

WEDGEWOOD VIEW. 2nd QUARTER 2003

WINNING THE LOSER'S GAME

We have good news to report. The stock market (S&P 500 Index) recorded its third best quarter (+15%) in over a dozen years. Tony and I (plus Ms. Dana Webb, CFA – an old hand at the firm, but the newest member of our investment team) are very pleased to report that our full discretion equity portfolios gained nearly 20% during the quarter. Our year-to-date results (as this is being written) are almost double the market's gain to-date. Lastly, over the past twelve months (a period when most investment managers failed to generate positive returns) we posted double-digit returns, which are significantly ahead of the market as well. Our (yours, really) patience has paid off in spades from whence doom and gloom gripped the stock market throughout last year and this spring.

We are also very pleased to report that a growing number of your holdings are posting terrific advances thus far in 2003. Leading our common stock hit parade through the second quarter was **Juniper Networks** (+83%) and **Nextel Communications** (+56%). Other notables so far for this year are **Analog Devices** (+46%), **Home Depot** (+38%), **Amgen** (+36%) and **Intel** (+34%).

There was much news to digest during the quarter. Stock market bulls feasted on much of it. Of significance was the lightning quick regime change in Iraq. Just this past Sunday (7/13) a multiethnic, multireligious Governing Council of Iraqi men and women assumed power. Here at home investors saw the passing of the most significant legislation for investors in common stocks since 1982. Taxes on capital gains and dividends will be the lowest since 1941.

All told the investment environment could hardly be better. The list for the bulls has not been this lengthy for some time. The economy is once again growing. Consumer and capital spending have picked up. Interest rates are at generation lows. Inflation is so low that deflation fears are in vogue. The Federal Reserve continues to prime the money pump. S&P 500 profits are up +10% from a year ago. Oil fell to under \$25 a barrel.

The stock market has done a fine job indeed digesting all of this good news. In fact, we are worried that the market has had more than its fill of good news. At 20X forward earnings we would like nothing better than for the market to pause for a few quarters to digest, so to speak, this feast of bullish news.

Bolstering our current pessimism is the fact that at the portfolio level we currently have a dearth of compelling new stock market ideas. The type of company we prefer to invest in (profit powerhouses) have been universally recognized in the current market environment and have been bid up far above levels at which we would consider buying. In fact if the market continues its heady advance unabated we would assume the position of a net seller in our portfolios. We are undoubtedly “buy and hold” investors, but if the excesses of the late nineties taught investors (yours truly included) anything it is that valuation extremes matter. Buy and hold should never morph into “buy and pray.” Too many sectors (including many of our holdings) have priced in a lot of future good news at today’s valuations.

From our perspective the stock market has become even more bifurcated into corporate have and have-nots. We have written about competitive corporate advantage in the past. Most recently we have discussed the virtues of those companies with balance sheet strength. But we would like to offer another take on so-called balance sheet strength.

The wonders of 40-year low interest rates are obvious to the mortgage refiner, as well as to sustaining higher valuations for the stock market. Less obvious, but critical for corporate profitability and growth, is the effect such low interest rates have had on capital formation. Cheap capital raised during the boom years of the late nineties, including the past twelve months, has served to create too much capital. Capital utilization rates are mired at 25-year lows. Too much capital has created a business environment in which there exist too many companies with decent balance sheets looking for a reasonable business model. The end results are far too many companies without pricing power and with poor profitability and lackluster growth. The corollary is that a rare few companies exist that have truly outstanding and sustainable levels of profitability. Those that do are just not that cheap at current valuations. But like the weather in the Midwest, change usually comes more quickly than one does suspect. We will be ready when valuations make more sense.

In 1988 we penned a piece for prospective client presentations called “Our Investment Philosophy: Winning The Loser’s Game.” We have used this commentary since then, so many of our current clients have seen it. Given the difficulties and volatility in the stock market over the past few years we thought it was time to revisit and update the piece.

