

LETTER OF VALUE

Ruminations for investors seeking to enhance their wealth using the principles of VALUE INVESTING

What Makes A Good Investor?

We spend a lot of time studying successful money managers, with the goal of learning from their successes and failures. Whitney Tilson, a successful value investor, wrote that long-term investing is a function of 2 things: the right approach and the right person.

The right APPROACH:

- Buying companies, not trading stocks
- Ignore the market, other than to take advantage of its occasional mistakes
- Buy only when a stock is on sale
- Avoid losses first, and only then think about potential gains
- Invest only when the odds are favorable, then invest heavily
- Ignore predictions of macroeconomic factors
- Be flexible
- Shun consensus decision-making

The right PERSON:

- A businessperson with intellectual horsepower
- Good with numbers
- Simultaneously confident and humble
- Independent
- Patient, but long-term greedy
- Makes decisions based on analysis, not emotion
- They love what they do.

We hope you find that your writers exhibit most, if not all, the traits of successful money managers listed above.

The 21st Century's Benjamin Franklin

While we talk constantly about Warren Buffett and his investment record, it wouldn't be nearly as good if not for the influence of Charlie Munger, Vice-Chairman of Berkshire Hathaway. Buffett and Munger have been friends and business partners for close to 60 years.

Munger's wit and wisdom has finally come to light with the publication of *Poor Charlie's Almanack*, a compendium of speeches, writings, and articles over the course of his career. One of our favorite quotes is a ringing endorsement of independent thinking and patience:

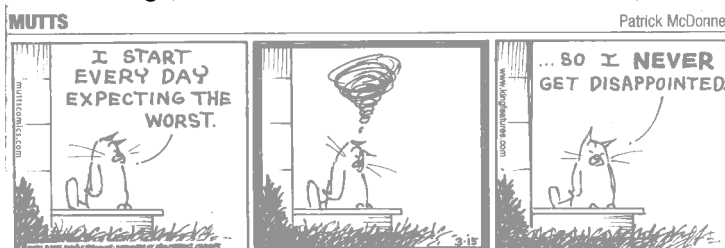
"It is occasionally possible for a tortoise, content to assimilate proven insights of his best predecessors, to outrun

hares which seek originality or don't wish to be left out of some crowd folly which ignores the best work of the past. This happens as the tortoise stumbles on some particularly effective way to apply the best previous work, or simply avoids standard calamities. We try more to profit by always remembering the obvious than from grasping the esoteric. It is remarkable how much long-term advantage people like us have gotten by trying to be consistently not stupid, instead of trying to be very intelligent.

Rough Weather Ahead?

The stock market crash of 2000-02 is now a distant memory. Prices bottomed in October of 2002, and have recovered at least 50%, as measured by the S & P 500. Smaller company stocks have done considerably better. Stocks look priced today as though the world was perfect and problem-free. At the same time sentiment in the marketplace strikes us as complacent, if not giddy, over the health of the economy and financial markets.

Risks are high, future investment returns have diminished, and a



bit of caution is in order. Here are some things we worry about:

- Stock valuations are at dangerously high levels; speculation in IPOs and second-rate companies is rampant
- Not only are interest rates rising, but short-term rates are nearly as high as long-term rates, which all but guarantees an economic slowdown
- Debt has piled up at all levels – government, corporate, and consumer; a high degree of economic leverage is risky
- Rapidly increasing energy prices should eventually put a dent in consumer spending and corporate profits

We're like the kitty -- we recommend keeping your expectations low and build a margin of safety into your investments.

Golf is Investing, Investing is Golf

Tommy Armour won every major golf championship at least once as a professional in the mid-to-late 1920s, then went on to be a great teaching pro. Tips from his 1953 book, *How to Play Your Best Golf All the Time*, apply to the approach one should take to investment management.

- *Every golfer scores better when he learns to play within the limits of his capabilities.* This applies to focusing on what we know well and staying within our circle of competence.
- *Simplicity, concentration, and economy of effort have been the distinguishing features of every great player's methods, (while others) lost their way to glory by wandering in a mass of detail.* Focus on what's important, and avoid the institutional herd mentality.
- *Action before thought is the ruination of most of your shots.* We prefer a portfolio with 15-20 well chosen long-term holdings, to a mutual fund that owns 100-200 stocks and turns its portfolio over 1-2 times a year.
- *It is not solely the capacity to make great shots that makes champions, but the essential quality of making very few bad shots. The way to win is by making fewer bad shots.* The way you win in investing is minimizing losses, and then the upside takes care of itself.
- Other notable pros have weighed in on the idea of winning by not losing; Gene Littler said, "Golf is not a game of great shots. It's a game of the most misses. The people who win make the smallest mistakes; legend Jack Nicklaus said, "I think I fail a bit less than everyone else."

More Golf Shots: Nothing's Relative

The obsession in the investment community with relative performance strikes us as quite silly. It should matter more what returns you produce in your portfolio than how you look compared to "the market" or other managers.

Does Tiger Woods care who his playing partners are in tournaments? No, he couldn't care less! He's trying to hit one

shot at a time, minimize mistakes, and shoot the best score possible. Winning a championship is the by-product.

At one point this season, ladies' tour pro Annika Sorenstam had won five out of seven tournaments. She emphatically denies being unbeatable. "I don't walk around wondering who can beat me. I know what I have got to do. I have to play from A to B in as few shots as possible. That's really my mindset."

Likewise as investors, we'd rather focus on our own "game," – high returns on invested capital with a margin of safety -- and let everyone else worry about who is doing what against whom.

It's All about Buying the Business

Benjamin Graham believed that investment is most intelligent when it is most businesslike (*The Intelligent Investor*, 1949). Like us, the guys who run the Fairholme fund have adopted this philosophy. Here's what they wrote in a recent client letter:

(We're) not prejudiced by whether a company is growing or shrinking, or whether it is large or small. We strive to understand businesses as if they were old-fashioned corner groceries, where each day the neighborhood purchased staples for cash, which was then used to re-supply and pay for the labor and capital needed to operate the store. Remaining cash in the till equaled the owner's earnings and together with its redeployment determined the store's value.

The economic value of a good business grows from the intelligent use of excess cash, and its stock price will eventually rise alongside the underlying worth of the company.

If everybody is thinking alike, then somebody isn't thinking.
General George S. Patton

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