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Animal Spirits Rekindled

THIS ISSUE

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Summary

Dear Clients:

Wow! What a difference a year makes. As 2003 began, the U.S. equity market had just endured its third consecutive annual decline, with all 10 of the S&P 500 sectors showing losses for 2002. There was nowhere to run and no place to hide. Investors' portfolios and collective psyche were savaged during the bear market decline. Optimists saw modest gains for the market and economy while the pessimists saw war as imminent and the economy headed towards a double-dip recession and deflation. The gloom was palpable and investors were preoccupied "hanging crepe." As we all know now, 2003 showed the optimists conservative and the pessimists wrong. The S&P 500 surged to a total return for 2003 of 28.7%, with all 10 sectors gaining. The economy not only didn't decline, its growth was explosive (witness reported Q3 2003 GDP growth of +8.2%) as the massive amounts of monetary and fiscal stimulus finally gained traction. Corporate earnings followed suit, with S&P 500 operating earnings estimated to have gained 18.4% for the year (ISI Group). In our letter of a year ago, we stated the crisis of confidence paralyzing businesses and investors could endure for a while longer, but wouldn't be a permanent condition. Economist John Maynard Keynes had written about the "animal spirits" of capitalism that cause entrepreneurs, corporate managers and investors to take risks in hopes of reaping economic reward. These animal spirits had become suppressed during that time of extreme stress and fog of war, but we surmised the overpowering force of economic self-interest would eventually cause these spirits to rekindle.

Overall, we are pleased with the returns generated in client accounts, particularly given 1) the S&P 500 was *down* 9% for the year through March 11, 2003, as the U.S. prepared for war, 2) with valuations becoming extended, it was more difficult to find securities with both the quality and risk/reward characteristics we seek, resulting in lower than normal invested levels in client equity and fixed income portfolios, 3) with credit spreads rapidly contracting, our commitment to lower-yielding intermediate Treasury securities increased, 4) with interest rates falling to 45-year lows, we shortened maturities, which also lowered yield and 5) returns in both the U.S. equity and bond markets were strongest in the most speculative securities, which were underweighted in client portfolios.

Periods ending December 31, 2003
(Total Returns – Cumulative – Bloomberg)

	S&P 500 Index	NASDAQ	Russell Midcap Index
3-months	12.18%	12.30%	13.97%
One-year	28.69%	50.77%	40.06%
Two-years	0.24%	3.68%	17.39%
Three-years	-11.67%	-17.89%	10.79%

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Investing—Process vs. Outcome

It is perfectly understandable investors focus almost exclusively on performance (outcome), choosing to ignore how performance was generated (process). After all, at the end of the day you can spend performance, but you can't spend process. However, we believe a sound investment *process* is a vitally important foundation for generating outstanding, *long-term* investment outcomes. Over the short-term, a good outcome does not imply a good process and a bad outcome does not imply a bad process. The perfect example of this was the bubble market of the late 1990s. Growth managers, some of who were proud of the fact they paid little heed to valuation or fundamentals, enjoyed great returns and strong asset inflows. Value managers who maintained fundamental, valuation-driven discipline struggled to keep up as the bubble inflated and saw assets stream out the door. However, investing is a long-term, probabilistic endeavor and the best long-term performers all emphasize process over outcome. We thought year-end would be a good opportunity to review thoughts on the investment process.

"Be the House"

CSFB published a research piece by this title on October 7, 2003. Briefly, the expected value of any investment can be modeled using the possible payoffs and the probabilities of those payoffs coming to pass. We try to identify situations where there is a significant gap between *our* calculation of the expected value of the investment and the current price of the security, which is the *consensus* assessment of the expected value. This gap is referred to as **positive expected value**. Because of the laws of probability, any single investment can yield a negative payoff. However, if we are correctly applying probabilities and payoffs to form a *portfolio* of investments with positive expected values, over the long haul we should do quite well.

