

Understanding Basic Investment Principles



Greetings from LFS

Dear Clients and Friends:

Here is my quarterly newsletter, *Invest*. The goal of *Invest* is to keep you abreast of what is happening in the financial market, inform you about new investments and keep you informed about your current investments. I welcome any questions, comments or suggestions.

Sincerely,

Douglas Ruth

Invest

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I continue to search for new investment opportunities. As I indicated in my April newsletter, I continue to believe that the U.S. stock market is overvalued.

With an over-valued market and few opportunities for value investing, I decided to dedicate this quarter's edition of *Invest* to explaining how some security analysts view market psychology.

Basic Investment Premise:

A basic investment premise is that the U.S. stock market is very efficient and all securities are perfectly priced. A large number of books have been written about this subject. This premise is correct most of the time.

I am trying to seek out opportunities for you that are exceptions to this basic premise. In the pages that follow I will explain the psychological principles that affect market value and then show you how it effects Tembec, Inc.

Tenets of the Stock Market:

There are several basic tenets of the stock market. Most of them are obvious once you read them. It is interesting to note, however, how they all tie together.

People:

- Buy stocks and therefore, the stock market is made up of people.
- Are emotional.
- Are not always rational and reasonable.

Educated Investors:

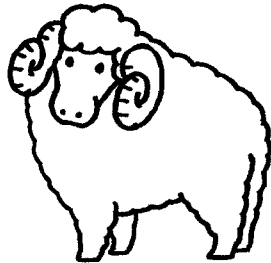
- Can benefit from understanding these basic facts.

Sheep:

The following Associated Press story appeared in the July 11, 2005 *Chicago Sun-Times*:

Hundreds of sheep die in suicide plunge

ISTANBUL, Turkey – First one sheep jumped to its death. Then stunned Turkish shepherds, who had left the herd to graze while they had breakfast, watched as nearly 1,500 others followed, each leaping off the same cliff, Turkish media reported.



In the end, 450 dead animals lay on top of one another in a billowy white pile, the *Aksam* newspaper said. Those who jumped later were saved as the pile got higher and the fall more cushioned.

After one of the sheep tried to jump a ravine, the rest of the flock followed.

“There’s nothing we can do. They’re all wasted,” Nevzat Bayhan, a member of one of the 26 families whose sheep were grazing in the herd, was quoted as saying.

The estimated loss to families in the town of Gevas, located in Van province of eastern Turkey, tops \$100,000, a significant amount of money in a country where average GDP per head is around \$2,700.

Three Classic Investment Stories:

Three classic investment stories show how people get caught up in the moment, stop thinking and simply react. Unfortunately, these reactions caused severe problems, similar to what happened with the sheep in Istanbul, Turkey.

Story 1. Soap Operas:

Television soap operas show pure raw human emotion. The daily life of most typical rational adults is fairly calm. On most days, we:

- Are not getting married or divorced.
- Do not find out that the woman we thought was our sister is really our mother.
- Do not find out that someone we know is living a double life and has two families that don’t know about each other.

Soap operas are exciting to the people who watch them because they show extreme emotional events. Additionally, the actors and actresses that appear on the programs are extremely attractive people. The homes and wardrobes on these shows are elaborate and expensive. It is fair to suggest that TV soap operas are relatively harmless to watch.

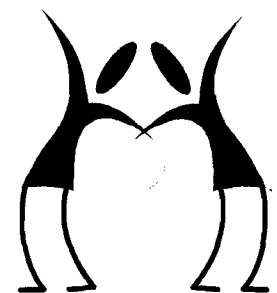
Soap operas regularly use love and hate to add drama to the programs. For example:

Love: On the spur of the moment Don and Sue, who are madly in love, decide to go to Las Vegas to get married immediately. Their love is superficial but emotionally charged. The lovers believe each new day will be better than the last.

Hate: Two weeks later, Don and Sue decide to divorce. Don travels to Pittsburgh each week to see his biggest customer. It turns out that he has a ex-girlfriend who also lives in Pittsburgh. Now Sue wonders if Don is really meeting with the customer or the girlfriend.

When she finds out that he is indeed seeing the ex-girlfriend, she hires the best lawyer in Dallas to represent her in the divorce hearings.

Don, who has been charged with minor theft in the past, runs into some old “friends” from the past. These “friends” are going to talk to Sue and adjust her “attitude.” Viewers must tune in tomorrow to see how these matters are resolved.



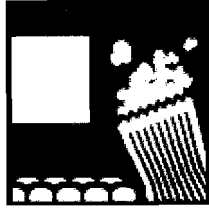
It is easy to laugh at or brush off this example. However, often people do in fact get caught up in the moment. One recent example is actress Renee Zellweger, age 36:

- In January 2005, she met country singer Kenney Chesney, age 37, at the Concert of Hope Tsunami Relief Benefit in California.
- On May 9, 2005 the two married in St. John, Virgin Islands.
- On September 17, 2005, the couple announced they were getting their four-month marriage annulled.