Winning the Loser’s Game: An Update

If Benjamin Graham, teacher and mentor to the likes of Sir John Templeton and Warren Buffett, is the dean of modern security analysis (author of the two seminal books *Security Analysis* and *The Intelligent Investor*) and John Bogle, penny-pinching curmudgeon and founder of the Vanguard Group, as well as the conscience of the mutual fund industry, then the less well-known Charles D. Ellis, of the consultant firm Greenwich Associates, is surely the dean and conscience of institutional investors. Charles Ellis’ three decades worth of books, essays, and numerous articles have, at a minimum, provided provocative

critique and commentary at and for the community of institutional investors and, at a maximum, has permanently changed the way many dozens of money management firms manage portfolios, as well as interact with their respective clients.

At Wedgewood Partners, two of Ellis' most significant essays, *The Loser's Game* and *The Paradox*, have been nothing short of guiding forces in the development of our investment philosophy and common stock selection methodology. Given the continued lack of relative performance against major market indices by active money managers, we believe a review of these essays, in conjunction with our own investment management principles, is timely and in order.

In *The Loser's Game*, Ellis chronicles the glaring lack of relative performance of *active* managers versus the well-known, *passive* Standard & Poor's 500 Index. He concludes that due to the continued growth and influence of institutional investment management firms, plus the growing enormity of the mutual fund industry, these firms have "effectively" become the market. Ellis further states:

The institutions are the market.

They cannot, as a group, outperform themselves. In fact, given the cost of active management - fees, commissions, and so forth - most large institutional investors will, over the long-term, under perform the overall market.

Because investing institutions are so numerous and capable and determined to do well for their clients, investment management is not a winner's game. It is a loser's game.

An important aside: Ellis' description of the business of money management as a loser's game is not a direct indictment of common stock investment in general (far from it), or all active money management. However, Ellis does make a strong, if not irrefutable critique (which we wholeheartedly share) of the majority of professional, active money management.

Specifically, Ellis identifies a winner's game when the outcome is determined by the "winning actions of the *winner*." Conversely, the outcome of a loser's game is determined by "the losing *behavior* of the *loser*." Golf and tennis are perfect examples of the "profound distinction" between winning and losing games. In tennis, "professionals *win* points; amateurs *lose* points." Amateur tennis players usually beat *themselves*, but rarely beat their *opponents*. In a like vein, professional golfers, relative to the average hacker, hit *fewer* poor shots. In both professional golf and tennis, less (fewer errors) translates into more (winning). The same can be said for the profession of institutional investing.

The democratization of the stock market has never been as deep and broad-based as it is today. Mutual funds via self-directed 401K retirement plans, full-service and discount brokerage firms, and financial planners and banks, have exposed millions of individual investors to the stock market. However, in a perverse reversal of capital market democratization, due to the popularity of mutual funds (some would say mania) and due to the growing consolidation within the mutual fund industry, combined with the increased numbers of mergers and acquisitions of money management firms with banks and brokerages, the number of ultimate and actual direct decision makers who manage portfolios continues to shrink in proportion to individual investors.

If one doubts that the 50 or so major investing institutions and the few hundred medium-sized firms are in fact the market, consider the following stats from Bogle:

- The mutual fund industry has become a giant. From its 1949 base of \$2 *billion*, fund assets soared to \$6.5 *trillion* at the outset of 2003, a compound growth rate of 16%. If the fund industry had grown at the 7% nominal growth rate of our economy, assets would be just \$72 *billion* today. (Such is the magic of compounding!). The largest 10 mutual fund companies control almost 50% of this amount.
- So too has the number of funds exploded. Those 137(!) mutual funds of yesteryear have soared to today's total of 8,300. More relevantly, the total number of common stock funds has risen from just 75 to 4,800, although it is not at all clear that the *nature* of this increase has created investor benefits, for, in retrospect, "choice" has done investors more harm than good.
- Since the 1970's, the buy and sell decisions of institutions have multiplied threefold from just 30% of total public transactions to almost 90% of such transactions. Today, as much as 50% of the daily trading activity comes from the most hyper short term performance chaser – hedge funds.

A smaller number of professional investors are no longer competing against a relatively larger number of less-informed amateur investors. Armed with mounds of almost instantaneous research and trading capabilities, experts are now competing against equally armed experts - there is no "research missile gap" on Wall Street. The latest performance statistics from Bogle tell us that in a single year, the passive market portfolio is apt to outpace about 60% of all moderate-cost actively managed portfolios. But over 15 years it will outpace some 80% of such active portfolios, over 30 years about 90%, and over 50 years, about 95%.

