Investment Thoughts
from
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Newsletter
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Dear Clients:

"THE GREATEST OBSTACLE TO BEING HEROIC IS THE DOUBT WHETHER ONE MAY NOT BE GOING TO PROVE ONE'S SELF A FOOL; THE TRUEST HEROISM, IS TO RESIST THE DOUBT; AND THE PROFOUNDEST WISDOM, TO KNOW WHEN IT OUGHT TO BE RESISTED, AND WHEN TO BE OBEYED." - *Nathaniel Hawthorne*

The exercise of judgment is ultimately the most important service that we can provide to our clients. We need to listen carefully to you, and to earn your trust so that you will listen to us, but the expertise that you are paying us for is the exercise of our judgment. Don, Greg and I have many doubts, and we spend a great deal of our time together deciding which to resist and which to obey. Whether we are foolish, heroic or wise (or all three) remains to be seen, but we think our record during the past 3 years indicates that we're on the right track.

In this issue we've once again turned to Jonathan Clements of *The Wall Street Journal* to help us reinforce our standard messages: establish an asset allocation that you can live with over the long term, make incremental adjustments as conditions dictate; read history carefully, take interpretations of history with a grain of salt; and finally, be realistic about the need to stick with it. In addition, we've excerpted a few passages from Charlie Munger, Warren Buffett's long-time partner, that we found particularly fitting (and rather enjoyable). These passages were taken from the December 31, 2002 issue of *Outstanding Investor Digest* (www.oid.com).

Variability of stock prices should be your friend… .

Shareholder:… You said in Omaha that it's important to be able to turn around your decision on something if you think that you've gone wrong. If you bought a share and it just continues to tick down and down – and you can't see that there's any reason for it to have done so and there's no change in the news at all — how do you know when you've just made a mistake and when you should just sell?

Munger: Over many decades, our usual practice when we buy something and it keeps going down is to buy more and more and more and more. And we don't like the idea of buying something at X if we wouldn't be much more eager to buy it at *half* X. But once in a while, something will happen that changes the prospects of X, or you realize you've made a mistake. So you just turn around and sell out and go to something else. But by and large, you want to develop a correct confidence in your judgement that will cause you to buy *more* as things go down.

You want the variability of stock prices to be your friend and not your enemy. If the direction of market movements is telling you what you should be buying or selling, you're using investment methods different from ours.

Without an adequate checklist, you may crash.

Munger: Generally speaking, I think you need mental models – and what I call checklist procedures –where you take a worthwhile list of models and run right down them: "Is this here? Is that here?" and so on and so on. And by the time you complete your many-part checklist procedure, you've made an intelligent attempt to analyze the situation.

Now if there are two or three items that are very important that aren't on your checklist – well, if you're an airplane pilot, you can crash. Likewise, if you're trying to analyze a company without using an adequate checklist, you may make a very bad investment.

Proof of Munger's point about learning correct thinking… .

Munger: So, generally speaking, I think you've got to have a bunch of models in your head and you've got to use them in a checklist fashion. That is obvious. Yet, how many of you were taught in your college educations that that should be your routine way of tracking problems? Will you raise your hands? There's *one*. ..

In investing, there's no substitute for experience.

Shareholder: When do we make the decision a stock is a good buy...?

Munger: Well, that's a perfectly good question. But I can't tell you when to buy some pork company. And it's not because I know and I'm holding back from you.

If you're going to be an investor, you're going to make some investments before you've learned the game as well as you may eventually learn it. And if you just keep trying to get a little better all the time, it's been my experience that in due course, you start making some investments where you're practically sure that the odds are overwhelmingly in your favor. You get justified confidence through work, discipline and practice — ending with powerful habits.

There's no shorthand way to get it by going to the master and whispering in his ear for the solution. [Chuckling] It's like learning to play good golf. You've got have some aptitude – and then *work* at it.

An awful lot of stuff just goes in the too tough basket.

Shareholder:… Is there some direction and clarity you can give us when you think about trying to increase your circle of competence regarding a particular industry or company? And I know you've answered the question partially [by saying] go out and do it yourself and just keep fighting until you get everything you need…. But are there things that you look to first?

Munger: Well, there are things that we stay away from. We're like the man who said he had three baskets on his desk: in, out, and too tough. We have such baskets — mental baskets — in our offices. An awful lot of stuff goes in the "too tough" basket. And then we work on the rest.

