



Value, Performance, & Service

From the desk of:
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2005 Annual Letter to Clients

We are pleased to present the following reports as of December 31, 2005, which summarize your investment account(s) with Aldebaran Capital, LLC. For 2005, the stock market turned in a rather uninspired performance, as the S&P 500 with dividends reinvested rose 4.9%. Aldebaran client portfolios, on average, hovered around this result.

Viewed in isolation, this year's investment results leave us feeling like we pedaled the bike hard all year without covering a whole lot of ground. Needless to say, while we found the year's returns unsatisfying, we still have maintained a respectable margin of out-performance versus the widely followed market averages over longer measuring periods. While 2005's overall market return was unexciting, several of our holdings undertook some interesting shareholder-oriented actions that unlocked value (some of which was recognized in a very strong January, 2006.) In the Appendix to this letter, we discuss a few of those events.

The Low Return Environment

The subdued performance of the stock market in 2005 did not catch us by surprise. In last year's annual letter we discussed some of the reasons we felt the stock market might have difficulty pushing higher in a section titled, "A Few Issues for a Pricey Stock Market." While overall valuation levels have improved over the past 12 months, bargains are still not exactly plentiful as of this writing. (Note: You can find all of our past letters on our website at www.aldebarancapital.com.)

To provide some insight into this low return environment, it is instructive to break down the market's performance over the past two years. For 2004 and 2005, the cumulative return on the S&P 500 was 16.3%, which works out to 7.8% annualized. Yet, a significant chunk of the gains during the two-year period came from just the last three-months of 2004, when the market was up over 9%. Remove the 4th quarter of 2004 and the remaining seven quarters of the past two years have been marked by a sluggish stock market.

Ironically, this lackluster performance by stocks has come in the face of strong corporate profit growth. A recent article in the Wall Street Journal noted that the companies in the S&P 500 have recorded 10 quarters in a row of double-digit earnings growth - the longest such run in over 30 years. This disconnect, between strong earnings growth and muted stock returns, has confounded many investors - professionals included - who naturally assume that impressive business performance should be accompanied by high returns on stocks.

So what is holding stocks back? As we have commented before, the stock market is still suffering from the heartburn of digesting the excessive values that were placed on businesses in the late 1990's. The halting progress in market returns (at least relative to the high returns achieved during the 1990s) is part of the process of business values catching up to elevated stock prices.

But all is not gloomy. The good news is that the healthy corporate profits earned over the past two years, accompanied by lethargic stock prices, have brought valuations back toward more attractive levels for long term investors. When one looks at P/E ratios – with P representing stock prices, and the E corporate earnings – the denominator, earnings (E) have been rising faster than the numerator, stock prices (P). The result is that P/E ratios have fallen, which on balance means that stocks are more reasonably valued today versus the last year couple of years.

That being said, investors do need to rein in any expectation that the stock market will soon revert to a 1990's type of environment when stocks returned over 18% annually. It would be wise to tune-out the chorus of Wall Street pundits, who have those days-gone-by cemented in their memories, and are ceaseless in their strongly bullish views on the market. *Just because stocks have not been great performers of late doesn't mean they finally deserve to skyrocket. As Warren Buffett once remarked, "The Tinker Bell approach – clap if you believe – just won't cut it."*

Outlook: Managing Your Portfolio in this Environment

Our method of operation, and one that has worked quite well over the long term, is to seek out a relatively small number of securities that we believe are selling at prices that significantly understate their true value. This discrepancy between price and value provides us with some cushion (or margin of safety) to the downside risks always present in the market, and gives the potential for attractive long-term gains.

This process has been more difficult for us to implement over past couple of years as the spectrum of asset classes; stocks, bonds, real estate etc...have reached elevated price levels. Regardless of this condition, we can't use this as a cop out in our duties of managing your investment portfolio. Our job is to identify a handful of undervalued securities where we can make a significant commitment. And it is our expectation that your investment performance, when viewed over a reasonable time-period of say 3-5 years, should outperform the market – otherwise we aren't doing our job.

