

# Invest

## 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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In the October 1, 2005 edition of *Invest*, I explained that I believed 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 spend time discussing investing in story stocks.

### Basic Theory of Investing:

Investing is saving today with the goal of getting a larger sum back in the future. Part of investing is finding desirable stocks in which to put money.



Desirable stocks tend to trade on the New York Stock Exchange (NYSE): Stocks that trade on the NYSE often have high levels of liquidity. This simply means that there is a lot of daily buying and selling so an individual investor's trading activity can be easily absorbed.

### Rules of Investing:

Over a period of time I have learned several rules of investing:

**Rule #1 – Invest in companies where there is a constant need or desire for the product or service.** Consumer nondurables are one category that fits this requirement. Consumer nondurables are items that we buy and use up; then we must buy them again. Examples include soft drinks, food and laundry detergents. Nondurables have universal appeal. This is, every adult in the whole world is a potential customer.

**Rule #2 – Invest in companies that either raise their prices or sell more units.** One of the rules of profit is that whenever a company can raise its prices, most of the increase goes to the bottom line, “profits.” Whenever a company lowers the price of its goods or services, most of this price decrease comes off the bottom line.



**Rule #3 – Invest in companies that earn an above-average return on equity (ROE).** These companies have what are called *franchise qualities*, which allow them to charge a premium for their product or service.

**Rule #4 – Invest in companies that have not had a loss in the last 10 years or longer.** By investing only in successful companies, investors can say “no” to a lot of questionable stocks. We all work hard for the money that we earn or that we have saved. The challenge is to hang onto it.

**Rule #5 – Invest in companies that have paid a dividend for at least the last 20 years and, if possible, invest in companies that have raised the dividend over the last five years.** Regular and rising dividends show us that a company is committed to rewarding its shareholders.

**Rule #6 – Invest in companies that are one of the leaders in their market.** If the number 1, 2 or 3 company in an industry stumbles, it can usually overcome any temporary obstacles because of its size and prominence.



I believe that you will agree that all the rules make sense. There are obstacles, however, that challenge an investor following the rules. As I noted earlier, I believe that the U.S. stock market is

over-valued and the results produced over the last 18 months suggest that this is, in fact, true. The results are underwhelming.

Comparison of 2005 and 2006 Returns

Returns	Dow Jones	S&P 500	NASDAQ
2005	(0.6%)	3.0%	1.4%
2006 <sup>1</sup>	4.8%	2.6%	(0.7%)

1. Through 07/03/06.

In spite of difficult market conditions, it is still possible for individuals to generate satisfactory

results if they are invested in the right stocks.

**Story Stocks:**

Story stocks are often small public companies that provide a unique product or service. Story stocks often have interesting histories that require a level of effort to both understand and appreciate. Many investors will not spend the time to understand the “story.”

As your broker, I have the ability and experience to find the story stocks.

**Successful Investing:**

Successful investors need to:

**Have Patience:**



*Old Wives’ Tale: “A Watched Pot Never Boils.”*

The companies that you and I are investing in are professionally managed. We must give the managers a chance to do their jobs. Many investors micro-manage their accounts. Often the best solution is to do nothing.

**Watch the Trend – Not the Stock Price:**

Story stocks often have small problems or challenges that must be solved. Understanding the challenges and monitoring the progress resolving them is often more important than the stock price at any given time.

Sometimes the stock price will move sharply higher or lower without any changes positive or negative.

**LFS Story Stocks:**

Lenox Financial Services (LFS) has invested in seven story stocks. A description of each one is presented:

1. Sport-Haley (SPOR)
2. R. G. Barry (DFZ)
3. Emerson Radio Corp. (MSN)
4. Movie Star Inc. (MSI)
5. IOMED (IOX)
6. Tembec (TBC.TO)
7. Delphax Technologies (DLPX)

### Story Stock #1 – Sport-Haley (SPOR):



Sport-Haley designs, sources, markets and distributes men's and women's fashion golf apparel and outerwear under the Sport-Haley, Top-Flite and Ben Hogan labels.

