



# OAK VALUE CAPITAL MANAGEMENT, INC.

Portfolio Commentary – Second Quarter 2007

## Worry – “to torment oneself with disturbing thoughts”

-Webster’s

There is an old adage in the stock market that rising stock prices climb a “wall of worry.” Such was certainly the case in the second quarter of this calendar year as the S&P 500 Index advanced more than 6 percent in the face of a long list of such worries. Foremost among these worries were a slowing US economy, a slowing housing market, a shakeout in the sub-prime mortgage market, continued concern over the risk of terrorism, high energy prices, and the risk of inflation resulting from increased commodity prices.

While never completely immune to the indirect impact of these and other “worries” that may be present in the market at any given point in time, the collection of businesses in which we have invested on behalf of our clients performed particularly well during the quarter. The portfolios we manage for clients handily outperformed the broader market averages, generally posting returns in excess of 8 percent for the quarter (net of fees). We attribute this outperformance (as well as that of the last year) largely to the disciplined focus on buying higher quality, sustainably advantaged businesses where the risks we assume are more than appropriately reflected in the prices that we have paid. Our task is not that of completely eliminating risk or uncertainty. Alternatively, we believe that our charge is to identify, understand and price risk and to take advantage of that mispricing when we believe the rewards are attractive.

### Recent Purchases

Despite overwhelming advances in health care in the several decades since his defining by Benjamin Graham, Mr. Market has yet to find treatment for his manic-depressive tendency to sell a good business at a disadvantaged price when times are tough and to pay an exorbitant premium for that same business when times are better. His long-term brilliance is often masked by his short-term preoccupation with the *worry of the day*. In the cases of the three new additions to client portfolios during the quarter, we believe his unresolved manic tendencies have severely impacted his decision-making and afforded us some interesting opportunities. These three new holdings are Omnicare, Medtronic and, United Parcel Service (UPS). Each of these companies is a leader in its industry, and, interestingly enough, specializes in delivering critical products and services via complex and highly specialized channels and networks.

2Q 2007 Value Composite Portfolio Activity Summary	
New Positions	Eliminated Positions
Medtronic Omnicare United Parcel Service	Masco Time Warner Tyco International
<b>Note:</b> Not all positions may have been purchased, owned, and/or sold in all client accounts.	

**Omnicare** is this country’s largest provider of pharmaceuticals and related ancillary services to skilled nursing facilities, assisted living facilities, retirement centers, independent living communities and hospices. In total, the company serves institutions with approximately 1.4 million beds in 47 states and Canada. The company’s pharmacies provide a critical service in an industry where timely delivery is paramount. While near-term pricing can be influenced by external factors such as reimbursement regulations, the long-term underlying demand for Omnicare’s services is very predictable. Prescriptions for chronic illness are, by definition, recurring in nature. We believe the company is positioned to benefit from the powerful demographic effect of the aging US population, as the number of elderly persons

requiring long-term care should grow significantly in the next dozen years. This trend suggests that the need for Omnicare's services should continue to experience above average growth potential over that period. The company's competitive advantage is largely defined by its size and scale since it is the industry's largest competitor with more than four times the number of beds served by its nearest competitor. We believe the potential for another competitor to challenge this advantage is limited in that there appears to be a scarcity of remaining large acquisition candidates for other competitors to pursue.

Several "worries" have joined forces in recent periods to create what we believe to be a very attractive investment opportunity. The transition to Medicare Part D, which changed the way that states pay for drugs, (formerly via Medicaid but now through Medicare via private health plans) caused a significant confusion among nursing facilities and private health plans about eligibility, co-payments, and general coverage. The confusion amongst Omnicare's customers as they sorted through this very significant change clearly had a dampening effect on the company's revenue growth. Additionally, the predictability of the company's revenue base was somewhat challenged when it recently received less than favorable treatment in negotiations with one of its largest customers. Finally, service at one of the company's primary drug repackaging facilities was disrupted as a result of a fire at the facility. The "torment" experienced by investors in this company has been painful to say the least, as shares of Omnicare declined by nearly 40 percent over the past 18 months.

**Medtronic** is a global leader in medical technology geared towards pain relief, health restoration, and life extension. While the company's excellent corporate reputation stems primarily from its original core business of manufacturing pacemakers, it has been transformed into a broad and diverse medical company that develops, manufactures, and sells device-based medical therapies in more than 120 countries around the world. Medtronic currently enjoys nearly 75% gross margins on its product portfolio, which translates into operating profit margins of more than 30%. In our view, these outstanding economics are driven by six different operating platforms: Cardiac Rhythm Disease Management; Spinal and Navigation; Neurological; Vascular; Diabetes; and Ear Nose & Throat. We believe that Medtronic has a sustainable advantage in many markets and that the company's above-average revenue growth and visibility, its operating leverage, and strong balance sheet will enable Medtronic to earn outsized returns for its shareholders in the future.

