

WEDGEWOOD VIEW. 2nd QUARTER 2005

IN SEARCH OF GROWTH

All intelligent investing is value investing – to acquire more than you are paying for.

Charlie Munger

Vice-Chairman, Berkshire Hathaway

Value and Growth are two sides of the same investment coin.

Warren Buffett

Chairman, Berkshire Hathaway

At Wedgewood Partners, we are Growth (capital “G”) investors. In the most simplistic sense, we invest in growing companies. Furthermore, we expect such companies to grow at relatively rapid rates. Our philosophical counterparts are Value (capital “V”) investors. Again, simplistically stated, value investors invest in companies where corporate growth has been either disappointing or expectations of growth are believed to be too low (often both).

Investment philosophies are often born of personality, but seasoned and tempered by experience – usually harsh experience at that. Growth investors tend to be an optimistic lot. Value investors are apt to be of the pessimistic sort. There are more than enough investment managers within each of these philosophical extremes to prove that each respective investment discipline has merit. In our view, however, it is not one’s philosophical conviction which leads to superior investment performance, but it is the recognition and understanding of the inherent weaknesses in any single investment philosophy that are the key to outperformance.

Once again, at the risk of oversimplifying (but perhaps not), Growth investors too often assume that growing corporations will continue to grow at high rates. Reversion-to-the-mean is an all too powerful reality in investing and this phenomenon usually confounds the most optimistic Growth investor. Furthermore, all too often, Growth investors overpay for expected corporate growth. This matter of corporate growth, specifically *sustainable* growth, is always at the forefront of our minds.

We would like to share with you a provocative (if not sobering) research report from Bernstein Investment Research and Management. Bernstein (C. Toub) examined companies within the S&P 500 Index from 1990 through 2003. Among the questions examined were: How many companies sustained 25% annual earnings growth over the entire period of study, plus how many sustained 10%? Intuitively, most investors would likely realize that sustaining 25% earnings growth over just a few years is quite an accomplishment. Yet, we were still surprised by Toub's findings.

Starting in year one of the examination (1991), 87 companies in the S&P 500 Index reported at least 25% earnings growth. (1991 was a very good year – post recession – for corporate earnings.) By year five, the list of 25% growers had fallen to 12. By year eight, only two cleared the 25% hurdle. Over the remaining five years of the study (1999-2003), not a single corporation could sustain such a rapid rate of growth.

(An aside: At \$300 per share, Google investors (speculators? cheerleaders?) should understand that the embedded growth rate of operating earnings, at current valuations, is in excess of 20% for the next 15 years. Google may well be one of the greatest growth companies of all-time. At current valuations, it had better be for the bulls on the company.)

The 10% growth hurdle was challenging as well. In year one, 145 companies grew earnings over the previous year by 10%. Surprisingly, as early as year five, only 22 companies still made the cut. By year 10, only three survived. By the last year of the examination, just a single company made the 10% sustainable grade.

Bernstein defined “growth” in very specific quantitative terms in their study – namely earnings per share growth. At Wedgewood, our definition of “growth” is more varied. At the end of the day, we are trying to single out those very few exceptional companies by utilizing numerous quantitative and qualitative metrics and measures. Here are a few examples from our current portfolio:

Amgen: Gross margins +80%. Net profit margins averaging 27% over the past five years. Free cash flow + 20% of sales.

Berkshire Hathaway: +\$200 million in cash flow generated weekly. 37% return on net tangible assets. \$45 billion in zero cost float.

Commerce Bancshares: 39% 5-year annual deposit growth rate. Average branch pre-tax net income margin 98%.

Countrywide Financial: All organic growth. #1 market share both mortgage origination and mortgage servicing.

Comcast: Six-year monthly revenue per basic subscriber \$42 to \$77. Expected 5-year compound cash flow growth 25%.

Gentex: General Motors supplier of the year eighth consecutive years. Operating profit and free cash flow 20% of sales. 78% market share. Only 18% of autos produced annually have installed interior self-dimming mirrors.

Home Depot: Non-cash return on capital 27%. Over past four years 55% of accumulated earnings returned to shareholders.

Legg Mason: Assets under management revenues have increased 59 out of last 60 quarters. Assets under management have increased 54 out of last 55 quarters.

Linear Technology: Gross Margin 80%. Net margin 42%. Non-cash return on equity 215%. Return on operating assets 99%. 77 consecutive quarters with positive cash flow from operations.

SLM Corp.: Positive earnings every year since firm inception in 1972. Fee-based income covers +90% of operating expenses. Low interest rate risk and credit profile allows for prudent leveraging of balance sheet: 5-year average return on equity 55%.

Since the power of reversion-to-the-mean is typically a headwind for growth investors, after 5-plus years of dismal relative performance versus value investors, growth investors have been rooting for reversion-to-the-mean to kick in against value investors like never before. Growth investors have been out in the relative performance wilderness since their last glory days in the mid to late 1990's. When recalling the Valhalla years of 1995 through 1999, growth investors weep remembering that special time and place when the Russell 1000 Growth Index outperformed the Russell 1000 Value index by nearly 1000 basis points per year (actually, five-year compounded 32.4% versus 23.1%).

In early 2000, reversion-to-the-mean kicked in for value investors as never before. Over the past five years, the Russell 1000 Value Index has outperformed the Russell 1000 Growth Index by a stunning 1400 basis points per year (five-year compounded 5.3% versus -9.3%). A recent white paper study by GMO (Grantham, Mayo, Van Otterloo Inc.) found that over the past 26 years, more than 100% of the outperformance of the Russell 1000 Value Index versus the Russell 1000 Growth Index has occurred in just the last five years. Furthermore, on a current price/earnings valuation basis, GMO calculated that value stocks are currently in their 10% most expensive range – a valuation range which historically underperformed growth stocks by 600 basis points per year over the following three years. Worse still, on a price/sales basis, GMO calculates that value stocks are at their most expensive range in 26 years.

As powerful as GMO's findings are for the prospect of growth stocks outperforming value stocks in the years ahead, GMO reached another conclusion regarding a subset of growth

stocks. GMO singled out higher quality growth stocks. They define higher quality as the companies that exhibit higher and more stable levels of profitability and lower debt on their respective balance sheets. As we mentioned earlier, such stocks are the foundation of our investment philosophy and process at Wedgewood Partners. In addition, they observed that higher quality growth stocks:

“... have significantly lower volatility and beta than growth stocks. High quality stocks have actually outperformed the market in the long run, despite the fact that they are, on average, ‘growth.’ They have also outperformed in bear markets, doing at least as well as value stocks have.”

We are pleased to report that GMO’s four findings above square nicely with the experience and history of our portfolio and performance.

Lastly, GMO observed that:

“While the opportunity in high quality stocks is not as extreme as it was for value stocks in 2000, high quality stocks are trading cheaper, relative to the market, than we have ever seen them.”

We agree with GMO.

David A. Rolfe, CFA
Chief Investment Officer

Dana L. Webb, CFA
Senior Portfolio Manager

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