Without judging either Renee or Kenny, it would appear that they got caught up in the moment. How did this happen? I do not know the answer.

Story 2. Fire in a Movie Theater:

A movie theater is usually a rectangular shaped building. Most movie theaters have either four or six exits depending upon the number of seats. The exits are located in the four corners of the rectangle. Sometimes two additional exits are located in the middle of the outside walls.



People who patronize movie theaters state that the experience is:

- Usually enjoyable.
- Affordable.
- Provides an escape from daily life.
- A safe activity.

If people who attend movie theaters were asked why they do so, they would state these reasons – reasons that have not changed much over the last five decades.

Safety experts suggest that when attending a movie theater you should think about how to react in an emergency. The experts suggest that you should decide which exit door (or doors) you would use if a problem occurs. This simple exercise could be a lifesaver.



Occasionally, a news story appears that details the following events:

- A small fire broke out in a movie theater.
- Everyone tried to exit the same door to escape the fire.
- Several people were severely injured when they were trampled.
- Fire officials believe injuries could have been avoided if some people had used any of the other five exits located near them.

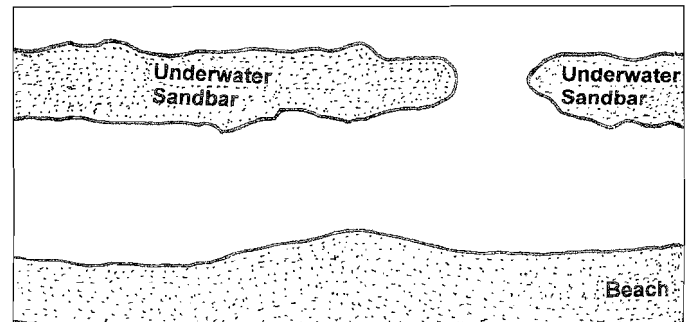
A person's normal reaction is to follow the crowd. In this example, if the patrons simply had taken a minute and thought about "going against the crowd" and walking towards the nearest exit rather than the one everyone else used, they could have exited the theater safely.

Story 3. Rip Tide:

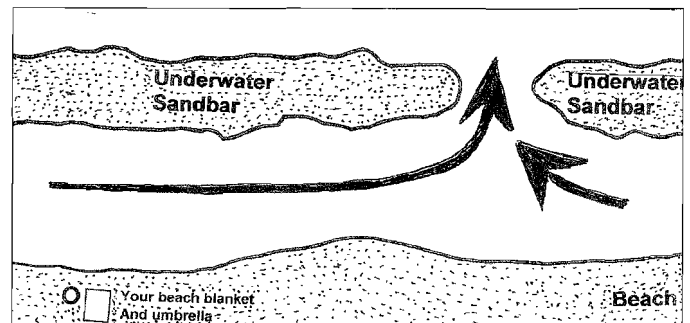
Rip tides are the third event that occurs occasionally. Approximately 150 people die each year because of rip tides. A simple example can explain this event:

- Al and Mary are sunning themselves on the beach.
- Their 12 year old daughter Meg is playing in the surf.
- Suddenly Al and Mary look and see Meg being carried out to sea.

How could this happen? According to Careful Parents.com the following is happening:



At high tide you stand on the beach and look out at the water and that is what you see – water. Under the water, however, are hidden sandbars, and a channel that lets the tide flow in and out. When the tide starts to fall, most of the water will flow out through the channel, like this:

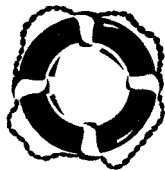


- If Meg happens to be swimming in the water near your beach blanket as the tide is going out, she will get carried to the right along the shore by a powerful current.
- Then she will get pushed out to sea as the water flows through the channel.

- The current in a rip tide like this is moving along at a surprisingly fast clip, and there is no way Meg (or an Olympic swimmer for that matter) is going to be able to swim against it.

If you or your child gets caught in a rip tide, here is what you need to know:

- Floating is the best course of action, especially for a child. There is no way the child can outswim a rip tide once it is pushing through the channel. If your child tries to swim against the current and becomes exhausted, he or she will drown.
- Staying calm is important, but so is yelling. People on shore need to know there is a problem.
- Once through the channel, your child can swim back to shore. In some cases, it is possible to find and stand on the underwater sand bar.
- If you attempt a rescue, make sure you have a flotation device like a life preserver or an inflatable raft with you. You don't want to get out there and become exhausted as well.



It is upsetting to hear that someone has drowned or been injured because of a rip tide. While trying to get to shore is the normal reaction for anyone caught in a rip tide, the swimmer needs to take a moment to think about what is happening rather than simply reacting.

Tembec:

The initial Tembec report was distributed on a limited basis starting on February 21, 2005. The report highlighted the opportunity to invest in Tembec bonds. A brief summary of the report follows.

About Tembec:

Tembec (TBC.TO) is a leading integrated Canadian forest products company, which markets its products in over 50 countries.

Company operations are located in Quebec, Ontario, New Brunswick, Manitoba, and Alberta British Columbia as well as in the U.S., France and Chile. As of September 25, 2004, Tembec employed 10,000 people and had more than 55 manufacturing facilities.

