ADDING VALUE

Volume 6: Edition 1 First Quarter 2007

SUMMARY:

In this issue of Adding Value, we examine alternative investments. We discuss the terminology, the historical performance, the "retailization" of the asset class, and the cost structure.

First Quarter Investment Review and Outlook

Alternative Investments

Once upon a time, "alternative investments" were a very good idea. They were available only to qualifying investors, there was limited competition for investment ideas, the amount under management was relatively low, there were high minimum account balances, and there was an alignment of interest between the investor and the manager; fees were high but so were the payoffs. Since investors are always under significant pressure to achieve investment returns in the upper quartile of their peer groups, these investments seemed to offer performance nirvana. These investments covered a gamut of opportunities including hedge funds, private equity, leveraged buyouts, commodities, venture capital, and early on real estate. In fact, at one point anything that was not stock, bond or cash, "the traditional asset classes", could be classified as alternative. This newsletter seeks to explain the current marketing of these investments and to compare and contrast these investments with our management of your portfolio.

Alternative Investments Grow up and out

The basic premise in constructing portfolios is to have investments that are diversified. The art in our business is the ability to construct portfolios of investments that operate differently from each other thereby reducing overall portfolio volatility. Alternative investments are tailor-made for this purpose. At the outset, they were unique, differentiable ideas. We struggled in the early 1990's to get enough information, to understand the nuances of these investment opportunities, and to find managers who could deliver consistent performance in accordance with their mandates. At that point, there was not a centralized depository of managers, nor was there any performance history. It was a fledgling market with great inefficiencies.

One Wall Street truism states that when investors lust for investments, supply will almost always be created to meet the demand. At that point, the exclusivity of the early 1990's becomes mass consumption of the early 2000's. Since the early 1990's, hedge funds alone have grown at a staggering rate. Between 1990 and the end of 2005, the number of hedge funds burgeoned from a few hundred to some 8,200, representing almost $1.3 trillion, compared to $600 billion five years ago. Private equity capital raised in 2006 was roughly five times the decade ago level. With this explosive growth, three things happen. First, data bases

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 230
Bethel Park, PA 15102
412-854-2100 (PHONE)
412-854-2550 (FAX)

are created to track managers and to compare past performance. Second, marketers develop to find buyers for all the supply—enter the public investors. Third, given the well-documented hype of the fantastic returns and the performance nirvana, the public becomes really excited about the opportunity to get a piece of the action. In fact, they get really excited just as the insiders are selling, believing that they're being cut in on a great deal. To give an example, in February, 2007 the first U.S. hedge fund went public (in WallStreet-ese issued an Initial Public Offering, or ("IPO")). The IPO was initially priced at $18.50, but closed the first day at $31 a share. According to the prospectus, the five guys who started the business collectively now own shares worth about $9.4 billion. With the rise in the marketing machine, the tide has turned from a solid investment idea to a profit machine for the sponsors.

Performance-Based Fees

There is no doubt that alternative investments are a great business for the practitioners. There is no other business that offers such unbelievable profitability to the owners. Initially, hedge funds typically charged a 2% management fee and a 20% share of the profits (but of course, not on the losses). The performance-based fee was originally designed to create proper incentives and a fair apportioning of risk and reward between manager and client. However, ever-rising fees (one hedge fund now charges a 5% management fee and 44% of the profits; at least one very successful private equity firm charges 2% and 30%) have created a vast income stream for some managers and, simultaneously, a challenging performance hurdle that works against their clients. Interests are no longer aligned. Further, assets have skyrocketed ensuring that the managers profit handsomely from sheer size alone, while in all likelihood lessening their ability to outperform. In other words, "heads we win/tails you lose."

It's the old rear view window investing

Investors today are assessing the future by looking at the rosy past results. They are reading David Swenson's book Pioneering Portfolio Management and saying that they want to replicate this success. (David Swenson is Yale's acclaimed endowment manager who lays out the case for investing in alternative vehicles.) Investment committees are asking: "How much should we put in private equity?"; "What is the appropriate allocation to energy?"; or "How can we put more money in hedge funds?" Ironically, what was originally seen as too risky, is now seen as entirely prudent. But, alternative investments will ultimately obey the economic laws that apply to every investment and every asset class. There are no magic investments that make money for you no matter what you pay for them. The more you pay, the less the return; the greater the competition, the less the inefficiency. The correct question that investment committees should be asking is: "Given today's market conditions, can we make an acceptable return over the long-run by this investment on a risk-adjusted basis?" Sadly, this question is not verbalized.