**Reasons to Own the Stock:**

- **Cheap Security:** Statistically one of the cheapest securities listed on a public stock exchange.

- **Executive Stock Ownership:** Ron Norick, Chairman of the SPOR Board of Directors, owns a large position in stock (110,617 shares) purchased with his own money.

Mr Norick wants out, meaning that he would like to sell the company so he can turn his stock into cash at an acceptable price.

- **Underachieving Management:** The company management team is composed of classic underachievers.

- Regular functions such as inventory control and computer software glitches create large problems for management.

Additionally, the Board of Directors has:

- Historically rubber-stamped management's plans.
- Not protected investors more by challenging management's results.
- Is somewhat better under the direction of Chairman Ron Norick.

**Best Short Term Solution:** SPOR has a very strong balance sheet. The assets from the balance sheet could be used to fund a large stock buy back. A stock buyback at \$6.00 or more per share would be a reasonable price to expect.

**The Next Financial Report** is scheduled to be released on approximately September 30, 2006.

### Story Stock #2 - R. G. Barry (DFZ):

R.G. Barry was founded in Columbus, OH in 1947. Products are sold through traditional, promotional and national chain department stores, discount stores, warehouse clubs, specialty retailers and catalogs.



**Reasons to Own the Stock:**

- **Undervalued Stock:** DFZ stock is undervalued in relationship to its peers (see table next column.)
- **New President:** The company has a new seasoned president and CEO. Greg Tunney was hired in February 2006.
- **Sales Growth:** The company is projecting a 5% sales growth for calendar year 2006.

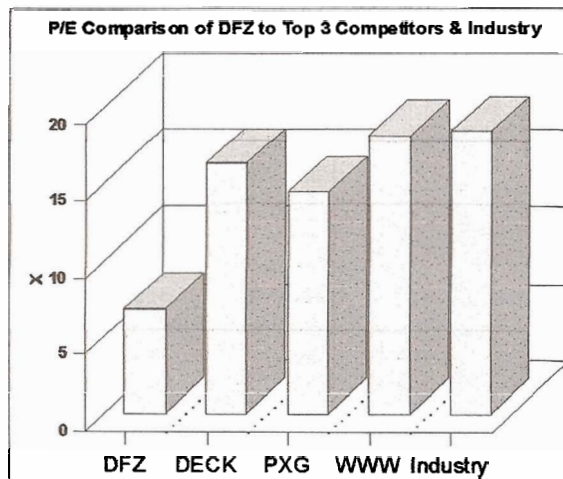
**DFZ Compared to Top 3 Competitors And Industry**

	DFZ	DECK <sup>1</sup>	PXG <sup>2</sup>	WWW <sup>3</sup>	Industry
Market Cap \$M	\$58.35	\$453.96	\$44.67	\$1.39B <sup>4</sup>	\$456.28
Oper Margins	11.01%	20.37%	5.83%	10.91%	9.90%
Net Income \$M	\$8.75	\$28.61	\$3.04	\$78.94	\$22.40
EPS	\$0.869	\$2.230	\$0.370	\$1.376	\$1.05
P/E	6.82X	16.26X	14.43X	18.15X	18.41X

1. Deckers Outdoor Group  
 2. Phoenix Footwear Group, Inc.  
 3. Wolverine Worldwide, Inc.  
 4. B = Billions

DFZ stock is trading at 6.82 times earnings while its competitors are trading at higher levels. At minimum, DFZ should trade at least 10 times earnings, which suggests that the stock could be at \$8.69 per share.

- **High Expectations:** Expectations are high that the stock will appreciate when calendar third



quarter calendar results are released in mid-November 2006.

- **Little Risk:** Very little downside risk.