The company bears many of the hallmarks of an Oak Value-style investment: a broad and diverse product portfolio; market leading positions supported by a rich pipeline; competitive advantages in the product development process; a deep and experienced management team; and high returns on capital. While the company does not necessarily manage its product portfolio for breadth and depth, such is the end result of a portfolio that leverages the strength of its cash-generating larger platforms (core cardiac rhythm management) and reinvests successfully in higher-growth platforms such as spine, neurological, vascular, and diabetes. The company's prospects appear particularly promising, with significant new products in the spine segment and the vascular segment near launch, not to mention the company's new drug-eluting stent technology which should not be far behind. Medtronic's incorporation of the gathering of clinical data to support the approval process into its research and development function illustrates how critical the ability to get to market is in the process of both product creation and value creation.

Management transition at the company has been smooth and we do not anticipate significant change to the company's focus on above-market growth, ROIC (return on invested capital), infrastructure leverage, and shareholder value creation. Finally, we believe the company's high ROIC will continue to get leverage from an improving cost structure. Our view is that the company will continue to expand its margins in the face of pricing pressures and reimbursement challenges, setting itself apart from its competitors.

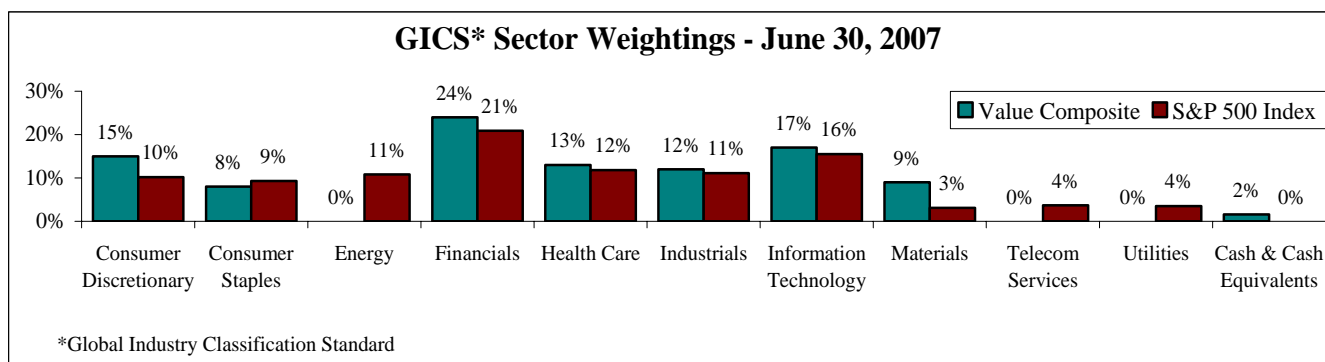
Mr. Market's propensity to *worry about the wrong things* was again demonstrated in the recent period as we were given the opportunity to invest in this good business. We think that the market is

overemphasizing the timing of new product introductions instead of assigning value to the pipeline itself. In candor, we must also acknowledge that the company has also been penalized due to a number of product recalls in the ICD (Implantable Cardiac Defibrillator) industry that have dampened sales. We are inclined to look past these near-term distractions and focus on what we believe is a sustainably advantaged collection of businesses available at an attractive long-term valuation.

**United Parcel Service (“UPS”)**, with its ubiquitous fleet of drivers and brown vehicles, is the largest package delivery company in the world and is one of the leading players in global supply chain management. The company will celebrate its centennial birthday this year by delivering packages every business day for 1.8 million shipping customers to 6.1 million consignees in more than 200 countries and territories around the globe. Last year, the company delivered on average more than 15 million pieces per day worldwide. The company’s supply chain solutions are available in more than 175 countries and territories. Despite the company’s global reach, UPS continues to develop its international network through organic growth, partnerships, and bolt-on acquisitions.

While UPS is the market leader in ground delivery services in the US (63 percent of revenue), the company is becoming an increasingly important player on a global scale, with nearly one-fifth of its revenue coming from international package products and services. Supply chain and freight services now accounts for approximately 18 percent of revenue. The company leverages its integrated platform into a long-term competitive advantage through extensive use of technology that provides its customers with better supply chain management, cost savings, and improved speed to market. We believe, in aggregate, UPS is far and away the most integrated transportation and shipping company in the world.

