ADDING VALUE

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SUMMARY:

There is no simple rule of investing. However, there are three elements that must be present to have a chance at being successful. These include:

First, it is necessary to think in advance of what you are trying to do and why.

Second, it takes discipline, experience, and back-breaking hard work to execute the strategy. Everyone makes mistakes; even the most successful manager is only correct 70% of the time.

Third, we must be aware of the changes in the world around us so that we can make adjustments to the strategy as needed. We must remember that we are forecasting the unknown and sometimes the unknowable.

Adding Value is mailed quarterly to our clients and friends. The intent of this publication is to share some of our more interesting views and research with our cli-

Investment Review and Outlook: Investing is simple, but is it easy?

There are many possible approaches to investing. Some of the greatest minds in the investment world both past and present have earned their reputation as either growth investors, value investors, international investors, etc.; any or all of these strategies can lead to long-term success. Anything works if you are passionate about your vocation.

There is, however, only one absolute truth about investing.

Warren Buffett in <u>Lessons for Corporate America</u> puts it this way: “Investment success will not be produced by arcane formulae, investment committees, computer programs, or signals flashed by the price behavior of stocks. Rather an investor will succeed by coupling good business judgment with an ability to insulate his thoughts and behavior from the super-contagious emotions that swirl about the marketplace.”

Robert R. Barker, a lesser known but successful growth investor, reports from years of experience: “Long-term success comes not from any simple rule or rules that can be followed by everyone, but only from the most rigorous pursuit of disciplines designed to neutralize the emotional pressures that inevitably descend from time to time upon anyone who is responsible for investing other people’s money.”

Finally, F. J. Chu, a professional investor, philosopher, and aphorist states in his book <u>The Mind of the Market: Spiritual Lessons for the Active Investor</u>: “Successful investing, even under the most favorable conditions, requires equal parts hard work, diligence, patience, and luck.”

If these are the simple truths of investing, why are so many people unsuccessful?

Personality/Organizational Culture

Culture: The set of shared beliefs and practices that define an organization's way of life. Culture provides the mental map that guides individuals of the organization through their jobs.

Superior investors, from our observations, tend to be different, perhaps deriving from the fact that the essence of the game is to <u>oppose</u> the crowd. Personality theory may help to explain why this is so. Freud and many others have described personality terms such as the internalizer and the externalizer. The internalizer likes to think, analyze, and organize concepts. Satisfaction derives from identifying an undervalued stock, buying before the crowd does, and watching the market confirm the theses of the stock purchase. The single focus of superior investors is on investing, not on running an investment business.

On the other hand, the externalizer needs to interact with people and to operate in the outside world. This person is constantly sensing the feelings of the people around him and taking pains not to offend. Bad manners are original ideas and client confrontation. The externalizer cares about people and derives satisfaction from long-term relationships. Organizations whose sole aim is to increase assets under management will most likely not be the generators of unique investment ideas. The single focus of these organizations is on running and growing the business, not on investing.

The characteristics of both the internalizer and the externalizer are necessary to an investment business. The mistake arises when the externalizer capitulates to the client desires (in their effort to please) although it may be more appropriate to take a firm investment stand and possibly, lose the business.

Investors who rely on advisors for investment assistance should closely examine the culture of the organization that is providing the service.

Data versus information

Information: Knowledge obtained from investigation, study, or instruction.

Data are our industry's raw material. Our challenge is to add value by transforming data into meaningful and actionable information. The precise measurement or calculation of a thing is profoundly different from the interpretation, significance, and meaning of that thing. Meaning is important, not measurement per se. We often confuse the two because measurement appears to be precise, objective, and simple (it is not any of those) whereas meaning appears to be vague (or at least flexible), subjective, and complex (it is all of these.)

Over quantification and complexity will only increase as we charge into the information age. We are literally drowning in an ocean of data, analyses, prognostications, and commentary. We have heard repeatedly, and seen poignantly in the current Iraq War, that the telecommunications age is upon us. Today we can watch CNN and follow a missile launch from the order to deploy to the actual strike. We can visit any of the Internet sites and see the actual street where the missiles have exploded. Similarly, we can use our same computer from our office to hear a live recording of a CEO's presentation of financial results. Thanks to Regulation FD (Fair Disclosure), we have <u>identical</u> access to information that any other analyst does anywhere in the world. But more importantly, this dispensation of financial "data" is one of the greatest growth industries of the post-industrial age. As stated by Chu: "Market gurus often claim to be predicting the future when they are doing little more than describing the present, forever prophesizing a tomorrow that might be or is already here… and yet… the market is still as unpredictable, volatile, and paradoxical as it has always been."