**The Next Financial Report** is scheduled to be released on approximately August 15, 2006.

**Story Stock #3 – Emerson Radio Corp. (MSN):**

Emerson Radio Corp., founded in 1948, is one of the nation's largest volume consumer electronics distributors with a recognized trademark in continuous use since 1912.



The company designs and internationally markets full lines of video products that include televisions, video cassette recorders (VCRs) and Digital Versatile Disc (DVD) players, audio products, microwave ovens, home theater, high end acoustic products, office products, mobile stereo and wireless products.

Products are primarily distributed through mass merchants, discount retailers, and specialty catalogers and, to a lesser degree, the Internet.

**Reasons to Own the Stock:**

- **New Product Introductions:** iPod compatible products with nice profit margins of approximately 30% in comparison to core products 12% profit.
- **New Strategic Partner:** The Grande Holding Ltd has joined with MSN.
- **Cheap Security:** Historically MSN has traded at 2 times book value. Currently, the stock is trading at only 1.2 times. The table that follows shows MSN's stock price and book value from 1995 through 2006.
- **Little Risk:** Very little downside risk.

*The Next Financial Report* is scheduled to be released on approximately August 15, 2006.

**MSN Stock Prices and Book Value**

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
<b>Stock Price:</b>												
Hi	\$3.38	\$3.75	\$3.00	\$1.06	\$0.69	\$1.00	\$2.94	\$2.00	\$7.94	\$7.88	\$4.10	\$3.98
Lo	\$0.94	\$1.38	\$0.88	\$0.38	\$0.25	\$0.44	\$0.63	\$1.00	\$1.05	\$2.47	\$2.56	\$2.28
<b>Book Value:</b>												
Book value/ share	\$1.33	\$1.00	\$0.40	\$0.27	\$0.21	\$0.27	\$0.48	\$1.11	\$1.87	\$1.77	\$1.97	\$2.59
2X Book Value	\$2.66	\$2.00	\$0.80	\$0.54	\$0.42	\$0.54	\$0.96	\$2.22	\$3.74	\$3.54	\$3.94	\$5.18

**Story Stock #4 – Movie Star Inc. (MSI):**



MSI is a New York corporation organized in 1935. It designs, manufacturers, markets and sells an extensive line of ladies' intimate apparel, which includes sleepwear,

leisurewear, robes, loungewear, panties and daywear.

It is interesting to note that women's intimate apparel is fashion-driven. A large portion of MSI's sales is to Wal-Mart and are based on fashion, not quality. MSI's sales to Wal-Mart can change up or down in dramatic fashion.

**Sales to Wal-Mart**

(In \$Millions)

Fiscal Year	Total Sales	% of Total Sales to Wal-Mart	Sales to Wal-Mart
1996	\$84.1	X 5%	= \$ 4.2
1997	\$61.5	X 17%	= \$10.5
1998	\$53.9	X 14%	= \$ 7.5
1999	\$63.0	X 25%	= \$15.8
2000	\$62.7	X 21%	= \$13.2
2001	\$62.6	X 27%	= \$16.9
2002	\$54.4	X 32%	= \$17.4
2003	\$64.9	X 42%	= \$27.3
2004	\$53.7	X 38%	= \$20.4
2005	\$58.5	X 20%	= \$11.7

**Reasons to Own the Stock:**

- **Increase in Sales:** Based on a financial report filed on July 6, 2006, it would appear that MSI sales are going to increase substantially in fiscal 2007.

**MSI, continued:**

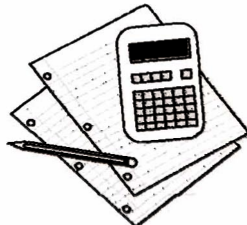
• **Strong Management Team:**

MSI's management team consists of Melvyn Knight, age 60; Saul Pomerantz, CPA, age 54; and Thomas Rende, age 42.



