



Quarterly Commentary 1st Quarter 2006

When the term “risk” is mentioned in the investment field, many thoughts probably come to mind. We have mentioned before that our firm’s definition of risk (i.e. the potential for a permanent loss of capital) is not the same as the traditional academic version of risk, which is classically defined as the variability of return. There are other measures of risk such as credit risk, interest rate risk, default risk, price risk, liquidity risk, systematic risk, and unsystematic risk. There is another version of risk that is rarely mentioned in textbooks and is only experienced in the real world. This version is generally under-appreciated but has a genuine influence on portfolio managers and thus securities markets. This very real but under-recognized form of risk is called **career risk**. We would like to discuss this topic in greater depth to illustrate the direct and indirect effect it has on the management of our clients’ portfolios.

First of all, what is career risk? We would define career risk as the risk associated with an investment that causes discomfort. In a recent article, respected investment strategist Jeremy Grantham described this effectively:

“In markets where investors hand over their money to professionals, the major inefficiency becomes career risk. Everyone’s ultimate job description becomes ‘keep your job.’ Career risk-reduction takes precedence over maximizing the client’s return. Efficient career-risk management means never being wrong on your own, so herding, perhaps for different reasons, also characterizes professional investing.”

It is almost always the case that when the reputational or career risk of investing in something is extraordinarily low, the future returns get pushed way down, often into negative territory. The converse is equally true. We say that we have almost never made a successful long-term investment without queasiness deep in the pit of our stomach. This feeling we

experience is career risk, and it is real. In our opinion, investors pay far too high a price to be comfortable and avoid uncertainty.

Career risk applies at multiple layers within the investment field. We would like to highlight where we recognize career risk within the food chain of the portfolio management field. For our individual (non-institutional) clients, there exists only one layer of career risk, and it simply is the risk of the portfolio manager being terminated by the client. Since the assets in this example are actually owned by the end client and there is no third party intermediary, such as a consultant or a board of trustees, the client is the sole decision-maker regarding the future of the investment manager/client relationship. Often in such a relationship, there is a natural pressure for the manager to not deviate from the index or the benchmark against which he is being compared. In fact, we believe that deviation from the benchmark is likely if we are to be successful in the long-term. We cannot outperform the market if we are afraid of deviating from it. However, this natural pressure to conform to the benchmarks results in closet indexing and is more prevalent than most would believe.

Institutional clients typically have two layers of career risk with which to contend. Institutional investors have both a layer of management **and** an oversight board which are susceptible to pressures to perform. Both of these fiduciary layers are challenged with the natural pressure to avoid failure. Failure could lead to job insecurity, and the attitude of “not on my watch” can dominate. We believe that the greater investment risk often is actually being **with** the crowd at a time when career risk is the least. You see, we believe that a large part of our past investment success is our willingness to look foolish in the short-run if we believe the long run payoff in future returns is likely.

For institutional clients there is sometimes an extra layer of career risk that exists. In the situation where a third party investment consultant is engaged, there is an added layer of career risk. In that instance, a consultant’s reputation is at risk. Should the investment manager’s investment performance be sub-par, then the investment consultant’s career risk increases and the justification to retain that investment manager becomes more challenging. This situation becomes even more heightened when the investment manager invests in a manner different from the pack.

That brings us to a short discussion of absolute returns versus relative returns, and the excessive emphasis, we feel, that the investment community places on benchmarking. We are probably guilty of falling into the same trap on occasion. At the end of the day, the most important aspect of performance for us is if the clients' investment objectives have been met. Benchmarking of performance started out as an earnest attempt to judge long-term performance. What has resulted is institutional fear of being too far removed from the benchmark. Doing so results in career risk, thus leading to the preponderance of index funds and closet indexing strategies by portfolio managers. Our focus on absolute returns is evidenced by our willingness to hold cash in times when investment opportunities are not abundantly present. As mentioned last quarter, our newer clients have higher than normal positions in cash, which makes total sense to us but is a different position than most investment managers would take. We recently had an opportunity to discuss this point with a prospective client that has been a successful timber investor. We asked the question, "If someone hired you with \$20 million to invest in timber, would you invest it immediately, or would you look for bargains, however long that took?" His answer was the latter, and we would concur.