Rich has been working hard sifting through annual reports, from small to large companies. (Note: Due to the large volume of reports our Postal-lady regularly hauls into the office, Ed felt it was wise to provide her with a generous holiday tip...) Further, Rich and I have regular conversations about interesting companies, but more often than not, the conclusion is the price is just not attractive enough to make a commitment at present. This is not completely discouraging to us, for it is what we enjoy doing - researching and learning about thousands of businesses. And while we may pass on a company today, the interesting businesses are placed in the hopper to follow and revisit, in case the market were to hiccup and give us an attractive entry point.

For the market as a whole, there is always the ever-present laundry list of worries. The slate of anxieties varies depending on the point in time, but investors can never escape dealing with future uncertainties. At present the concerns include: Iraq, Iran, twin deficits, and high energy/commodity prices. At the individual company level, issues that we have discussed in the past are becoming more visible to investors and include: pensions, health care costs, and stock option expensing.

It is important to recognize that that these are items that are largely outside the control of the individual investor, and the best way we know of to deal with these uncertainties is to make rational investment decisions that possess a margin of safety. In an environment where many stocks still appear to us as fully valued and in areas, overvalued, we do on occasions find pockets of opportunity. We may go through an extended stretch without much happening and then a flurry of activity arrives. That is the nature of the current market where it is difficult to find bargains; *the availability and timing of our purchases can't be predicted.* In the meantime, we do have some thoughts on where we expect to find investment opportunities for your portfolio this coming year and we discuss this next.

Mergers and Acquisitions: Arbitrage and Workouts

Recently, institutions (namely public and private pension funds) have invested large sums of money into private equity funds. A private equity fund is an investment firm that raises money from investors, and then uses that pool of funds to acquire companies. A recent example was the purchase of Toys-R-Us by a group that included one of the well-known private equity shops in the business, Kohlberg Kravis and Roberts (KKR).

The massive amount of money controlled by these funds will surely lead to an increased level of mergers and acquisitions. On a side note, we do have our doubts about the returns that institutional investors will earn on their investment in these funds. With so many large private equity funds competing for acquisitions, the risk that these buyers will overpay increases - potentially leading to unsatisfying returns for their investors.

Regardless, our interest in this area is that the heightened merger and acquisition activity will allow us to participate in more work-outs and arbitrage transactions. The term work-outs describes investments in companies undergoing some type of corporate transaction and includes, mergers, spin-offs, liquidations, reorganizations etc. Investments of this sort typically have a time period upon which the deal will be completed - and when we evaluate these investments, we are less interested in the actual fundamentals of the company and are primarily concerned with what could go wrong to scuttle the deal. *We make our investments only after the deal and its terms are announced – in other words we don't invest based on rumors.*

Some find it odd that when a company offers to buy another company for, let's say \$30 per share, that the market price of the company being acquired only rises to maybe \$28.50 per share. How come the stock doesn't immediately go to \$30 and why is the stock trading over 5% below the purchase price?

When a merger is announced, the stock of the company being acquired usually remains lower than the acquisition price for several reasons. First, there is a time-value-of-money factor, since the stockholders will not receive the buyout price for some months down the road. Next, there are often uncertainties as to whether the acquirer can secure the funds to complete the deal. Further, there may also be anti-trust hurdles that the company must negotiate to complete the deal. So there are a number of factors that can create uncertainty as to the timing and success of completing an acquisition. Every merger, or business reorganization, is different. We read the merger documents and make our judgment as to the probability of the deal being completed. And if the "arbitrage spread" between the current market price and the announced acquisition price provides us with a relatively safe and attractive short-term return, we will buy stock in the acquisition target.