The pandemic of performance chasing is not the exclusive domain of the so-called investment pros. The investing business is one of the only businesses we can think of where the consumer wants less of the product as prices get cheaper! Far too many investors have unwittingly adopted the anti-Wal-Mart business model for investing. Chasing the hottest returning funds along with far too many funds to choose from has led to truly dismal returns for the typical fund investor.

The following is from a recent Wall Street Journal editorial from Bogle.

This bewildering array of choices among nearly 5,000 equity funds has ill served investors. The returns incurred by the average equity fund investor since 1984 have averaged just 2.7% per year, a shocking shortfall to the 9.3% return earned by the average fund. The result is that the average fund investor has earned less than one-quarter of the stock market's 12.2% annual return. Compounding these annual returns over the 1984-2002 period presents a dramatic picture of the plight of the typical mutual-fund investor: As the chart nearby shows, \$1,000 invested at the outset would have produced a profit of \$7,910 in the stock market itself, a profit of \$4,420 for the average equity fund, and a profit of just \$660 for the average equity-fund investor.

The Paradox

If one accepts the aforementioned conclusion that institutional active money management is indeed a loser's game, the question begs (and each active firm - including ourselves - should answer to themselves and, most importantly, to their clients), "Why not an index fund?" Ellis partially answers this vex in his equally provocative essay, *The Paradox*. Ellis summarizes the paradox as follows:

A paradox is haunting investment management.

The paradox is that funds with very long-term purposes are being managed to meet short-term objectives that may be neither feasible nor important. And they are not being managed to achieve long-term objectives that are both feasible and worthwhile.

In short, too many - if not the vast majority of - equity portfolio managers are transfixed by "trying to beat the market." This seemingly notable, but foolhardy short-term quest has become the great driver in the money management business. The quest for annual outperformance drives compensation, marketing, and dramatically shortens the portfolio manager's investment time frame. Equity investors maintain multiyear, if not decade-long time horizons. Paradoxically, portfolio managers - the investor's agent-performance and job security are increasingly and narrowly measured by just a few years (and in many instances a few quarters). Add, or pile on, other institutional imperatives (read: "losing" biases) such as fund size, style constraints (small-cap, mid-cap, equity-income, etc.), over-crowded portfolios, rapid fire portfolio and portfolio manager turnover and inefficient capital gain taxation, it becomes clear that active money management is an abysmal loser's game.

Our answer to the vex, "Why not index?"

We manage *into* the Paradox and *away* from the Paradox. In other words, we endeavor to turn "institutional imperatives" or "forced errors" into a winner's game.

Our respect for index investing and investing as business owners has led us to two aspects of our approach that are quite different than our competitors.

1. To outperform an index we believe that our portfolios must be constructed as different from an index as possible. In addition, thinking and acting like business owners reduces our interests in those few businesses that are superior. Both of these views lead to our focused (concentrated) approach.
2. To outperform our peers we believe that we must emulate the most powerful attributes of index investing. By definition, index investing is buy and hold investing. This leads us to our history of minimum turnover of our portfolios. As a corollary, this also affects our stock selection. If we expect to invest in companies for many years we must then focus on those select companies with the brightest multi-year prospects for growth. In addition, our view on risk is contrary to the typical manager. We do not view risk via individual security price volatility (beta); rather, all of our risk analysis is centered on the underlying business.

Our collective history of money management with the short theme of less is more - less crowded portfolios, less portfolio turnover, less short-term performance fine-tuning, less trading expense, and less inefficient capital gain taxation has led to better performance over our competitors and (in most years) versus the S&P 500.

Our clients' portfolios are purposefully and most distinctly different from that of the typical institutional portfolio or equity mutual fund in terms of the concentration of holdings and in annual turnover. The average mutual fund holds as many as 125 companies. We concentrate our portfolios in 20 or so unusually profitable companies in just a handful of industries. We believe that if our research effort is focused and thorough enough to derive truly long-term convictions, a beneficial byproduct is the concomitant reduction of company specific risk (though not short-term price and market risk) through the pursuit of superior knowledge of our limited investments.