We believe that the CFA (Chartered Financial Analyst) exams can be a good contrary indicator of career risk. The CFA designation is considered the top professional designation in the investment management field. The two principals of our firm are proud to have this credential. On every exam there are portfolio management problems pertaining to asset allocation. The "correct" answers are heavily influenced by the current views (think low career risk) on particular asset classes. In the late '70s, a properly diversified portfolio must have had a high exposure in commodities, since inflation was very high. In the mid-80s, real estate was accentuated, unfortunately, right before the real estate bubble burst. Portfolio insurance was validated on the exam prior to that approach becoming discredited in the crash of '87. International investing was "in vogue" in 1989, about the time of the Japanese stock market's peak. You would not get fired or fail the exam if you favored mortgage backed securities in 1993, before that market suddenly unwound. Equity indexing was the answer of the day in the late '90s. In the very late '90s, AIMR, which was the predecessor to the CFA Institute, held a conference entitled, "No Profits, No Revenues, No Product, No Problem – How to Value Companies in the Internet Age." Professional investors would not likely have been criticized for attending that conference in 1999, right before the internet boom busted. That leads us to today.

In our opinion, the area of investing that possesses the lowest current level of career risk but the highest level of investment risk is in the area called “A.I. – Alternative Investing.” A.I. consists primarily of hedge funds and private equity pools. The amount of institutional and, even now, individual money flowing into this area is unprecedented. For example, the percentage of endowment fund assets invested in A.I. is currently 33%, up from 10% five years ago according to a recent Wall Street Journal article. It has recently been made clear to us that A.I. managers are now interviewing endowments, rather than the traditional process of clients interviewing managers, to determine if they are willing to accept certain endowments’ multiple millions of dollars. That was news to us.

Why is this phenomenon occurring now? We believe there are two main reasons.

First, because returns for most equity investors have been so modest over the last five years, investors are becoming increasingly desperate for return. The five year annualized return for the S&P 500 Index is 0.54%, hardly anything to get excited about. We are thankful that our clients have experienced much better results than this. It is estimated that corporate pension plans are currently \$450 billion under-funded up from “only” \$40 billion under-funded five years ago. Rather than lowering their pension return assumptions or increasing their contributions, which would be the more conservative approach, many corporate managers are choosing the less painful option. A.I. managers touting high recent returns are seen as the “Holy Grail” that could painlessly close the funding gap. Interestingly, some of the most under-funded pension plans have the highest A.I. exposure. Although endowments, foundations, and other institutional investors do not have the under-funding problems of pension plans, most have experienced similar pressures for higher returns. We find it intriguing that the universe of private equity funds claims to beat the stock market by approximately five percentage points annually. However, according to Steve Kaplan of the University of Chicago, the private equity fund universe actually trailed the S&P 500 Index for the period 1980-2001.

Second, and this is a big one, is the compensation structures of the A.I. industry. Put simply, A.I. fees can be obscene. According to Institutional Investor magazine, the average take home pay for the top 25 hedge fund earners in 2004 was over \$250 million. We are confident that 2005 earnings

exceeded those. These are not the hedge fund companies' earnings. These are individuals' W-2 and K-1 income. The standard hedge fund fee is 1-2% of assets plus 20% of profits. This extraordinarily high fee structure can cause managers to swing for the fences. This "tales I win, heads you lose" fee structure is inequitable to the client, but caveat emptor rules. The thought is as if to say, "If the customer will pay it, why not stick it, I mean, give it to them?" These excessive fees have spawned a record number of A.I. pools. Which poses the question, "How does this affect me and my portfolio?"

The flow of money into A.I. is likely to have had a positive impact on recent investment returns. The trend of public companies that have lately been taken private has directly increased price levels for the targeted companies and has indirectly inflated prices of similar securities. Likewise, hedge funds have taken a more activist approach to maximizing short-term shareholder value. These near-term actions have undoubtedly aided shareholder returns. On the other hand, higher overall valuations have hindered bargain hunting. Investment opportunities are harder to discover. We believe this herding by institutional investors should create vast investment opportunities in the inevitable unwinding phase.

Dividends

A final observation we would make is the increase in dividend payments by corporations in general and your stockholdings in particular. In the past fifteen months, thirty-one of our clients' various core holdings have increased their dividends, some more than once. We believe that corporations are generally very liquid with solid profits and conservative capital spending policies. This has enabled them to increase dividends to shareholders. Also lower tax rates on dividend income are a contributing factor. We could not be more pleased as we LOVE dividends.