Now, we can't put a thing in the too tough basket if it's some subsidiary of our own. We've got to deal with it. But if it's some security we don't own now and it looks too tough to decide whether or not to own it, we just put it in the too tough basket and think about something else….

I don't know any other way of coping with reality.

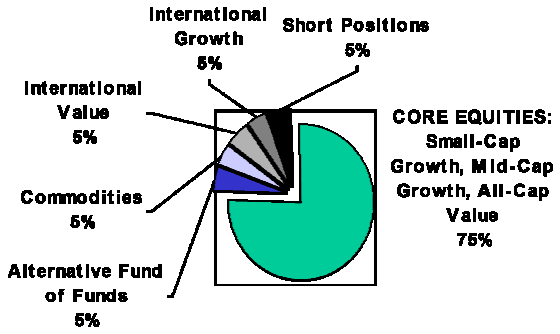
Munger: I don't know any other way of coping with reality when it's as overwhelming as *all* securities and *all* businesses. We want something to come in where we can have a very valuable insight that other people don't have. And there are certain fields where we feel we have a greater likelihood of getting such an insight.

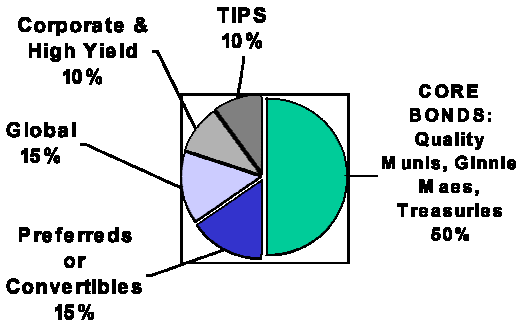
So we ordinarily put all the others in the "too tough" basket. I think all of you are going to have to do the same thing. You have to look for some area of competency and then specialize in that, while not forsaking some generalized wisdom from many disciplines.

(Chris's thoughts continued...)

Periodically, most of us read articles telling us about the "next best great thing" for investing. When stocks are doing well, as in the late nineties, these articles and advice columns tend to recommend investing more in what has done well recently. When stocks are not doing well - as has been the case for the last three years - these same sources of advice tend to recommend moving away from what has done badly most recently and toward…well, the "next best great thing."

The current crazes are real estate investment trusts, bonds, and stocks only if they pay dividends. Our recent favorite was an article in *Barron's,* for which we have the greatest respect, written by Jacqueline Doherty, for whom we also have the greatest respect, which suggests the following allocations for the equity and fixed income portions of a portfolio:





If you were to adopt this approach, your portfolio would not contain: Microsoft, Cisco Systems or Dell Computers; Wal-Mart or Home Depot; McDonalds or Coca-Cola; Merck or Pfizer; General Electric or Fannie Mae. This same sort of article recommended only these stocks in the fall of 1999.Our approach has always been - and continues to be - that we're not smart enough to decide if Alcoa or Zebra Technology, Pfizer or AstraZeneca, Intel or Taiwan Semiconductor is likely to outperform over the next few years. We try to determine what your goals are and how well you sleep at night, and then attempt to build a portfolio that is likely to help you reach those goals without upsetting your stomach. In almost all cases, we employ stocks and bonds, domestic and foreign equities, large companies and small companies. To build that portfolio, we choose managers whose only job is to make the micro decisions between Alcoa and Zebra, selecting separate managers with biases towards either growth stocks or value stocks. Our decisions tend to be at the macro end, and our reallocations incremental. As a result, we are never 100% right, but as we passed the three-year anniversary of March 25, 2000 when the S&P peaked at 1553 and the Nasdaq at 5132 (today 933 and 1520), we are pleased that our clients' portfolios continue to reflect a realistic mix.

GETTING GOING

By Jonathan Clements

Don’t Let the Bombs in Iraq Devastate Your Finances

March 22, 2003

Sure, you might lose more money. But you can't afford to lose your composure.

Already battered by a bruising three-year bear market, stock investors are likely to face even more chaos in the weeks ahead, as the conflict with Iraq unfolds. For many folks, I fear, this next bout of market turmoil could prove to be the final straw.

