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ValueWorks
quality assets. compelling valuations.

Volume 10,2 **Q2 2012**

After two strong quarterly advances, equity markets retreated from the March highs. The S&P 500 slipped -2.8 for the quarter and our Capital Appreciation composite fared similarly giving back -3.4 (gross of fees).

Having scaled out of exposure on the way up, we were positioned to add to our holdings on a pull-back. While this recent retreat may have run its course, we do have additional potential firepower to deploy should more downside create further buying opportunities.

Beyond the natural tendency of markets to consolidate after the 20% advance from last summer's lows, the proximate causes of the recent correction were (1) a seeming growth deceleration in the US and (2) further fiscal dislocation in Europe. Should something go significantly wrong on either of those fronts, we can expect some sharp market moves. However, the potential for positive developments on both fronts should not be dismissed. Oil is at $80 a barrel and geopolitical risk sourced from Iran seems more modest. US residential real estate may be bottoming. Europe may have put an incremental piece of a unified political structure in place at its most recent summit. Not all the big macro news has been bad and there are plenty of reasons to believe today's concerns can be managed.

Top 10 holdings*:

1. **American Express Co.**
2. **Calpine Corp.**
3. **Xerox Corporation**
4. **Nokia Corp** 6.625% Due 05-15-39
5. **Boeing Company**
6. **Williams Companies**
7. **Pfizer Inc.**
8. **Paccar Inc.**
9. **Dow Chemical Company**
10. **3M Company**

—as of 06/30/12—

*see notes on p4 for additional Information

We used recent weakness to add Xerox common shares and Nokia bonds to our portfolios. Nokia common shares have been punished for years as the company struggles with the industry's transition to smart-phones. In the last quarter, the company's debt joined in the sell-off, declining from roughly 102% of par in January to our entry point in the mid-high seventies. At that price the trade back to a premium with an improved perception of the company's prospects, which may well happen in something like a twelve month time frame, translating to a total return in the order of 40%. While the challenges in the handset business are real, there are important considerations that argue that their bonds are safe. Currently, Nokia holds over ten billion euro in cash on the balance sheet, which is more than two times the amount of total debt outstanding. The company's current assets exceed total liabilities, and they have not been bleeding cash. Also, Nokia has a very valuable location and mapping business, as well as a large networking joint venture with Siemens.

Xerox is often lumped together in investor's minds with Eastman Kodak, Polaroid and Pitney Bowes – all companies that once dominated their tech-based businesses and which have more recently been upstaged by newer technologies and younger firms. But I think that comparison misses a fundamental distinction. Xerox has been much more successful in using its historic strength in document management to fund a transition into more general business services – much as IBM used its strength in mainframe computers to move into a similar business. For example, over 85% of Xerox's current revenue comes not from the one-time sale of a copier, but from an annual service contract of some kind. And the part of its business that is not document related is now over 50%. I consider the company to have $4 billion in net debt, a $10 billion equity cap with annual revenues of $23 billion and an annual cash flow over $2.5 billion. Looking out 24 months (at which time I would expect

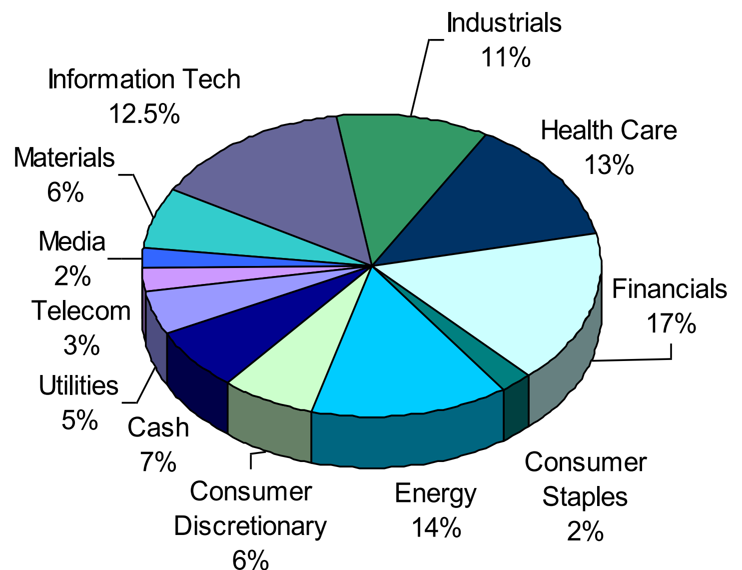
thoughts of European contagion to be distant memories) it seems likely that the share count will be almost 15% lower, cash flow 15% higher, earnings forecast at 1.50. We believe that could likely translate to a 15x earnings multiple and a $22 share price.

Meanwhile, the businesses we own continue to make progress and increase their underlying value. Eli Lilly and Pfizer's "patent cliffs" are generally behind them and they each look to be growing on both the top and bottom lines, with chunky dividends supporting their share prices. I expect to sell these in two to four years from now at twice today's prices. Maybe it will take five years.

Micron Technology seems to be buying (at a very modest cost) Elpida – which represents almost the entire DRAM production business of Japan. It seems Japan's DRAM producers did not bankrupt and take over all American competitors, but somewhat the other way around (Micron's competition will now come as Korea and China step up). Recent noisy distractions notwithstanding, Chesapeake Energy has helped change the face of energy production in the US, producing natural gas at one tenth today's price of oil. Williams' company is growing its capacity to store and transport that gas, and Dow Chemical is building new plants to turn this commodity into materials used everywhere throughout the modern economy. Calpine Corp may be at a long term inflection point where – based upon market dynamics, not government intervention – natural gas is becoming a cheaper input for electricity generation than coal. That could trigger a step-up in the underlying earning potential of Calpine's fleet of gas fired generating facilities.

While near term market gyrations can be unpredictable, I expect the underlying value of these businesses to continue to grow. We believe that history is a guide and that at some point in the future the valuations of these companies will be more than fair. We think the right investment strategy is to build exposure during these more uncertain windows so that we can be positioned to take profits in those more ebullient times.

— Charles Lemonides, CFA



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