We have heard some people describe investing in workouts as "scooping up the last nickel." And while the gross profits earned in these transactions can be quite small, their relative predictability coupled with the short time period we have to commit funds, can produce attractive annual rates of return - *our goal is to achieve low double-digit returns over a one-year period.*

Recent examples of these arbitrage investments include Tommy Hilfiger and Tyco. Hilfiger is being acquired for \$16.80 per share and we should receive the cash this spring. Tyco plans to split into three companies and we think the stock market will value the three separate businesses at a greater amount than the existing conglomerate's value. The split up of Tyco will take place in early 2007 - clients can expect to see some new purchases that appear (buy), and then disappear (sell) from your statements as the deals go through.

Closing

As always, we want you to know that we appreciate your business with Aldebaran Capital, and your continued commitment and confidence in our approach. We 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."

APPENDIX: 2005 Annual Letter to Clients

Blair Corp.

During 2005, Blair recognized that they had an attractive asset on their balance sheet in the form of profitable credit card receivables. These were installment credit balances extended to their customers who had purchased clothing from Blair's catalogues. Last April, the firm announced that they would sell these receivables to a unit of Alliance Data Systems, a finance firm, for \$180 million. With that substantial cash pile, the company took a very shareholder oriented step.

In May 2005, Blair announced a tender offer for 53% of the outstanding shares of their stock at \$42 per share. Blair shareholders were able to tender as much stock as they wished and the company would pro rate the cash payout based on the number of shares tendered. We felt that \$42 was a fair price and one that gave us an opportunity to monetize a portion of our investment in Blair. So in late August we tendered all of our Blair stock and based on pro rata results of the tender, we received \$42 in cash for about 70% of our client holdings. We continue to hold the remaining shares and still view Blair as an attractive long-term holding. Since the tender, the company has doubled their dividend payout and still maintains a solid balance sheet with no long-term debt.

Some of our longer-term clients had an original cost basis in Blair stock of around \$17 per share, first purchased in June of 2001. The annualized rate of return on a holding bought in June 2001, and cashed out at \$42 last August, was 25%. In addition, Blair paid a nice dividend over that period in excess of 3%, thus providing a total annualized return of over 28% for the 4 ¼ years. This contrasts with a 1% annual return on the S&P 500 over that time period.

We are constantly looking for "Blairs" in our research efforts. This nondescript business, with solid financials and third generation employees, up in the northwest corner of Pennsylvania, flew under the radar of many investors. In some respects, the company we mention next, and which is our most recent sizable purchase, possesses some of the financial characteristics that remind us of Blair.

Kimball International

Throughout the fourth quarter of 2005, we were buying stock in Kimball International. Kimball is based in Jasper, Indiana, and has two main businesses: office furniture and electronics assembly.

Some of you may be aware that I write a bi-weekly column in the Indianapolis Business Journal. For the November 7th issue, I wrote an article discussing the reasons we thought Kimball was an attractive investment (that article is attached as the last page of this letter.)

In general, we do not like to publicly discuss a stock we are in the process of buying. However, in this case, we made an exception. First, because we thought an Indiana investing audience could benefit from a local idea and the thought process that goes into making a rational investment decision. Second, in a time where people still seem to gravitate to financial hype, ala the Jim Cramer's (CNBC "Mad Money" host) of the world, we felt that doing some "community service" might be worthwhile. I have my doubts that our article hit home with too many readers. That is the interesting thing about value investing - it can make all the sense in the world, but doesn't have the appeal of a Google (in other words, it's boring) - or, it often requires too much patience for the cravings of an "instant gratification investor."

And while it is far too short of a period to claim victory, Kimball has risen 26% since the publication of that article and we have collected our first quarterly dividend from Kimball with a yield of 6%.

Imperial Sugar

Our initial purchases in Imperial were made not long after they exited from bankruptcy in 2003. The company went bankrupt in 2002 after an acquisition spree left them with substantial debt. Coming out of bankruptcy, Imperial had new management and had shed the vast majority of those debts. It was clear to us that the restructured company had some valuable assets that were underappreciated by the market. Ignored by investors and possessing the stigma of bankruptcy we made our initial purchases around \$6.25 per share.