UPS has been doing this a long time, and its market leadership results in returns on capital of more than 20 percent, which we view as impressive for a company of its size and infrastructure. We believe that the company’s ability to invest its capital at above average rates in an industry where competitors’ returns are markedly lower demonstrates a competitive advantage. Even without major new share buybacks, the company’s prodigious free cash flow, which we expect will exceed \$9 billion a year within four years, provides the company’s solid management team with ample resources to continue to create value for its shareholders. Significant free cash flow generation, high returns on capital, and a pristine balance sheet seem to have been overlooked by a market more “worried” about the potential for a slowing global economy, rising fuel prices and near term operating glitches which have stemmed from recent acquisitions. We believe investors are more than adequately compensated for these worries with a very attractive valuation.



## Recent Sales

The economist John Maynard Keynes is reported to have said “When my information changes, I change my opinion.” To varying degrees, this statement characterizes our decisions to eliminate holdings in three companies in client portfolios during the quarter – Tyco, Time Warner and Masco. Though each of these

businesses remains a good business, the “information” upon which we base our purchase decisions has evolved somewhat as time has passed. “Competition for capital” continues to be a driving force in our daily efforts to manage the collection of businesses in client portfolios. We are more than willing to sell a good business to buy a comparable or better business at a more attractive price. Consequently, we have concluded that the capital allocated to each of these investments would be more prudently allocated elsewhere.

**Tyco** – We eliminated client portfolio positions in shares of Tyco during the quarter. The path of our Tyco investment has been less than ideal as some of its businesses have performed better than we would have anticipated while other segments have been disappointing. The decision to split the company into several individual businesses may well be the right decision for its shareholders in the long term, but it has been far more expensive than management had anticipated. From our perspective, perhaps the most attractive long-term segment of the company is the healthcare business. We have been disappointed in management’s execution in this particular segment and find ourselves faced with other healthcare related investment opportunities that we believe provide more attractive risk/reward opportunities.

**Time Warner** – As the share price of Time Warner had advanced in recent periods, we concluded that the margin of safety provided in this investment had diminished. Our original decision to invest in shares of Time Warner some years ago was based on the premise that the post-AOL dislocation had been largely experienced and that the businesses represented attractive long-term opportunities. The film business has performed reasonably well though it does not demonstrate the long-term sustainability that we require. The company’s cable network business has likewise performed very well. Meanwhile, AOL has once again changed its business model and the magazine business continues to face increasing competition. In a vacuum, a continued investment in this company may well be justifiable, but we continue to face the enviable position of having more and better investment opportunities served up to us by Mr. Market.

**Masco** – In an environment of increased “competition for capital,” the business of Masco just did not make the cut. Our investment thesis in this company was based on the belief that the company’s significant exposure to the remodel business would dampen the impending downturn in the new home construction business. Furthermore, we believed that management’s focus on continuing to rationalize costs and return capital to its shareholders would also help offset the near term challenges the company would face. Now with the benefit of hindsight, our investment thesis was partially confirmed. Management has done an excellent job of managing costs and allocating capital. Our belief has been confirmed that the prices at which we purchased shares provided an appropriate downside protection, though the downturn in new home construction has potentially limited our upside.

Value Composite Top Ten Holdings As of June 30, 2007		
Company	Primary Business	S&P Sector
3M	Manufacturing & Marketing Technology Products/Services	Industrials
American Express	Charge Card, Travel, Network, & Global Payments	Financials
Apollo Group	Education & Training Services	Consumer Discretionary
Berkshire Hathaway	Insurance, Reinsurance & Capital Allocation	Financials
DuPont	Chemicals	Materials
E.W. Scripps	Entertainment & Information/Media	Consumer Discretionary
Fidelity National	Financial Transaction Processing	Information Technology
Oracle	Database, Middleware, & Application Software	Information Technology
Praxair	Industrial Use Atmospheric & Process Gases	Materials
United Technologies	Diversified Manufacturing and Service	Industrials

## ***Update on Largest Holdings...***

**Apollo Group** – Shares of Apollo Group have indeed scaled a wall of worry as the shares have advanced more than 60 percent since original purchases in client portfolios less than a year ago. The list of worries included concern over potentially slowing demand for the company's programs, reduced marketing effectiveness, a stock option re-pricing audit and related SEC investigation and a new chief executive officer. Now just a few months hence, most of these worries have been put to rest and the share price has recovered significantly. Meanwhile, the underlying business remains a very profitable operation that generates high returns on invested capital, prodigious amounts of free cash flow and growth opportunities that continue to unfold. The risk that we assumed in making this investment on behalf of our clients was, in our opinion, more than adequately reflected in the valuation at the time.