Once again, Ellis constructively clears the conundrum over the perceived efficacy of portfolio diversification:

Increasing the number of holdings dilutes our knowledge, disperses our research efforts, distracts our attention, and diminishes our determination to act - when really called for - decisively and with dispatch. If you work hard enough and think deeply enough to know all about a very few investments, that knowledge can enable you to make and sustain each of your major investments with confidence. The more you "diversify" by increasing the number of different investments you must understand, the more you risk increasing your not knowing as much about each

investment as do your best competitor investors - particularly the most expert and thus the quickest to take preemptive action.

Only a surprisingly small number of well chosen different positions are needed to provide diversification protection against errors of commission. Usually, this protection can be achieved with fewer than a dozen different positions. After that, increasing the number of different investments in a portfolio increases uncertainty more rapidly than it reduces risk. Moreover, the cost of diversification accelerates geometrically, while the benefit of risk reduction decelerates inversely. So, the cost of “diversification” continues to grow at an increasing rate long after the benefit has virtually stopped rising. That is why surplus “diversification” can do more harm than good.

Ironically, the core problem with widely diversified portfolios is that their expected source of safety becomes, instead, a real source of danger.

Outside of the knee-jerk rollout of a handful of “concentrated” or “focused” funds, the fund industry, due to its sheer size, could never hope to offer such funds on any sizable scale. In fact, a second paradox of institutional investing could well be that as the fund industry grows, actual investment opportunity *diminishes*. According to Andrew Bary of *Barron’s*, out of a potential pool of over 7,000 companies, “a \$1 billion fund can select from 2,644 stocks, assuming that no stock makes up more than 2% of its portfolio and that the fund’s stake doesn’t exceed 10% of the company’s outstanding shares. But for a \$20 billion fund, the universe is just 352 companies. The limits actually are more severe at places like Fidelity, where many big funds share similar holdings.”

In addition, according to Don Phillips of the fund-monitoring firm Morningstar, “Too many managers are taking bows for simply giving investors broad market exposure.” Phillips’ criticism may be harsh, but it contains more than a kernel of truth.

On the turnover front, our annual portfolio turnover has averaged about 10% to 20% over the years. The reciprocal of this measure translates into our holding the average position in our portfolios over five years. The average annual portfolio turnover in mutual funds now exceeds 100%. Our colleagues are not idle people, but are almost frantic in their daily activities. In fact, a recent study of the largest mutual fund firms revealed that the average tenure of a fund manager is just five short years. How’s this for an advertising campaign: *we hold our investments as long as the typical fund manager holds their job*. Maybe not, but you get the drift.

Furthermore, to quote Bogle:

Indeed, between 1950 and 1965, it was a rare year when fund portfolio turnover much exceeded 16%, meaning that the average fund held its average stock for an average of about six years. But turnover then rose steadily and surely and fund managers now turn their portfolios over at an astonishing average annual rate of 110%(!). Result: Compared to that earlier six-year standard that prevailed for so long, the average stock is now held for just eleven months. “The contrast is stunning. At 16% turnover, a \$1 billion fund sells \$160 million of stocks in a given year and then reinvests the \$160 million in other stocks, \$320 million in all. At 110%, a \$1 billion fund sells and then buys a total of \$2.2 billion of stocks each year—nearly seven times as much. Even with lower unit transaction costs, it's hard to imagine that such turnover levels aren't a major drain on shareholder assets.

Net-net, the better investment management firms realize that successfully achieving their clients' long-term investment goals while delivering actual results in excess of the majority of the competition (market indices included) need not be mutually exclusive.

The implementation of our firm's investment management principles over a time horizon - measured in multiple years, not a series of single calendar years - is of a similar time horizon matched by our clients' multiyear investment objective. Furthermore, we believe that this duality and similarity of time horizons gives us a significant and distinct advantage over our competition.

As usual, John Bogle of Vanguard got it right when he was recently quoted on the current state of the investment industry. “This is a great industry, but it could be a whole lot greater.”

David A. Rolfe, CFA
Chief Investment Officer

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