// ADDING VALUE
Volume 4: Edition 2 | Second Quarter 2005

ADDING VALUE

Volume 4: Edition 2

Second Quarter 2005

Second Quarter Investment Review and Outlook

SUMMARY:

Patience and an understanding of the economics of stock market returns are important concepts during an era of subdued returns. This newsletter reviews your portfolio positioning during this trying period. Our task remains: earning for our clients their fair share of whatever returns that our financial markets are generous enough to provide.

ROC Squared

The return on capital (ROC) **and** the return of capital (ROC) equal ROC Squared (ROC^2). This was the underlying mantra by value managers during the pre-bubble years of 1998-2000. (Time showed how correct this philosophy was!) It may well be the mantra again for all investors during this period of subnormal returns, which we are now experiencing. For this reason, we would like to use this newsletter to explore some of the fundamental premises of future returns.

Where we are today

There are very few bargains in the market today. We don't know when the opportunities will reappear, but we remain confident that over time, they will again present themselves. In the meantime, our strategy has been to indirectly (through the fund managers) increase or maintain a high level of liquidity. In addition, we are constantly evaluating the price levels at which we will be sufficiently compensated for the potential risk we may be accepting with each new purchase.

One of the simplistic ways to determine whether the general market is overvalued is to calculate the Total Market Price (TMP) of the market as a percentage of Gross Domestic Product (GDP). The total market price is determined by adding the total market value (capitalization) of each individual stock on the NYSE, NASDAQ, and AMEX. At year-end 2004, the total market price by this measure was $16.1 trillion. The next step is to divide this number by GDP, where GDP is defined as the total market value of all goods and services produced within the borders of the nation during a specified period. In other words, GDP represents the sales portion of the entire economy. At year-end, GDP was $11.8 trillion. Therefore, total market price as a percentage of Gross Domestic Product as of year-end 2004 was **136%** ($16.1 trillion divided by $11.8 trillion).

To put this number in perspective, the 40-year average is 76%; the 80-year average is 62%. At the market peak in 2000, this ratio was 191%. Further calculations of this ratio over various time periods, as provided by Century Management in Los Angeles, are as follows:

TOTAL MARKET PRICE AS A PERCENTAGE OF GDP
(80 and 40-Year Percentages)

	80 Years 1924-2004	40 Years 1964-2004
High	191%	191%
Low	25%	32%
Median	56%	68%
Average	62%	76%
Avg. 20 Lowest Yrs.	34%	49%
Avg. 20 Highest Yrs.	103%	103%

Source: Century Management Newsletter dated 12/31/04.

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 clients.

Wright Associates
1500 Oxford Dr., Suite
Suite 230
Bethel Park, PA 15102
412-854-2100 (PHONE)
412-854-2550 (FAX)

Therefore, at the current ratio of 136%, the market remains expensive compared to history by virtually any time period.

The unwinding of excesses

There are many examples of the returns in various markets throughout history that went to great excess and then took many years to recover once the unwinding process began. As a U. S. example, if you owned a DJIA index fund from 1965 through 1982, it only provided an annualized return of 0.45%, excluding dividends. In other words, it took approximately 17 years for the market to finally recover before making a new high, and thus beginning the greatest bull market in history (1982-2000). As a Japanese example, the Nikkei index peaked on December 29, 1989, at 38,916. After hitting bottom at 7,831 on April 30, 2003, the Nikkei was still down 72.18% from its peak after 14.75 years. This translates to a negative compounded annual return of –8.31% over 14.75 years!

It is interesting to note that investors who adhered to the "buy and hold forever" strategy, as well as those who believed that buying an index was the only way to go regardless of the fundamentals, made virtually no money during these periods. However, for those investors who bought and sold U. S. large capitalization stocks based on fundamentals, discipline, and value, there were numerous opportunities to make great profits during this same period. (Seven by our count). In addition, if an investor searched for "value" in real estate, small stocks and foreign stocks, the opportunities were even greater. This is the investment strategy that we are currently pursuing in your portfolio. In this period of modest returns, your portfolios have little resemblance to the popular indices, include mutual fund managers that excel at understanding individual company fundamentals, and have no compunction about closing the fund and/or holding cash if there are no immediate opportunities.