Though investing is obviously not gambling, the casino business is a purely probabilistic endeavor and relatively easy to understand. For example, take the American version of the casino game of roulette, which has a wheel with the numbers 1-36, 0 and 00. If a gambler places a $10,000 bet on the single-number 23 and 23 comes up, the bet is paid at 35-1 (or $350,000). This is clearly a bad outcome for the casino, but the casino is happy for the gambler and would absolutely love for all its customers to put $10,000 on 23. The reason for this apparent conundrum is the *true* odds of any single number appearing on the wheel are 37-1 (the wheel containing 38 possibilities). With true odds of 37-1, but winning single-number bets only paid-off at 35-1, the casino's ("house") advantage is 5.3%. What this means is for *every* $10,000 bet placed on 23, the gambler expects to lose $530 (5.3% x $10,000) and the house expects to win $530. In other words, the gambler has a negative expected value of $530 and the house has a positive expected value of $530, on each and every spin of the wheel. Now, for any given spin (i.e. the short-term), the gambler may win $350,000 or lose $10,000. However, if the gambler sits at the table long enough, the casino will eventually win all of his money. This is a simplistic example of why you want to "be the house" (and construct a portfolio of investments with positive expected values). It's also the principal upon which billion-dollar casinos are built!

Warren Buffet and "The Superinvestors of Graham-and-Doddsville"

Warren Buffet has been the leading disciple of value investing and needs no introduction. We certainly make no pretense of comparing ourselves to him, but we apply the same theories, in our own manner. Benjamin Graham and David L. Dodd wrote Security Analysis in 1934 and Graham wrote The Intelligent Investor in 1949. Though the first publication will be 70 years old this year, together they are still considered the timeless "bibles" of value investing. Buffet gave the "Superinvestors" talk at Columbia University in 1984, commemorating the fiftieth anniversary of Security Analysis. Below are selected excerpts from that talk. If you'd like a copy of the full talk, we'd be happy to send one to you.

- "It is extraordinary to me that the idea of buying dollar bills for 40 cents takes immediately to people or it doesn't take at all. It's like an inoculation. If it doesn't grab a person right away, I find that you can talk to him for years and show him records, and it doesn't make any difference. They just don't seem able to grasp the concept, simple as it is. I've never seen anyone who became a gradual convert over a ten-year period to this approach. It doesn't seem to be a matter of IQ or academic training. It's instant recognition, or it is nothing."

- "The common intellectual theme of the investors from Graham-and-Doddsville is this: they search for discrepancies between the *value* of a business and the *price* of small pieces of that business in the market. Our Graham & Dodd investors, needless to say, do not discuss beta, the capital asset pricing model, or covariance in returns among securities. These are not subjects of any interest to them. In fact, most of them would have difficulty defining those terms. The investors simply focus on two variables: price and value."
- "I'm convinced that there is much inefficiency in the market. These Graham-and-Doddsville investors have successfully exploited gaps between price and value. When the price of a stock can be influenced by a 'herd' on Wall Street with prices set at the margin by the most emotional person, or the greediest person, or the most depressed person, it is hard to argue that the market always prices rationally. In fact, market prices are frequently nonsensical."
- "I would like to say one important thing about risk and reward. Sometimes risk and reward are correlated in a positive fashion. If someone were to say to me, 'I have here a six-shooter and I have slipped one cartridge into it. Why don't you just spin it and pull it once? If you survive, I will give you $1 million.' I would decline—perhaps stating that $1 million is not enough. Then he might offer me $5 million to pull the trigger twice—now that would be a positive correlation between risk and reward! The exact opposite is true with value investing. If you buy a dollar bill for 60 cents, it's riskier than if you buy a dollar bill for 40 cents, but the expectation of reward is greater in the latter case. The greater the potential for reward in the value portfolio, the less risk there is."
- "In conclusion, some of the more commercially minded among you may wonder why I am writing this article. Adding many converts to the value approach will perforce narrow the spreads between price and value. I can only tell you that the secret has been out for 50 years, ever since Ben Graham and Dave Dodd wrote <u>Security Analysis</u>, yet I have not seen a trend toward value investing in the 35 years I've practiced it. There seems to be some perverse human characteristic that likes to make easy things difficult. The academic world, if anything, has actually backed away from the teaching of value investing over the last 30 years. It's likely to continue that way. Ships will sail around the world but the Flat Earth Society will flourish. There will continue to be wide discrepancies between price and value in the marketplace, and those who read their Graham & Dodd will continue to prosper."