Last September, the company realized some of that value when it sold their Holly Sugar division for \$55 million. The sale price for Holly Sugar represented only 18% of sales, but the \$55 million in proceeds represented about 40% of market cap of the company. The company does have one blemish that we have had to stomach; an under-funded pension plan. About half of the proceeds of the Holly Sugar sale went to

reduce this liability. But the other half was paid out to shareholders in November as \$2.50 per share special dividend. Presently, the company still has a strong balance sheet, and the pension liability (while still a problem) has been reduced.

In the last few months, sugar prices have spiked and the spread between raw sugar prices and market prices has widened. Imperial Sugar refines and packages sugar, then earns their income on the spread between refined sugar prices and their selling price to customers. A recent drop in natural gas prices, a key input cost in refining sugar has also helped the bottom line.

While writing this letter, Imperial reported their first quarter earnings on Jan. 31st. The company earned \$12 million for the quarter (the period Oct. 1, 2005 to Dec. 31, 2005), or \$1.08 per share. The stock rose 30% on the day earnings were released and frankly we feel that if industry conditions continue, the company is worth quite a bit more. (Note: Last February, Rich and I traveled to Sugarland, Texas, for the Imperial Sugar annual meeting - we enjoyed our visit, and gained additional comfort in the quality of our investment - it was also a nice opportunity to visit a few of our Texas clients!)

Lynch Interactive

Some of you may have noted an obscure purchase we made in the latter half of 2005 in shares of Lynch Interactive. One unusual feature of this purchase was the number of shares we bought for your accounts - all of our purchases were for less than 100 shares per account. This investment was based on the announcement last April that Lynch Interactive was going to take itself private in a transaction that has become to be known in investing parlance as “going dark”, a maneuver that essentially turns the company into a semi-private entity.

Several very small public companies announced going dark transactions last year. These transactions are structured to reduce the number of shareholders in a company to below 300 and thereby allow them to cease filing financial reports with the Securities and Exchange Commission. The main reason given for going dark by these companies is that it is just too costly for small companies to comply the recent Sarbanes-Oxley (SOX) regulations. The SOX legislation, passed by Congress following the accounting fraud episodes of the recent past (Enron, Worldcom et. al.), entails a rigorous set of procedures that public companies must follow in their financial reporting. The result has been a significant increase in auditing expenses to a point where it often cuts into a meaningful percentage of a small public company’s earnings.

The specifics of Lynch Interactive’s “going dark” transaction were that any shareholder holding less than 100 shares would receive the greater of 1) \$29 per share, or 2) 120% of the average of the closing price per share of Lynch Interactive’s stock on the AMEX (American Stock Exchange) over the 20 trading days immediately preceding the date of the transaction. With the current market price of Lynch fluctuating around \$24 per share, we saw an opportunity to earn an “arbitrage” profit of about \$5 per share.

So from August through November, we were busy buying Lynch stock when the trading volume permitted - always making sure our purchases remained under 100 shares per client account. Some of you might be interested how this worked. For example, if we were able to buy 1,000 shares in a day, we would simply divide by 11 and allocate 90 or 91 shares to various client accounts. All told, our purchases were made at an average price per share of \$24.72 and on December 1st, we received \$29.93 per share in cash, for an average return of 21% for the few months we owned the stock.

Some of you may also have noticed - and we did get some calls on this - that the November Schwab statement treated this holding as worth \$0. That is somewhat of a consequence of the timing and nature of these transactions. Once the shareholder vote to “go dark” passed (which we of course voted on your behalf to approve), the stock goes into a sort of reorganization limbo, where Lynch went through the process of cashing out shareholders who held less than 100 shares. It took about 10 days after the effective date of the vote for this to be completed.