We will all have to learn new ways of developing and managing processes for transforming complex data into meaning and action, ways of turning raw input of data into value-added output of meaning. Data are the commodities, easily and cheaply produced. Our task is to transform them into meaningful and actionable information. Effective transformation may require new approaches such as the use of analogies and metaphors, an awareness of the importance of human and social psychology, and a contrarian style that forever tries to falsify.

Investors who rely on the financial institutions for investment assistance should closely examine whether the data presented are the commodities of "group think" or have been transformed by some significant overlay of human judgment.

Conventionality

Conventionality: An adherence to conventions.

Our professional and educational backgrounds allow us to work as either consultants to institutional investors or with individuals. Over the years, we have found some very distinctive similarities and differences between the two investment audiences. Both involve analytics and quantitative theories and are intellectually challenging. However, on the institutional side, there is a great deal of emphasis on quartile rankings, relative performance, and committee structures. Portfolio values can always be replenished by the sponsoring institution or by additional fund raising. For the most part, committees would rather be wrong with conventional thought, than right with unconventional thinking as they make the investment decisions. O'Barr and Conley, who completed an anthropological study of the world of institutional investing, have this to say: "The decision-making is so complex that it would be impossible for the management of the fund or its sponsor to assign credit for a major success or affix blame for a major failure."

On the individual side, there is much more emphasis on absolute returns. Portfolio values cannot be replenished easily. While it is possible to hide in the relative anonymity of the masses, at some point managers have to look you in the eye and explain the results in terms that are understandable and honest. There is no spin at the foxhole level.

In our practice, we are creating our own culture that relies on thinking, analyzing and organizing concepts; that transforms data into knowledge; and that is unconventional. We do this because our money is invested alongside your own, and we know that this is the only way to protect and grow our assets.

Investors who rely on conventional financial institutions to deliver market returns would be better served by utilizing a low-cost index.

Latticework

Lattice: A framework or structure for points, objects, or ideas over an area in space.

As usual, when we search for a better understanding of investing, we can usually find some profound thoughts from the Buffett-Munger duo. In particular, Charlie Munger, although sometimes eclipsed by choice by his partner in speaking and writing, has in his own right contributed to the thought-processes of investment analysis. He has consistently challenged all students of investments to broaden their vision of the market, of finance, and of economics in general; to see them not as separate disciplines but as a larger body of knowledge, one that incorporates psychology, engineering, mathematics, physics and the humanities. In 1994, while speaking at a seminar to students at USC, he explained: "You've got to have models in your head and you've got to array your experience- both vicarious and direct-on this latticework of models."

This, therefore, is our challenge: to take the good and the bad from our prior work experience (ethics and culture come to mind here), to listen to our children as they discuss the 11th and 12th grade physics curriculum (now I have a better understanding of the theory of relativity), to evaluate the pros and cons of an engineering or a liberal arts undergraduate degree (engineering seems to be winning in my son's mind), to appreciate life's lessons of competitive sports team, and to constantly acknowledge the beauty of a mathematical discipline, while at the same time continuing to be voracious readers. Investment decisions are more likely to be correct when ideas from other disciplines lead to the same conclusions.

In designing our business, we have liberated ourselves from the conventional workplace. We are reapplying principles learned long ago from our undergraduate, liberal arts education and we are trying to recognize patterns of similarity. We are forcing ourselves to think and see differently. We hope that this makes us, not only better investors, but also better leaders, better citizens, better parents, spouses, and friends.

When you visit our offices, most clients are attracted to our bookcases. Now they are filled with investment tomes, slowly we are introducing wider-ranging topics of interest to give us a better foundation for building our mental models.

In closing, we would offer one last bit of philosophy:

It's what you know when you know it all that counts.

Sincerely,

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