Similarly, Buffet's annual letters to shareholders of Berkshire Hathaway are always eagerly awaited. Below are some of his musings on value investing and the investment process.

- "Investors should remember that their scorecard is not computed using Olympic-diving methods: Degree-of difficulty doesn't count. If you are right about a business whose value is largely dependent on a single key factor that is both easy to understand and enduring, the payoff is the same as if you had correctly analyzed an investment alternative characterized by many constantly shifting and complex variables."—1994
- "We try to *price*, rather than *time*, purchases. In our view, it is folly to forego buying shares in an outstanding business whose long-term future is predictable, because of short-term worries about an economy or a stock market that we know to be unpredictable. Why scrap an informed decision because of an uninformed guess?"—1994
- "The most common cause of low prices is pessimism—some times pervasive, some times specific to a company or industry. We want to do business in such an environment, not because we like pessimism but because we like the prices it produces. It's optimism that is the enemy of the rational buyer. None of this means, however, that a business or stock is an intelligent purchase simply because it is unpopular; a contrarian approach is just as foolish as a follow-the-crowd strategy. What's required is thinking rather than polling. Unfortunately, Bertrand Russell's observation about life in general applies with unusual force in the financial world: 'Most men would rather die than think. Many do.'"—1990

Simply stated, our strategy is to "buy straw hats in the winter." Our process is to find good businesses with strong management selling at attractive prices. We try to construct a portfolio of securities with positive expected value. Characteristics we look for are:

Financial Strength

- A strong balance sheet with high debt service coverage ratios

Strong Management
- High insider ownership of stock
- History of shareholder-oriented actions designed to enhance returns to shareholders

Good Profitability
- High return on capital
- Positive free cash flow

Compelling Valuation
- Low P/E
- Low Price/Free Cash Flow
- Low Price/Sales
- Low Price vs. Private Market Value
  (i.e. what a third-party would pay for the business)

Summary

A year ago we wrote, "The greatest *opportunities* occur when the skies are stormy, the news is bad and getting worse and prices are falling. The greatest *risks* occur when there is nothing but sunshine, the news is good and getting better and prices are rising." Overall, stock prices are materially higher now and we are somewhat uneasy about what appears to be a bullish, widely held consensus on the outlook for key investment issues (i.e. economy, interest rates, Fed and corporate earnings). Mr. Buffet argues that none of that macro "stuff" matters, in the long-run, but it sure can make the short-run interesting! Our outlook remains: "Gains going forward in U.S. stocks and bonds will be more modest and much harder to come by."

The bear market of 2000-2002, recovery of 2003 and the ongoing mutual fund scandal shined a bright light on the two central tenets of our business. First, if a business is worth a dollar and I can buy it for 50 cents today, something good may happen to me tomorrow, or the next day or the next day. Second, if we do right by our clients, we'll do well for ourselves. Our business is built on trust and we've developed a strong fiduciary culture over the past 28 plus years. Revelations of bad acts reaching to the highest levels of some investment management organizations were appalling and proved some in our profession lacked the genetic code to manage money for other people. We thank you for your business and the trust and confidence you've placed in us. We try hard each and every day to earn it. We wish you a healthy and prosperous 2004.

KM's Newest Partner, Richard Hummel, CFA

In recognition of Rich's major contributions to the success of our business as Director of Research, Rich was invited to become a Member of Kirr, Marbach & Company, LLC, effective January 1, 2004. Rich joins Mark Foster, CFA, Mickey Kim, CFA, Kip Wright, CFA, David Kirr, CFA and Gregg Summerville, CFA as Members of KM. Congratulations, Rich!

Regards,
Kirr, Marbach & Company, LLC