Against the crowd

In essence, most of the mutual fund managers in your portfolios are going against the crowd. Typically, most investors and institutions are running away from holding cash because it earns very little relative to inflation or their investment return requirements. Two quotes come to mind. First, "If you just follow the crowd, sooner or later somebody is going to take you somewhere you wish you did not go, and you will pay a price you did not have to pay." Or, "you'll never know the value of liquidity until you need it and don't have it." This is one of those times when it takes a great deal of patience, discipline, and conviction to maintain a contrarian position, because of the potential business and investment risk that it entails.

Today, most of our client portfolios consist of funds that are closed to new investors. This shows great fortitude by these managers, because they are willing to consider the prospect of "shrinking" assets under management just to be right. Further, they are willing to forego additional investment management fees in order to provide good expected returns to existing fund shareholders. From the perspective of Wright Associates, over 45% of the total equity assets in our firm are represented by mutual funds that other advisors do not have access to because they are closed. In addition, the amount of the equity position represented by index strategies is less than 1%. To further breakdown these numbers, 73% of our real estate managers are closed, 72% of our international managers are closed, and 46% of our small cap managers are closed. We are awaiting the closure of another small cap manager, which will then increase this percentage to 77%! We have more discretion in the domestic large cap area, because we believe this area offers some of our best <u>future</u> opportunities. In fact, only 17% of the funds in this area are presently closed. This portfolio construction gives our clients a powerful competitive moat and the ability to earn returns that may be unavailable to those whose belief it is to buy the broad market through an index, or to buy essentially a "closet" indexer. (A closet indexer constructs a portfolio whose characteristics are very similar compared to its benchmark index such as the S&P 500.) With our tactical strategy of shifting among managers and asset classes, we hope to take advantage of the pockets of opportunity to make money, even though an index may show no return for an extended period.

The value of liquidity

In addition to low expected equity returns, today's bond yields are also incredibly low. (2-3% yields are a tough pill to swallow). The consensus ("group thinkers") feels that they have to deploy capital, because they cannot stand the prospect of earning such low yields on their cash. In the case of pension funds, they have to be fully invested, because they have high and unrealistic pension rate-of-return assumptions (some as high as 8%). The level of their investment return requirement is driving their investment decision-making. Since the present level of yields is well below the average pension return assumption, pension plans are driven to seek alternatives that may give them an opportunity to achieve their required return assumption. The end result of this process is that they are moving out on the risk curve, whether they realize it or not. As Bob Rodriguez states: "They may even fool themselves by calling these "new" investment strategies "market neutral;" however, with so many pension plans, individuals, and other groups seeking market neutral investment strategies that allegedly deliver "Positive Alpha", I doubt that the average of these will result in a market- neutral outcome. More likely, it will result in a market- loss outcome."

Regardless of whether you are buying stocks, bonds, real estate, private businesses, hedge funds, etc., the price you pay will ultimately determine your return. Let us repeat: **The PRICE you pay for an investment determines your return, not how fully invested you are! Buyers beware if you search for higher returns in a low return world. It generally means that you are required to take on large amounts of risk for a potentially small level of return.** We are avoiding these traps in your portfolio, where possible, by utilizing managers who are very price sensitive.

Margin of safety

Most of the managers in your portfolio look to invest in companies where the share price is significantly less than the estimate of the underlying or intrinsic value of the business. Intrinsic value can be defined as the price an informed buyer would pay for the entire business in the private market. The determination of this value and the execution of the purchase are the most difficult parts of the investment process. Over time we have learned, that certain managers have different skill sets in applying the process. In general, however, the greatest part of the gains has come from those managers buying stocks at a discount to intrinsic value. To Ben Graham, Warren Buffett, and others, this discount from intrinsic value was the "margin of safety." Like a banker who is asked for a loan, the banker wants to know what collateral the borrower is putting up to secure the loan. Like an analyst who is making an investment, Graham liked to have coverage of 1 ½ times his purchase price in intrinsic value, which equates to buying stocks at about 65% of intrinsic value, or at a 35% discount. What confronts investors today is that the discount from intrinsic value at which a vast majority of stocks trade has never been lower. To paraphrase Warren Buffett, "why pay $80 for a stock that is only worth $83? Until such time as we have a sufficient margin of safety, we'll wait."