**Berkshire Hathaway** – Quarter after quarter we have allocated a portion of these pages to the discussion of Berkshire Hathaway as the company has remained amongst the largest holdings in client portfolios for several years. Throughout this period the intrinsic value of the business has continued to grow, the cash generated has continued to increase and the quality of the overall company has continued to improve in terms of its predictability and sustain-ability. This long-term experience has been an interesting case study in the notion that share prices do not necessarily track changes in intrinsic value on a quarter-by-quarter basis. Berkshire's business model continues to be driven by the ability to source capital at little or no cost and to invest that capital at positive and ideally high rates of return. As the size of the company's cash hoard has continued to mount, the challenge of investing this capital at attractive returns has increased. Though the shares still trade at a significant discount to our estimate of intrinsic value, we believe the company will need to demonstrate substantial progress on the capital allocation side if the valuation gap is to be closed. Still the largest among client portfolio holdings, Berkshire's pro-rata weighting has somewhat declined in recent months as a result of its underperformance and our selective re-allocation of a portion of that capital. Berkshire remains a great business with great management at an attractive valuation. We would expect that its place among our largest holdings is secure for some time.

**Fidelity National Information Services** – Shares of Fidelity National advanced nearly 20 percent during the period as management at this fine company continued to demonstrate its ability to leverage the combined operating platforms and client bases of the two predecessor companies. Our investment thesis for this company is based on the belief that they will further strengthen their domestic foothold in the bank and card processing businesses while expanding an already meaningful international presence. At this writing and based upon recent company reports, we believe this thesis to be intact.

**E. W. Scripps** – Shares of Scripps recovered modestly during the quarter as investors await further signs of the company's progress in their attempt to rationalize costs at the newspaper businesses and refocus the on-line businesses. Recent trends suggest some near term relief may be in the offing. It is very important to note that, in general, our long-term clients have been investors in shares of Scripps for more than a decade, so while we discuss these short-term challenges, we continue to view the company with a very long-term perspective. In that light, we believe this collection of good businesses is very attractively valued at the quarter-end market value.

**3M** – Shares of 3M outperformed broader market averages during the quarter, as the company posted what we believe was a truly outstanding financial performance in the first quarter. Our thesis that the company is in the early stage of a period of renewed revenue growth and profitability amid increasing returns on invested capital appears to be intact. We thought we had a great entry point in the first quarter when the market seemed fixated on near-term fluctuations in certain business segments such as optical films. As it turns out, Mr. Market's propensity to *worry* was particularly expensive (for him) in this case. Though good businesses are not entirely immune to short-term challenges, the flexibility afforded by their superior financial and operating positions typically allow their managers to respond effectively.

## *“We worry too late”*

-Nassim Nicholas Taleb, [The Black Swan](#)

It is human nature to worry about recent events or factors, which are apparent with the benefit of hindsight. An obvious example of this “worry” is the presumption that the shares of a company contain more “risk” after a decline that has been caused by some short-term disappointment or surprise. The ultimate risk that we attempt to guard against is that of a permanent loss of capital. The balancing of potential short-term volatility with the potential for significant long-term appreciation is an essential ingredient in our work. Our pedigree as value investors requires not that we “torment” ourselves with this task, but that we embrace the challenge as potentially ripe with opportunity.

We have often referenced this challenge as sorting the “wheat from the chaff.” The author Taleb further states that *“Sometimes a lot of data can be meaningless; at other times a single piece of information can be very meaningful.”* Our research efforts are keenly tuned to that which we believe to be relevant in the long term though ignored by the general market in the short term. We believe that it is more important to “worry” about that which may happen as opposed to that which has happened and to make sure that we have reflected such in our decisions. It is not necessarily our opinion that all “worry” is useless; we would argue that it is most important that an investor “worry” about the things that are relevant to long-term business models and the valuations thereof. This discipline is not easy. In fact, it is often very difficult and periodically contrary to public sentiment.

Fortunately, we operate with the confidence of a proven set of principles that have withstood the test of time. We believe our philosophical framework of searching out “good businesses with good management at attractive prices” continues to serve our clients and investors well. The recent results only reinforce this confidence, as we remain focused on making good investment decisions.

We thank you for the confidence you have placed in the Oak Value team.

Oak Value Capital Management, Inc. Investment Committee,

*David R. Carr, Jr.    Larry D. Coats, Jr.    Christy L. Phillips*

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A full disclosure presentation for the Value Composite is available upon request by contacting a member of the Marketing Department at Oak Value at (800) 680-4199 or [info@oakvalue.com](mailto:info@oakvalue.com).

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