The Price You Pay Matters

To be successful, investing doesn't need to involve a fancy computer model or the stocks that everyone's chasing. Just the opposite. James Potkul, the manager of the Bread and Butter Fund, believes that the contrarian value strategy, which is based on the simple idea of buying great companies at a discount, provides the best results at any market environment. Thorough research, careful analysis, and skillful stock picking, remain a must.

How would you describe your investment philosophy? What are the core beliefs that drive your investment decisions?

The Bread & Butter Fund utilizes a contrarian value investment strategy, which is built around several ideas. We believe that investors continuously overreact by overpaying for the most popular stocks, while discounting the most unpopular ones. We utilize overreactions to capture pockets of inefficiencies. Usually, undervalued securities are found in the least popular areas of the market, and are surrounded by controversy and pessimism.

Second, we believe that the price you pay for a security is crucial for the long-term rate of return. If you buy a great company at a high price, it will probably be a poor investment, while buying securities at a margin of safety minimizes the risk of permanent loss of capital. This approach gives us confidence in the face of the inevitable market correction, and there are always going to be market corrections.

Many investors can't control their emotions because they don't have enough faith in their system. In all the hot sectors, such as the Internet, technology, and even natural resources, most of the money flows in near the peak, or at the peak of these investments. It's just human nature, but that's when you generate permanent capital loss.

A cheap price does not always equal value because a cheap stock can represent a value trap or a business in decline. This is why it is crucial for us to determine the fundamental long-term viability of the security and the industry.

We are long-term investors as we believe that investor perceptions of securities fluctuate much wider than the underlying fundamentals, and short-term price movements are difficult to predict consistently. Finally, we believe that less is best, meaning less trading, taxes, and costs. Lower trading activity helps to minimize mistakes and to reduce short-term market focus.

Why do you believe that contrarian investing is a better way of managing money than growth or dividend strategies, for example?

Since the market psychology is so powerful, the contrarian investment approach has a built-in set of checks and balances that forces us to purchase the stocks that are best valued at the time, and to sell or avoid the expensive stocks based on fundamental measures such as earnings, book value and cash flow.

We won't chase the newest fad. The contrarian approach helps us to control the emotional aspects of the market by focusing on price and value, not on what the Wall Street herd is chasing at the time.

It is like jumping on a moving train. Some of these trains are moving at a high speed and jumping on them is quite challenging. We'd prefer to board them at the station when the investors are asleep and not noticing a company. Then we can buy in at good value.

The contrarian approach is not a complicated process; it is common sense investing. There is no fancy computer model spitting out information, it is buying a good company at a discount, just as you

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Potkul earned a degree from Brown University (1986) in Economics and Organizational Behavior & Management.

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would shop for groceries. When there are no opportunities, we just stay the course in cash and wait patiently.

The main strength of the contrarian value strategy is that it is for all ages and works well in good and bad times. It will work a hundred years from now and it worked a hundred years back. It is just like bread and butter - staples that have been around for the ages.

What are the typical companies you look for?

We like to buy growing companies at reasonable or cheap prices. We don't like dying businesses such as newspapers, radios, or even wire line businesses. We are hesitant to buy technology and retail stocks because their products and services are usually faddish and have short-term cycles. In addition, technology stocks have added costs, such as stock options and, therefore, offer less attractive returns in some cases.

It's very difficult to buy a great company cheap, but if you are patient, you sometimes get an opportunity. In this market, there are quite a few large, multi-national, companies that have treaded water for five or 10 years, but continue to grow. We have the patience to wait for our price.

How do you generate ideas and gather information for those least popular areas of the market?

We use both a quantitative and a qualitative approaches to seek undervalued and out-of-favor securities. We have a database that tracks stocks with characteristics that we like, as well as with great companies that don't fit only the valuation criteria. In the database, I have accumulated many ideas over the years, I also do a lot of reading, and follow annual reports, new low list, financial publications, Internet resources and spin-off market events.

Overall, accumulating our ideas requires discipline. It never ends; it's like a treasure hunt. You always look to see if you missed something or you revisit an old story.

Once we make our collection of these ideas, we put them on our screen, and we are very price sensitive. When a stock becomes attractive based on our valuation model, we'll put it through a qualitative process, where we could break it down and analyze the fundamentals of the industry and the company.

There are no secrets in our process. It's a lot of hard work, involving constant reading, keeping up with ideas and tracking them, and waiting for the price to meet our valuation and criteria.

Could you give us some examples of stock picks that illustrate your thought process? For instance, what were you buying during the Internet and technology boom?

We were buying energy stocks in 1998 and 1999, but every company is different. For example, for our individual accounts, I bought Ensco and Rowan Corporation, which are offshore drillers and had been out of favor for many years. They weren't reinvesting in the businesses. Everybody was asleep and not paying attention, but the demand was starting to creep up. We were able to buy these companies below replacement costs, when oil was under about $10 and natural gas was a little under $2.

The first step of the thought process was the understanding of the demand. Second, we felt comfortable to buy these companies at about 40% replacement costs. The balance sheets were strong enough and felt they could withstand an extended period of low energy prices.

Obviously, with oil at $10 and natural gas at $2, there was a lot of pessimism. It took a little courage to step in that area, but it is part of our strategy to buy stocks that are undervalued. When you rely only on earnings momentum, it may be a short ride. However, when you are buying assets at a 40% discount and believe in the long-term fundamentals of the industry, you have confidence despite the general pessimism.

Of course, there is a certain pressure on institutional managers. In 1999 and 2000, some investors were generating 50% returns in tech stocks for a few months, while I was only up 20% annually. I would just warn my clients that Cisco can't keep growing at this rate, because it will be a trillion-dollar company in several years. The same refers to the housing market.