We concede that this return, while very attractive, was accomplished on a small amount of money (approximately \$2,000 per account). But we think it does demonstrate one of the ways we are always seeking safe ways to improve returns particularly when we have cash on hand. In fact, we view these short-term “arbitrage” transactions (where we know the general length of time of our investment and the price we will receive) as a way to boost the return on our cash holdings.

We constantly scour the SEC filings on the lookout for more of these going dark transactions, so you may occasionally see some of these pop into your account, and subsequently, get cashed out of your

accounts. If we had liked the long term business prospects for Lynch Interactive, we could have purchased more than 100 shares per account. In that case, we would have remained a shareholder in a semi-private company. The negatives in doing so, aside from the fact that in Lynch's case we were not enamored with the company's future business prospects, would be decreased liquidity and less formal financial reporting of business results.

On that note, you may have realized that Michael Anthony Holdings is a company that has "gone dark" - they did so at the end of 2004. This is one where we chose to remain a shareholder even though it is now a semi-private company, unregistered with the SEC. We'll update you on that holding next.

Michael Anthony Holdings

First, you may notice a different name for the company. Michael Anthony Jewelers became Michael Anthony Holdings last year. The events began on May 31st, when Michael Anthony Jewelers announced that they were in preliminary negotiations for a possible business combination— an event that we considered possible when we originally acquired the stock.

In early August, to our delight, Rich opened the mail to find a document outlining the purchase of the company for about \$38 million. (You may recall that in last year's annual letter, we sent to you a simple analysis suggesting that the liquidation value of Michael Anthony Jewelers was at least \$27 million and noted that the book value of the company was \$37 million.) The stockholder's meeting to vote on the sale was set for just a week later on August 11th, so I went out to New York to meet the principals of Michael Anthony and get the details of the sale.

The company buying the operating assets of Michael Anthony Jewelers is Bel-Oro International, a privately held New York distributor of jewelry. Of the \$38 million sales price, \$15 million is in the form of a 5-year note that pays interest quarterly. Another \$20 million or so in cash is expected to come in throughout 2006, via the liquidation of account receivables and inventory. Not included in the \$38 million sales price, Michael Anthony Holdings will still own two office buildings, one in Mount Vernon, N.Y. and the other in the Dominican Republic, both of which they will lease to Bel-Oro.

So where do we stand with this "unconventional" portfolio holding? Well, when we reported to you last year, the market price for Michael Anthony in the pink sheets was Bid: \$2,600 Offer: \$3,500. As a result of the sale, the price has risen some to a present market price of Bid: \$3,900 Offer: \$4,400. At this price level, with a total of 3,788 shares now outstanding in Michael Anthony Holdings, the company has a market value of about \$15 million.

You may ask why there is still a substantial discrepancy in value between the \$38 million sales price of the business and the current market value of \$15 million. We think there are a couple of reasons, first since \$15 million of the \$38 million sales price is in the form of a note to be paid out over the next 5 years, there should be a discount applied to that instrument. After all, it is not a Treasury Note and the assurance of payment is reliant upon the ability of Bel-Oro International to fulfill its obligations. (From conversations we have had with Michael Paolercio, we have been told that Bel-Oro is financially sound with over \$200 million in sales.) Second, this is essentially a semi-private company and the lack of liquidity results in an inefficient market for the shares.

At present, we are anticipating that we will receive year-end financial statements on Michael Anthony Holdings sometime in the next couple of months. In addition, we are eager to hear what kind of plans the principals have in mind for the liquid assets of the company. Our preference would be a distribution of a portion of the cash, however we realize that the note has a 5-year term and that the company still has real estate assets. While Aldebaran client portfolios own over 11% of the company, the principals hold nearly 50%, so they certainly have a vested interest in seeing a full and final realization of value at some point in the future. We will continue to fill you in on the progress of this investment as further details are announced.

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