Hedge Funds

Perhaps the greatest growth in assets under management in the past few years has been in hedge funds. According to an article in the New York Times, the amount of money invested in hedge funds has grown from $50 billion in 1990 to more than $1 trillion today, a twenty-fold increase. In this era of subnormal returns, hedge funds have emerged into a marketing nirvana. There seems to be several reasons for the increase in assets under management in these vehicles including the marketing of the funds as the exclusivity of the "rich" (implying the rich have an advantage over the little guy in gaining access to the top performing money managers), the belief that these vehicles provide "steady, positive, and superior returns irrespective of what the overall stock market is doing," and have less risk than conventional investment strategies.

There are three issues regarding hedge funds that require further examination: the historical annual performance of hedge funds, the expected future return as the size of the assets increases, and the cost of owning these vehicles. In the following table, we compare the annual performance of major hedge funds to the performance of the S&P 500 and to a client portfolio with a 65%/35% asset allocation.

HEDGING FOR TROUBLE

	Major Hedge Funds**	S&P 500	Wright Assoc. Portfolio***
2005 (YTD)*	-0.11%	-2.15%	+0.03%
2004	+9.64	+10.87	+11.15
2003	+15.44	+28.67	+28.72
2002	+3.04	-22.09	-6.76
2001	+4.42	-11.88	-0.06

*Through 3/31/05
**CSFB/Tremont Hedge Fund Index
***65% Equity/35% Fixed Income Portfolio

For the privilege of earning these returns, it is important to analyze the costs of ownership. Business Week recently outlined the costs involved in Merrill Lynch Multi-Strategy Hedge Opportunities Fund as 3.10%.

But that's not all. As is the case with most fund-of-funds, investors also bear the costs of the underlying hedge funds the portfolio invests in- each of which also charges up to 3% in additional fees per year, plus 15% to 25% of profits. For an investor who pays taxes, the math can get even worse. One study by the Hennessee Group, a hedge fund industry research firm, shows that more than 50% of hedge funds have turnover rates exceeding 200%. High turnover would indicate that most if not all of the returns are short-term capital gains, which are taxed at a federal rate of up to 35%.

If this isn't enough to turn your stomach, consider this report from the New York Times magazine dated 6/05/05: "I casually inquired of one hedge fund steward how much he controlled. Came the reply, "Six and a half billion dollars." I whistled and replied that 1% of $6.5 billion would be a decent living. He smiled and held up 2 fingers (2%). Do the math; this gentleman's firm will earn, annually, $130 million a year for switching on the lights each morning and $260 million if his fund earns a ho-hum return of 10 percent." One cannot help but be somewhat amused that the main critics to registered investment advisers who place client money with mutual funds are accused of extracting high fees, but have jumped wholeheartedly into the hedge fund arena. No wonder Warren Buffett has been known to remark that hedge funds are not so much an industry as a compensation formula!! There is also some evidence that the opportunities that created the ability to make the "steady and dependable" hedge fund returns are being minimized or eliminated because of the number of the participants in the marketplace, but this theory is for another newsletter.

In summary

The good news is that in managing your portfolios, we do not subscribe to conventional wisdom, popular opinion, Wall Street's conflicted research, or the majority of economic forecasters with their optimistic, yet poor predictions and dismal records. On any day, what is reported on the news and how your portfolio reacts are diametrically different. Your portfolios are being invested by buying fractional shares of companies at discounts to their intrinsic values, by managers who are trained in fundamental value analysis, and who have no compunction about holding cash and closing the fund to additional cash flows to protect existing shareholders. In other words, if we and the mutual fund managers that we select cannot invest with some reasonable margin of safety, we wait. Over the long-term, our objective remains to preserve your capital and give you a return on your capital- ROC squared!!!

We always welcome your questions and perspectives.

Sincerely,

Kathleen S. Wright, CFA
A. Gregory Lintner, CFA

Wright Associates
1500 Oxford Dr., Suite, Suite 230
Bethel Park, PA 15102