**Melvyn Knight:** He has spent most of his adult life working in the intimate apparel industry. He joined MSI in 1987. On 02-05-97, he was promoted to Sr. VP and Chief Operating Officer. In February 1999 he was appointed C.E.O. and to the Board of Directors. On 11-19-02, he was re-elected to both positions. He was appointed Interim Chairman of the Board 02-18-04.

**Saul Pomerantz, CPA:** Hired in 1981 as the VP – Finance, he became Chief Financial Officer in 1982. He held that position until February 1999 when he was appointed Chief Operating Officer. He was re-elected to that position and to the Board of Directors on 11-19-02.



**Thomas Rende:** Hired in 1989, he held various positions within the finance department. He was appointed Chief Financial Officer in February 1999 and was re-elected to that position and to the Board of Directors on 11-19-02.

- **Strong Relationship to Wal-Mart and Sears:** MSI has a strong relationship with both Wal-Mart and Sears. This on-going relationship continues to expand. Sales to Wal-mart have more than doubled over the last 5 years.
- **Sourcing:** MSI has the ability to source products throughout the world. The company continues to seek low cost suppliers for their merchandise.
- **Ability to Change:** MSI's management has shown the ability to change as the company continuously reinvents itself. Some recent examples include opening a sourcing office in the Dominican Republic and a licensing agreement with Maidenform.
- **Strong Balance Sheet:** MSI has an extremely strong Balance Sheet, which provides the financial flexibility to enable the company's

future growth. MSI's management is open to making an acquisition or pursuing additional licensing agreements.

**Positive Developments:**

- **Inventory Needs:** To support its inventory needs, MSI borrows money from its bank to buy merchandise.
- **Line of Credit:** A financial report filed on July 6, 2006 indicates that the company is going to increase its line of credit from \$20 million to \$30 million. The reason MSI would increase its line of credit would be to buy more inventory to support new customer orders.
- **Higher Sales:** Higher sales should lead to higher profits.

**The Next Financial Report** is scheduled to be released in late August, 2006.

**Story Stock #5 – IOMED (IOX):**

IOX pioneered the commercial introduction of treating acute inflammation in 1979. More than 24 million patients have been treated since 1990. The active trans-dermal drug delivery system has been accepted in the rehabilitation marketplace because of ease of use, non-invasiveness, recognized efficiency, and lack of side effects.

**How the Patch Works:** When a person injures her elbow, perhaps playing tennis, the first thing she usually does is make an appointment with her primary care physician.

The physician will examine the elbow and prescribe rest, icing and oral pain medication. A follow-up visit is usually scheduled. If the elbow isn't significantly improved, the physician will write a prescription and refer the tennis player to a physical therapist.



When the physical therapist checks the elbow, he will explain the five common methods used to treat elbow pain and that the methods may be used singly or concurrently. The options include:

- Icing.
- Stretching and exercise.
- Light therapy.
- Electric stimulation.
- Iontophoresis.

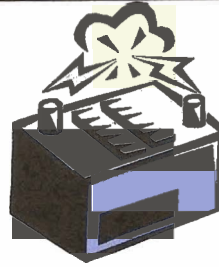
**IOX, continued:**

Treatment varies from person to person. In this case the physical therapist decides to use iontophoresis, which is when IOMED's products come into use.

The therapist will fill a syringe with a cortis-teroid, a drug considered to be a potent and effective way to treat local inflammatory conditions.

