



**Value, Performance, & Service**

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*\* The following is a reproduction of the letter sent to clients of Aldebaran Capital, LLC with their year-end 2005 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.*

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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](http://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 4<sup>th</sup> 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 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."**

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