Tempted to dump your stocks? Before you do anything drastic, here are four points to consider:

Staying Neutral

Every investor should have target portfolio percentages. For instance, those with a moderate appetite for risk might hold 30% large-company stocks, 10% smaller companies, 14% developed foreign markets, 3% emerging markets, 3% real-estate investment trusts, 15% high-quality bonds, 15% inflation-indexed Treasury bonds, 5% high-yield junk bonds and 5% money-market funds.

Once you settle on such targets, I believe you should stick with them, no matter how crazy the market gets.

But that sure isn't easy. Inevitably, some people get frightened or greedy and they abandon their targets. That, however, is a risky move. You might throw in the towel on a hard-hit market sector, only to see that sector come roaring back.

What to do? If you insist on making market bets, limit the amount of damage you can do, by limiting your room to maneuver. Indeed, that is what Wall Street's market strategists do.

These strategists might use 60% stocks and 40% conservative investments as their neutral mix. What if they are bearish on stocks? They wouldn't eliminate stocks entirely. Instead, they might trim their suggested stock allocation to, say, 50% from 60%.

"There's a lesson here for investors," says Meir Statman, a finance professor at Santa Clara University in California. "People look at investing in stocks as being an all-or-nothing proposition. In fact, it should be a matter of moving in relatively small increments."

Got 60% of your portfolio earmarked for stocks? No matter how bullish or how bearish you get, I wouldn't let your stock percentage rise above 70% or fall below 50%.

Misreading History

As investors fret about the future, they are a little too quick to draw on the past. Some people reckon that if the U.S. quickly gets the upper hand in war with Iraq, the U.S. stock market will take off, just as it did in early 1991. Others are sure we are in for a protracted bear market, like the one the Japanese suffered through over the past 13 years.

My worry: Investors will latch onto one of these historical analogies, convince themselves that we are set for a repeat performance and then bet accordingly. But the larger the bet they make, the bigger their potential blunder.

"Which history are we going to replay?" Prof. Statman asks. "It could be Japan in the 1990s or it could be the U.S. in the 1990s. Because you don't know which one it will be, you shouldn't lose the focus on diversification."

Looking Up

Among the historical analogies currently making the rounds, one seems especially popular. Again and again, readers tell me that we are in a long dry spell for stocks, comparable to the dismal period between early 1966 and mid-1982. During that 16½-year stretch, the Standard & Poor's 500-stock index gained just 5.1% a year, while inflation climbed 7%.

Suppose the pessimists are right. Suppose returns over the 16½ years that started in March 2000 rival the 16½ years that started in early 1966. Seem like a grim prospect? In fact, it would be remarkably good news.

Remember, we have already suffered a pretty good licking, with share prices cut in half over the past three years. If we are in the midst of a 16½-year stretch during which stocks clock 5.1% year, we need to do some serious catching up over the final 13½ years. Indeed, for the 16½-year period starting in March 2000 to match the 1966-'82 period, the S&P 500 would have to climb 10.5% a year over the next 13½ years, according to Chicago researcher Ibbotson Associates.

What's the lesson? No, I am not forecasting 10.5% annual stock returns. Rather, at issue is investors' appetite for risk. As stocks have plunged, many folks have become unnerved and some have sold in a panic. But if anything, the market's collapse should make you more optimistic about future returns, not less so.

Getting Even

It's a common stock-market phenomenon: Investors hate to sell at a loss. Instead, we prefer to get back to even before we get out. Why? Partly, it's the money involved. But also, selling at a loss forces us to admit we made a terrible mistake, with all the associated pangs of regret.

Now, think about the weeks ahead. If the U.S. quickly prevails in war with Iraq, the stock market could rocket higher. If that happens, there is a decent chance that many battered stock investors will rush to sell.

To be sure, these investors won't have recouped all of their losses. But after suffering through such a grueling market decline, I suspect many folks will happily sell, even if they recover only a small portion of their losses.

The fact is, over the past three years, there are plenty of stock investors who have discovered their stomach for risk isn't nearly as great as they imagined. These folks are anxious to make back a little of their losses and then swap into more-conservative investments.

If you have found the stock-market collapse unbearably stressful, you probably should sell. But if you can, try to hang tough.

You have suffered through one of history's greatest bear markets. With a little patience and a little tenacity, eventually you will get your reward.