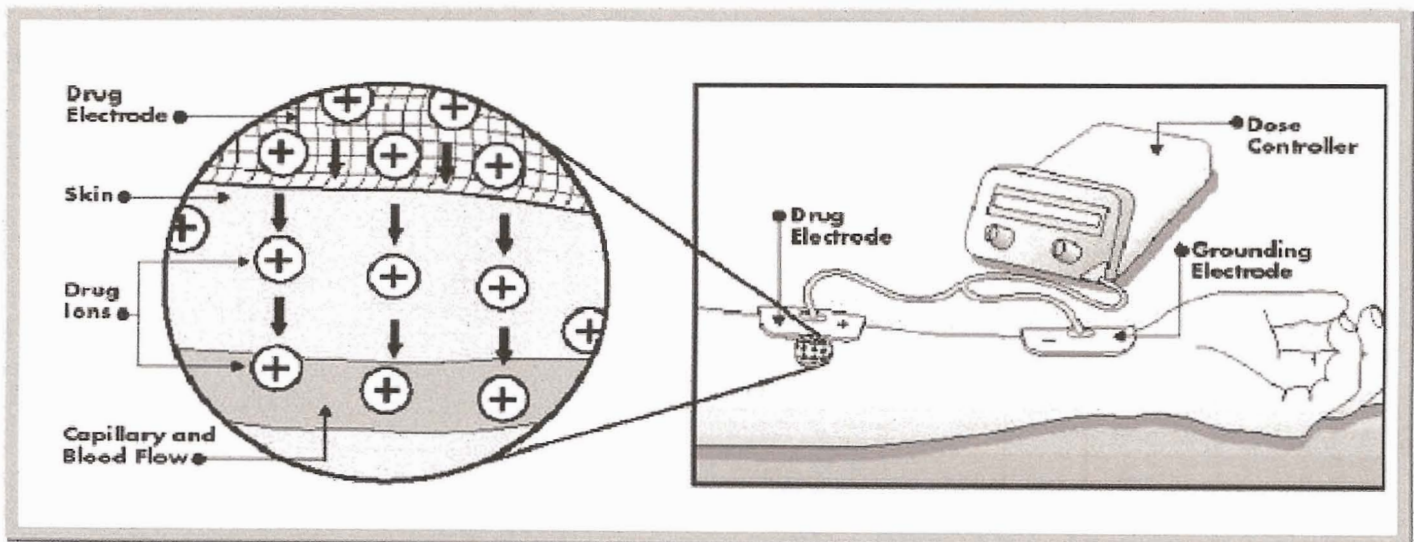
One of IOMED's disposable patches will be injected with the medicine and the patch placed on the elbow injury. A pair of electrical leads would then be placed near the elbow and another on the forearm.

The leads would be connected to a controller to complete an electrical circuit. The controller, which contains batteries, is turned on. The medicine is transferred electrically from the patch through the skin to the inflamed elbow (see illustration.)

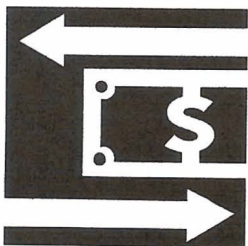


When an electric current with the same positive or negative charge as the drug is applied to the drug electrode, the drug is repelled from the electrode in the same way as like poles of two magnets repel each other:

- The amount of the drug delivered is proportional to the total electrical charge applied (which is a function of time and current). It is possible, therefore, to program the system's electrical current levels to control the desired drug dose, delivery rate and pattern of delivery more precisely.
- The process takes about 20 minutes depending upon how much medicine is required.
- Depending upon how severe the injury is, John would receive up to six treatments, which are usually prescribed a day apart.



**A Nice Business:**



A physical therapist would charge approximately \$50 to \$60 for a 20-minute treatment. Following is a list of costs:

It costs IOX about \$2.55 to make a patch.

- IOX sells the patches to distributors for approximately \$6.37.
- The distributor then re-sells the patches to physical therapists for approximately \$7.50.

**IOX, continued:**

**Reasons to Buy Stock:**

- **Healthcare** is a highly desirable business.
- **Balance Sheet:** Excellent.
- **Motivated Investor:** Ridgestone Capital owns 19.6% of the outstanding stock. Ridgestone wants and expects to earn a return on their investment.

In late May 2006, D. Stephen Antion from Ridgestone was added to IOX's Board of Directors.

**The Next Financial Report** is scheduled to be released in late August 2006.

**Story Stock #6 – Tembec (TBC.TO)**

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.

