement liabilities and saving for retirement** is a significant problem hovering over our future. This is a topic we have harped on before, and one for which we see no sign of being solved soon. The long-term pension and healthcare liabilities residing on corporate balance sheets and draining federal, state, and local public budgets, has become a great strain. To absolve themselves from these liabilities, many companies have migrated to 401k plans, where the employee becomes responsible for funding his/her retirement. The proposed changes for Social Security appear to be the first salvo in a similar maneuver to reduce the government’s funding obligations to retired citizens. Without question, more corporations and government entities will attempt to undertake the process of extricating themselves from these ballooning obligations. We suspect that battle lines will be drawn between the interested parties (companies and employees, government entities and citizens) over how these financial burdens get split up. In the meantime, *we still see too many pension plans that are operating with their fingers crossed*, expecting buoyant stock market returns to bail them out of their under-funded liabilities.

Also of note, **treating stock options as an expense** in corporate income statements is slated to begin in June 2005 - an item that has lately been ignored by the investment community. It may be that Wall Street analysts (misguidedly, in our opinion) will choose not to recognize the effect this expense has in reducing corporate earnings. However, we do think that, as reality sinks in, investors may begin to understand the ownership transfer these compensation plans have exacted on businesses. As we have said before, we are not against moderate stock option programs that are properly structured; however, there is clearly a cost to stockholders in option programs - and that cost should show up as an expense on a company’s income statement.

A final concern is the accounting issues and political firestorm surrounding the nations two massive mortgage lenders: **Fannie Mae and Freddie Mac**. Fed chief Alan Greenspan and a group of legislators are becoming more concerned about the risks residing on the balance sheets of these highly leveraged institutions. Considering the rapid growth of these businesses - funded by easy credit and a tangled web of derivative contracts - *the repercussions of a “market disruption” would not be well received by a pricey stock market.*

Outlook

At the risk of sounding like a broken record ...we still find it difficult to identify undervalued investment opportunities. *Our research has turned up a number of companies where we would be*

interested in becoming long-term owners - it's just that the stock market valuations for these companies are too rich at present. This was our message in last year's letter and conditions have not materially changed. In spite of this, we were able to find a few securities worth buying last year (one of which we detail in the appendix to this letter).

In managing your portfolio, we don't require a huge number of investment ideas at any given point in time. Occasionally, market conditions are such that we have little trouble finding companies that are attractively priced, making our job a lot easier. However, in direct contrast are periods like the present, when our initial analysis of company after company leaves us *concluding that the stock market has fully priced, if not overpriced,* the value of the business. This quandary reminds us of a remark Warren Buffett made in 1969, describing his frustration in identifying attractive securities for purchase:

"My idea quota used to be like Niagara Falls – I'd have many more than I could use. Now it's as if someone had dammed up the water and was letting it flow with an eyedropper."

A few weeks ago, Ed asked Rich and I (actually prodded might be a better word), how we reconcile our cautious talk about high stock prices, and our harping over a lack of interesting investment ideas, yet manage to achieve very satisfactory investment returns?

To answer, we go back to the principles and tenets that have successfully guided us throughout our careers as managers of capital. Our unrelenting cautious disposition is the result of being ever mindful of the risks involved with investing. *We think this attitude makes us better investors.* The "margin of safety" principle is ingrained in everything we do in our investment analysis - providing downside risk protection in challenging times, while positioning ourselves to profit nicely when value is recognized. We are miffed when a simple concept, like trying to buy a dollar bill for 50 cents, doesn't register with the majority of investment professionals.

Further, Wall Street never ceases to amaze us with some of their convoluted reasoning when spouting their views on the market. For example, one thesis for "loading up on stocks" was recently offered by a Merrill Lynch equity trading strategist who wrote, "... Years ending in '5' typically show a rise. Since 1935, the S&P 500 rose on average nearly 29% during years that ended in 5..." The concept of business valuation never seems to enter the equation with some pundits - *a scenario you will never have to worry about with us.*

In the end, we interpret our investment mandate for managing your portfolio to be twofold. Our first objective is preservation of capital. We are fully conscious of the financial setback that accompanies a permanent loss of capital for people who are striving to accumulate and grow their long term net worth. Many investors are still dealing with the impact of a permanent capital loss that occurred 5 years ago.

Second, within the above constraint (which amounts to an attempt to minimize risk), our goal is to make long-term investments that measurably add to your long term net worth. The best way we have found to do this is through the purchase of undervalued securities. *When we find them, we invest in them. When we can't find them, we are patient and willing to wait until they surface.*

"The Focus Investor"

Note: A lot of us have said at some point, "someday I'm going to write a book." Most of us never quite get it done, but we are proud to say that our own Rich Rockwood has made it. Rich has a newly published book, "The Focus Investor" - we asked Rich to share some of his own words in this year's letter...

...I have been working on an investment book for the last several years and I finally completed it at the end of 2004. It is called, "The Focus Investor", and it is 230 pages in length. My motivation to

write the book developed from my own difficulties learning what investing principles and philosophies really worked for investors who were willing to commit serious time and effort into their investment decision making. I also wanted to produce a book that would serve as a reference book, so that potential focus investors would be able to obtain relevant information on focus investing from one source. Following are some excerpts from the book:

"What defines a focus investor? Focus investors are similar to what the investment world defines as value investors. Like value investors, we believe in conducting fundamental analysis of a company we are interested in investing in; we believe in the margin of safety concept; we understand the psychological forces that shape the stock market; and we agree with Benjamin Graham's definition of an investment operation as "one which, upon thorough analysis promises safety of principal and an adequate return."

"What sets a focus investor apart from value investors is (1) our willingness to concentrate our portfolio by only purchasing investments that present the highest probability of outperforming the market over the long-term and (2) possessing the temperament that allows us to deal with the financial and psychological issues that arise from owning a concentrated portfolio."

For those of you who enjoy reading and want to 'get in the mind' of a true value investor - give us a call and we'll gladly send one out to you. The book is also available through Rich's website www.focusinvestor.com and Amazon.com.

As always, we want you to know that we appreciate your business with Aldebaran Capital, and look forward to continuing to provide you with a sound framework for investing your assets. Please feel free to call us if you ever have any questions, comments, or just want to check-in with us.

Sincerely,

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For those of you in the Indianapolis area, or subscribers to the Indianapolis Business Journal, be sure to look for Ken's articles that appear every other week in the investment section titled "Bulls and Bears." We will also be posting the articles on our website, www.aldebarancapital.com.

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