
LETTER FROM THE PORTFOLIO MANAGER

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All Good Things Must Come To An End



Eric M. Kobren

“People throwing money at small caps ... is like planting corn in October since it has grown well since April.” Ron Muhlenkamp April 2006

The quote above came from a conference call that one of our analysts listened to last month (among the 50 fund presentations we heard from portfolio managers or their representatives in April). This folksy reminder of the flaw inherent in “rear view mirror” investing caused a few chuckles, but the point is a serious one.

In our quarterly conference call last month (for those who missed it, please refer to this link: http://www.kobreninsightmanagement.com/conference_calls/confcalls_index.html), we addressed a couple of these hot areas: small caps and commodities. We would like to quickly address these topics again to reiterate a couple of key points.

For starters, it is important to stress that we believe in diversified portfolios and that exposure to a variety of asset classes and market exposures is critical in attaining solid, long-term, risk-adjusted performance. The weight of each market exposure in a portfolio depends on a variety of factors. First and foremost, it depends on a client’s particular situation, but beyond that, it depends on our expectations of the return and risk characteristics of each asset class *going forward*. In turn, these expectations (both in the near-term and long-term), are dependent on market conditions, including such factors as valuations and anticipated growth rates.

Over the long-term, which is measured in years, not months or weeks, the benefits of maintaining exposure to small caps and commodities make sense. Small caps offer ample opportunities for active managers to add value and commodities can provide equity-like returns while providing powerful diversification benefits to traditional equity-dominated portfolios.

We have done well maintaining exposure to these areas in recent years, and we are not eliminating our exposure at present (we always reserve the right to change our mind quickly if market conditions warrant). This all said, we are not adding to the positions either. One chief concern is the tremendous bullish sentiment in these areas. While we recognize and can appreciate the tremendous money flows coming into these markets, long-time clients and regular readers of ours also know that we tend to be contrarians and grow quite concerned when we see such sentiment extremes. Usually, when everybody is bullish on a market, the conditions become ripe for a sharp reversal lower. And vice versa. Contrarian-based investing may mean that we exit some positions too early, but we feel that this is better than getting out too late.

In summary, for the long-term investor, maintaining exposure to the currently hot markets can make some sense, but adding to the positions now, or maintaining significant overweights, may not be so prudent.

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“I Want Higher Risk”

Another great quote we came across last month was “It’s startling that in almost every client meeting I go into these days, clients are saying the same thing: ‘I want higher returns; I want higher risk.’” We have had some similar experiences with clients and prospects, but we have also witnessed it among our investment industry peers.

Rusty recently went to an investment conference on asset allocation sponsored by the CFA Institute (the leading membership organization in the investment industry). It was extremely well-attended by many of the “best and brightest” in the industry. There were many interesting take-aways from the conference, ranging from new research on the latest investment theory and practices to market-related discussions.

But what really stood out was that everybody in the room thought that the markets were due for below-average returns moving forward. If future market returns are, in fact, lower, while risks remain as high (or higher), then it would make sense for investment professionals to focus on using asset allocation to diversify and reduce risk. So it is perhaps not surprising that this was the most popular conference on asset allocation that the CFA Institute has held to date.

Yet, while “risk reduction” was supposedly the focus of the conference, what most of the crowd really wanted to hear about was the “return potential” of unconventional asset classes and market exposures. “Risk reduction” appeared to be the intellectual cover for figuring out how to actually take on *more* risk, not less. If people really were interested in *less* risk, then cash and Treasury bonds – the best diversifiers to equity-dominated portfolios – would have received more attention.

Quality Is Cheap

If there is one common thread that describes what has worked in the market in recent years, it’s that generally speaking, lower-quality securities have outperformed higher-quality issues.

To a degree, “quality” may be in the eye of the beholder, but we could fairly say that some characteristics of higher-quality securities would include the following:

- Less leverage (less sensitivity to the market or the economy, less debt)
- Lower volatility (not necessarily stock price volatility, but reliability in yield or earnings volatility)
- Better transparency (more easily available information to analyze)
- More liquidity (easier to buy and sell)

In the case of equities, those qualities describe the stocks of large-cap, blue-chip firms, which, as we all know, have been roundly trounced by the stocks of highly leveraged, higher-volatility, less-transparent, and less-liquid small cap companies.

In the fixed-income arena, those characteristics are typical of U.S. Treasury bonds, which have been left in the dust, by low-quality, high-yield or “junk” bonds — and the “junkiest” junk has performed the best.

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However, one thing that we know to be true about markets is that they are subject to “mean reversion.” By that we mean that when a market area (such as small caps) moves into overvalued territory, it will ultimately “correct” by reversing course and reverting back to its mean (average) or fair value. Typically, it won’t stop at fair value, but will continue until it is undervalued, and then the process will repeat in the opposite direction.

As we have noted in past commentaries, the relative valuations between high and low quality bonds and stocks now strongly favor high quality securities. Low-quality securities are clearly trading in historically “overvalued” territory. This doesn’t necessarily mean the market will start rewarding high quality this coming week, month, or even next quarter. Unfortunately, the *degree* of overvaluation that a market area or asset class will ultimately reach (and thus the exact timing) before mean reversion will begin is very difficult (if not impossible) to predict.

But we can be sure that mean reversion will occur. One of the industry’s leading value-based investment managers is Jeremy Grantham of the firm GMO. His latest 7-year projections for high-quality stocks are for a nominal annualized return of +5%, while his projection for low-quality stocks is -5%. While this is just one person’s forecast, and as you know we look at a wide variety of expert opinions, Grantham’s track record suggests he is worth paying attention to.

Summary

At Kobren Insight Management, we have been very consistent in our approach over the years. Our bets on the market’s direction and particular market sectors are measured. We are not going to jump completely out of the market if we think it is going down - or go “all-in” when it seems poised to takeoff. Quite frankly, we are simply not that smart. We spend most of our time attempting (and in our humble view, generally succeeding) to identify the “best of breed” managers within each market area. We then use those managers in combinations that engineer your portfolio to achieve a certain risk/return profile.

And in doing that, we try not to spend too much time looking in the rear view mirror, but rather remain focused on where the opportunities are ahead. This is especially important as we move into the May through October period — a timeframe that has historically been challenging for the stock market.

Thank you for your confidence and trust.

Sincerely,



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