**Reasons to Buy Stock:**

It is important to focus on two fundamental issues that justify an investment in the forest products industry:

- **Longevity:** The Canadian forest products industry is not going away.
- **Salable Products:** Tembec should be able to make money selling lumber, pulp and paper.

**Challenges:**

Three events have taken a rather stable company and turned it into an organization that is on life support. I have explained in previous updates that the events are extraordinary and, in my opinion, will not last long-term. Tembec's management is adjusting company business the best they can to contend with these events.

1. **Lumber duties:** Tembec does a lot of business with the U.S. and is required to pay substantial countervailing and anti-dumping duties.
2. **Currency:** The devaluation of the U.S. dollar when compared to the Canadian dollar, an external event, has resulted in increased costs for Tembec.
3. **Higher energy prices:** Energy prices have increased greatly throughout the world. Companies like Tembec that harvest lumber and manufacture a product have been more affected than others. This event has a profound effect on every segment of the company.



**Best Short Term Solution:**

- **Progress:** Progress has been made resolving the lumber duties debate. The participants in the debate are strong-willed. Even if the debate continues, lumber duty money represents an asset that can be monetized.

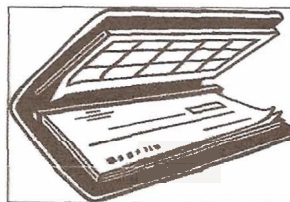
**Asset Class:** It is important to remember that every asset class has its day in the sun. Currently, oil assets are a hot category. At some point, another asset class will shine. If oil prices decline, the Canadian lumber stocks, including Tembec, will recover quickly.

In the recent past, other hot categories have included:

- Beanie Babies.
- Barbie Dolls.
- Baseball Cards.
- The NASDAQ stock market.

**The Next Financial Report** is scheduled to be released in mid-November 2006.

**Story Stock #7 – Delphax Technologies (DLPX)**



Formed in 1981, Delphax Technologies Inc. designs, manufactures, sells and services advanced digital printing production equipment based on its patented electron beam imaging (EBI) technology. The majority of the DLPX's sales derives from the sales of maintenance, spare parts and supplies that are used with company equipment.

**DLPX, continued:**

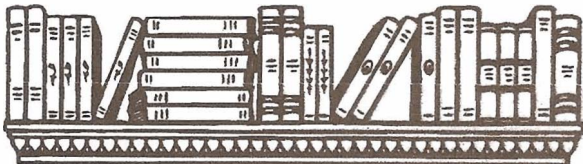


Delphax brand printing equipment provides customers with the capability to personalize, encode, print and collate documents for publishing, direct mail, legal, financial, security, forms and other commercial printing applications.

The first digital printing system for the production of checks and other financial documents, the Model 2000 *Checktronic* was shipped in 1983.

**Reasons to Buy Stock:**

- **A "better mousetrap:"** The company has built a better mousetrap. Customers will buy the equipment because it offers significant labor savings.
- **Two Year Payback:** Customers can pay for the machine in two years with the labor savings.
- **Digital Conversion:** The printing industry still uses analog technology. It is just a matter of time before the industry converts to digital.
- **Little Risk:** Very little downside risk.
- **Impressed R. R. Donnelly Co.:** In April 2006, DLPX sold one press to R.R. Donnelly & Sons Company. Donnelly is the world's premier full service provider of printed materials and related services. The company generated \$8.4 billion in revenue in 2005.



Donnelly was so impressed with DLPX's equipment that it issued a special press release. It would seem that the opportunity is available to sell Donnelly more equipment in the future.

- **New VP:** The company hired a new Sales and Marketing Vice President named George Carranza. He brings over 20 years of industry experience to DLPX.

**Challenges:**

- **Expensive Equipment:** The printing press is relatively expensive - \$750,000 to \$1 million.

**Best Short Term Solution:**

- **Labor Savings:** By stressing the labor savings and two year return, the cost of the equipment can be justified to buyers.

**The Next Financial Report** is scheduled to be released in early August 2006.



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