Alternative Investment Strategies versus Wright Associates Portfolios

We stated at the beginning of this newsletter that Wright Associates' searches for "alternative investments", or those that provide a different pattern of return and reduce overall volatility in the portfolio. We just don't want to pay high costs for the opportunities. Your portfolios are invested with some brilliant, curmudgeonly, and miserly managers. They make a lot of money for shareholders by producing good investment results, not because of high fee structures. Their net worth and your net worth are invested similarly. One of the more outspoken managers, Marty Whitman of Third Avenue, had this to say about the differences between Third Avenue's private equity common stock investments and those in a typical Private Equity Limited Partnership ("LP"). He states in the Fourth Quarter 2006 Letter to Shareholders:

1. Third Avenue buys into its private equity investments at prices that represent very substantial discounts from readily ascertainable net asset value. Private Equity LP's

obtain control by paying premiums over market prices.
2. The various Third Avenue investments are in companies that are extremely well financed. Controlled entities of Private Equity LP's tend to be leveraged to the hilt.
3. The Third Avenue Investments tend to be managed primarily for long-term growth. Private Equity LP controlled entities tend to be managed with the objective of extracting from the operating entities as much cash as possible as soon as possible.
4. The Third Avenue expense ratio is 1.1%. Typical Private Equity LP fees are 2% of assets under management plus 20% of gains.
5. There is no meaningful lockup for Third Avenue investors. Any shareholder can redeem daily, subject to only a small redemption charge for short-run holders. The typical shareholder in a Private Equity LP can't redeem any investment for at least one year.
6. In terms of corporate governance, Third Avenue shareholders have manifestly more rights and protections than do Private Equity LPs.
7. Third Avenue relies on the public records, and also interviews with management and others. Third Avenue owns common stocks. It does not negotiate terms. Not so with Private Equity LPs.

Marty Whitman has been compounding your assets in a tax-efficient manner at a rate of over 15% for the 15-year period ending 12/31/06, with only one negative year and an expense ratio of 1.1%. We'll stick with these investment opportunities, thank you very much.

Understanding Alternative Investment Performance

To put the return of The Third Avenue Value Fund in perspective, it is informative to compare it to some published performance numbers for "alternative investments". In the process, it is important to disaggregate the published numbers to understand exactly what an investor achieves net after-tax. Alliance Bernstein published an interesting research paper in November 2006 entitled What Lies Beneath: Navigating the Hedge-Fund Market. Most of the research was informative, but Table 1 was enlightening.

Table 1: Hedge-Fund ("HF") Fees and Taxes: A Hypothetical Example

	Typical Hedge Fund	**Tax Efficient Hedge Fund**	**Typical Fund of Funds**
Gross Return*	**12.0%**	**12.0%**	**12.0%**
Management Fee to HF	(1.0)	(1.0)	(1.0)
Incentive Fee to HF @ 20%	(2.2)	(2.2)	(2.2)
Return Net of Fees	**8.8%**	**8.8%**	**8.8%**
Management Fee to FOF	N/A	N/A	(1.0)
Incentive Fee to FOF @ 10%	N/A	N/A	(0.8)
Net Pretax Return	**8.8%**	**8.8%**	**7.0%**
Taxes+	(3.1)	(1.3)++	(2.5)
Net After-Tax Return	**5.7%**	**7.5%**	**4.5%**

**Hypothetical return inclusive of fund operating expenses, but before the deduction of management and incentive fees*
+Assumes 35% of pretax return is lost to taxes for the "typical" fund and 15% for the "tax-efficient" fund
++ Taxes for the "tax-efficient" fund do not include a future tax liability that may result from the deferral of unrealized gains, which reduces the tax cost for the current year

Source: Ruff, John, and Daniel J. Loewy. What Lies Beneath: Navigating the Hedge-Fund Market. AllianceBernstein LP. November 2006. 22.

Admittedly, this table is only for hedge funds, uses the more modest fee structure of 1%/20%, and doesn't encompass all alternative investments, but you get the idea. In a typical hedge fund, the investor's net after-tax return of 4.5% is a far cry from the published gross return of 12%. Note also that this "hot-shot, new-new return" differs significantly from the published long-term return of The Third Avenue Value Fund of 15%. Additionally, it is interesting to reflect on the tax bite. With all of the income to the U.S. Treasury from these high-turnover strategies, one could speculate that there is no

major reason for the SEC to reform the regulations on these alternative investments.

Conclusion

There are no shortcuts and no magic investment opportunities that deliver positive performance results under any market condition. Ultimately, every investment obeys the economic law that says—the higher the price that you pay for an investment opportunity, most likely the lower your ultimate return. “Buy low and sell high” and “Buyer Beware” are as true today as they were 100 years ago.

Sincerely,

Kathleen S. Wright, CFA

A. Gregory Lintner, CFA

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