What conviction and confidence do you have to hold onto it for the next 10 years or eight years?

We bought Rowan Corp around $8.7/8 a share and it went up to about $30 in 2001. That stock went down to $17 in 2002, which was a very difficult time, but I stayed the course because I believed in the energy story. Our approach enables us to stay on course and don't panic because our confidence is based on the fundamental industry analysis, combined with the specific company analysis. The next year, it rallied strongly.

In general, I believe that what we bring to the table is a selection of assets that we're willing to ride through market fluctuations. Of course, value traps are inevitable, which is the potential risk for any value manager.

The idea is to buy stocks, for which we are confident about at a reasonable price. If the market corrects, I still own a good company, while growth or momentum oriented managers are at great risk if their companies miss the earnings once.

I distinctly remember the comments in the media that the oil price of $35 a barrel was just not sustainable and the same comments when oil reached $50, or $70 a barrel. When gasoline was trading at $2 a gallon, people said that the economy is going to go into recession. How do you decide if there is more room to grow?

I rely on fundamental research. For example, the Mexican Cantarell field, one of the largest in the world is in decline. Russia's oil production is falling off. Non-OPEC production is actually falling off, even though the price of oil is over $100 a barrel. Of course, I'm not going to say that oil is going to shoot up to $200, but it can happen.

I can't predict the oil price, but I have to manage risks. If, at some point, I believe that speculation starts getting wild and the price of these securities is getting stretched, I will start selling a little off here and there. So, I can't predict the future, but value investing is not about trying to predict the future. When we buy value ideas that we believe in, we hope it works out well.

We still believe in the energy story because of the global demand story and because the valuations are not stretched. It's a volatile sector, and we keep an eye on potential alternatives that could harm the demand, on the costs of the production, and on all the industry fundamentals.

When do you decide to sell a stock? Which factors contribute to that decision?

I can give you the example of one of my value traps, a company called IDT Corp. I bought the company at a good discount; it had a large amount of cash and equivalents; it was run by a very entrepreneurial manager. They had a large market share in the calling card business, their core business, but with $800 million in cash and equivalents, they were looking for expansion and investments in other areas.

However, the dynamics in the calling card business resulted in huge competitive pressures, so their core business was falling apart. They were burning through cash, and they weren't able to get the costs in line. Also, they were very slow in finding alternatives to invest in. We had to take a slight loss on that position because it was a value trap.

So, one of the reasons for selling is when the fundamental story has changed, or when our assumptions haven't worked out. Another reason to sell or trim is when the valuations get stretched. This diminishes the risk in the specific position.

Our fund does have the ability to invest up to 15% in any one security at the time of purchase. We can invest up to 25% in one sector at the time of purchase. We own 23% in the energy sector. We can overweight a position, but if the valuation is stretched beyond what we feel comfortable with, we'll trim a little back.

Which index do you utilize for comparing your performance? And how many stocks do you have in the fund?

We utilize the S&P 500 index, which is a general index representing not only the U.S. economy, but is also global in nature. Many of its components get a large portion of their business overseas.

Typically, we hold about 20 to 40 stocks in the fund and very low turnover, between 0% and 18%. I anticipate the turnover to remain relatively low over the long-term, probably under 30%. The low entry price helps us maintain a long-term nature and the long-term holding period is our goal. However, we're not going to hold stocks just to hold them for the long term. If the valuation becomes stretched, we'll trim it back.

Do you have international investments and how do you approach them?

We can invest up to 30% in international stocks. International investing is a bit more difficult for us, but we usually stay with the ADRs of the larger international companies or the multi-nationals. There is the same emphasis on valuation and we look for the same characteristics - good managements, quality products, and at least some pricing stability We avoid companies with pricing pressures.

What risks do you perceive and how do you control them?

There are three types of risks - market risks, interest rate risks, and stock selection risks. In our definition of risk, we don't count volatility as a risk. Rather, it is an opportunity either to trim or acquire a position at a discount.

The risk that we really want to avoid is the permanent loss of capital. We cannot control the markets and the interest rates, but we can control the security selection. Our major risk controls are diversification and the stock selection. Buying at a discount helps to minimize the downside risk and the permanent loss of capital. We don't use stock options to hedge the valuation movements in a portfolio daily. T

Bread & Butter Fund

Symbol	**BABFX**
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Inception	10/31/2005

PORTFOLIO

Total Net Assets*	$1.2
Avg Mkt Cap ($ Weighted) *	$39,000
Average Price/Earnings Ratio	12.54x
Average Price/Book Ratio	2.39x
Turnover Ratio	18%

INVESTMENT INFORMATION

New Investment	Open
Min Initial Investment	$3,000
Min Subsequent Investment	$500
Min Initial IRA Investment	$3,000

RISK (AGAINST S&P 500 DAILY REINV IX - 3 YEARS)

Alpha	N/A
Beta	N/A
R-Squared	N/A
Ann. Std Deviation	N/A
Sharpe Ratio	N/A

RETURNS VS. S&P 500 DAILY REINV INDEX

	BABFX	Index
1 Year (Cum.)	-5.19%	-6.70%
3 Year (Ann.)	N/A	7.57%
5 Year (Ann.)	N/A	9.77%

FEES AND EXPENSES

Max Sales Charge - Front	0.00%
Max Sales Charge - Deferred	0.00%
Max Redemption Fee	0.00%
Total Expense Ratio	1.40%

PORTFOLIO MANAGER

James B. Potkul	2005

** millions*
Data through: 05/31/2008; Source: Company Documents; Lipper

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