The company has established itself as a world leader in pulping technology and human resources management.

Corporate Mission:

Tembec's corporate mission is to be a low-cost, profitable integrated forest products company converting forest products into competitive and innovative quality products for customers while protecting the environment and creating a positive long-term social, cultural and economic benefit for the region and its people, employees and shareholders. Tembec believes it is "A company of people building their own future."



Operations:

Tembec's operations consist of four reportable business segments:

1. Forest Products,
2. Pulp,
3. Paper/Paperboard, and
4. Chemicals.

The Perfect Storm:

In my August 13, 2005 update, I explained how Tembec is experiencing a "perfect storm."

Historically, the paper and forest products industry is relatively stable. At any point, one portion of the industry is usually performing well and other parts are either stable or are being challenged. The strong and weak performers tend to balance out each other, which provides stability. Currently, Tembec is facing five separate challenges, an almost unheard of situation. Industry participants do not expect the extraordinary conditions to continue.



The five challenges include:

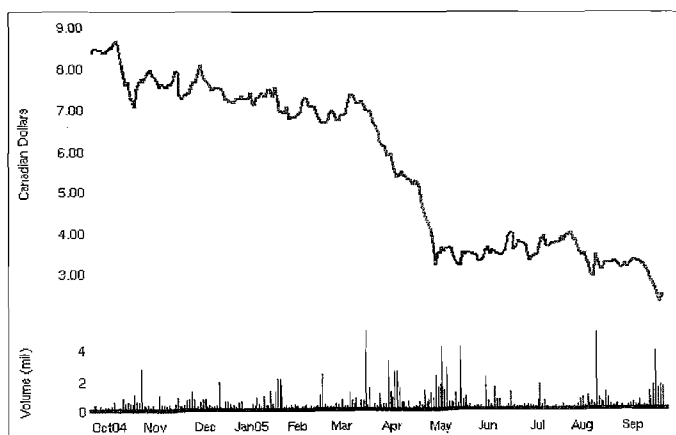
1. Tariffs (duties) on lumber.
2. Moderate prices for pulp.
3. Declining use of newsprint.
4. Weak American currency vs. strong Canadian currency.
5. High energy prices.

Tying It All Together:

The actions in soap operas, fires and rip tides all are examples of extreme events. Many of us will never experience any of these situations. It is reasonable to believe that what is happening with Tembec is also an extreme event and that the company's business will revert to being a calmer, necessity of life enterprise.

Currently, however, investor reaction is anything but calm! Both Tembec stock and bonds are in a free fall. Investors are not thinking – they are simply reacting.

The graph below shows the price of Tembec stock as of September 22, 2005.



Investors are panicking and selling both their stocks and bonds.

When we step back and think for a while, we immediately realize that:

- Lumber, paper and pulp is bought daily.
- Historically the industry was profitable.
- The demand for lumber, paper and pulp will never go away.
- Canada has a geographic advantage because it can transport products cheaper and supply faster than other fiber producers who provide the U.S. with lumber, paper and pulp.
- Tembec has a good management team.
- Extraordinary weather in the U.S. has created the opportunity to sell additional lumber.

Conclusion:

Successful value investing is based on having the time and money necessary to resolve the problems facing an organization:

- It is my opinion that Tembec has both the financial resources and the proper management to weather the perfect storm it is currently experiencing.
- As time passes, I look for Tembec's management team to first stabilize the company and then position it to prosper.

A Bond With An Above Average Yield:

Buying both Tembec bonds and common stock is an attractive opportunity. Please consider the following bond offering:

Tembec currently has a bond available that offers an above-average yield:

Coupon:	8.625%
Due Date:	June 30, 2009
Price Per Bond:	\$730.00
Minimum Purchase:	10 bonds
Yield to Maturity:	19.0%
Yield to June 30, 2007 Call	29.3%

A person who bought 10 bonds could expect the following events to occur:

Date	Interest Payments	Events If Bonds Are Called On 6-30-07
12-30-05	\$431.25	\$431.25
06-30-06	\$431.25	\$431.25
12-30-06	\$431.25	\$431.25
06-30-07	\$431.25	<u>\$431.25</u>
12-30-07	\$431.25	\$1,725.00
06-30-08	\$431.25	
12-30-08	\$431.25	
06-30-09	<u>\$431.25</u>	
Total	\$3,450.00	

On June 30, 2009, an investor would receive \$10,000 plus the eight interest payments of \$3,450 for a total of \$13,450 from the original investment of \$7,300. There is an excellent chance that Tembec will refinance its debt before the bonds mature. The best time for the company to do this is June 30, 2007. If Tembec were to redeem the bonds on that date, the original \$10,000 would be returned at that time. If this happens the investor will receive \$11,725 for their investment of \$7,300.

I will provide an update on Tembec when the fourth quarter and fiscal 2005 results are released in November 2005.

I hope this newsletter describing market psychology has helped you understand the current market conditions. I encourage you to call if you have any questions or concerns.



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