LETTER FROM THE PORTFOLIO MANAGER

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The Case For Diversified (Lower-Volatility) Portfolios

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As most of you know, one of the cornerstones of our investment process is to "turn over as many rocks as possible" in searching for investment opportunities, and one of the ways we do that is to talk to hundreds of fund managers each year. Already this year, we have spoken or met with over three hundred mutual fund managers (or their colleagues) about their philosophy, process, resources and positioning of their mutual funds.

As usual, there continues to be a great divergence of opinion among fund managers about the markets' future direction, even among those managers that we consider to be the 'best of breed.' Some of our favorite managers think the U.S. stock market is an undervalued *buy*, while others believe we are in the early stages of a new bear market. Some fund pros believe bonds are a great buy at today's yields, while others strongly believe that you shouldn't touch bonds with a ten foot pole. On the subject of energy, some managers are loading up on energy stocks with every pullback, which others are steering clear.

These diverging opinions are nothing new. For years we've listened to smart money fund managers make opposing arguments about the market. So, if many of them are wrong, how do they turn in solid long-term performance numbers? The answer is by controlling their bet sizes, diversifying their portfolios and focusing on stock selection.

As we've mentioned numerous times in the past, we take a similar approach. While we also have the resources, the historical perspective, and have opinions regarding the direction of the market, specific sectors and asset classes — you will never see us completely load up on one asset class or market sector no matter how strong our conviction may be. Just like some of our favorite fund managers, we know we could be wrong, and making such bets is not a formula for long-term success.

I'm emphasizing this point because it is such an important one and it is the foundation of how we invest your money. We strongly believe that having a diversified portfolio, albeit one with portfolio positioning in line with our latest thinking on the markets and appropriate levels of risks, is still the best way for us to help you realize your long-term investment objectives.

Shifting Towards Quality

Despite our commitment to stay diversified, our most recent conversations with fund managers did echo our view that higher quality companies are more attractive than they have been in several years (see "Quality is Cheap" in our May Letter). A movement towards quality (and away from risk) was a common theme expressed by many of the managers we met at Morningstar's annual conference in Chicago last month.

The first example of this trend is that many of the top managers we spoke with are reshaping their portfolios to feature more exposure to larger capitalization companies. The main thrust of their argu-

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ments was simply better valuations, particularly given the underlying growth rate of many of these firms. More stable, larger-cap companies are by nature of higher quality (less risky) than smaller-cap firms. And this is particularly so in a slowing economy.

Another example of this trend was an oft-repeated cautionary comment from managers about taking on too much risk, and there seemed to be a fresh appreciation for asset classes such as bonds and cash.

However, while a consensus view in favor of large caps appeared to be developing, it should be noted that industry-wide, mutual fund assets are still greatly underweight large cap names and overweight small and mid-cap names. So, while large caps may be getting the headlines of late, they are still unloved by the general public and "under-owned" by mutual funds.

An example of a manager who has already repositioned his portfolio towards quality is Bill Nygren of Oakmark and Oakmark Select, which we own for a number of clients. Though Bill's relative performance has not been strong in recent years (he was clearly early on his move towards higher quality, larger cap names), his reputation as one of the industry's leading stock pickers is well-noted.

As investors flocked towards the hot-performing riskier areas, Bill's funds have seen net redemptions. Despite his long-term track record of achievement, and the confidence of many industry professionals, fund flows are the ultimate test of market sentiment.

However, often the best time to buy a solid manager, such as Bill, is when his relative performance *is* weak — exactly opposite of what investors are now doing with the fund.

"You Can't Eat Risk-Adjusted Returns"

Investors always want to make more money than the market when it goes up, but they don't want to lose *any* money when it goes down. Unfortunately, this is next to impossible to consistently accomplish. A more reasonable goal is to participate in the bulk of the market's gains when it is rising, but lose less than the market when it is falling. This is typically accomplished by diversifying your portfolio to take on less volatility than the market. If done well, this can offer a higher risk-adjusted return than a less diversified, more aggressive approach.

We have often heard the statement "You can't eat risk-adjusted returns" made in defense of more aggressive approaches to portfolio management. We just happen to disagree with it.

The point of that statement is that an aggressive (higher risk) portfolio with an expected return of 10% return over a certain (long) time period is better than a lower risk portfolio with an expected

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return of 8%, because, after all, 10% is better than 8%. Who cares if after taking into account the differences in relative risks, the aggressive portfolio's risk-adjusted return drops to 5% while the lower volatility portfolio only declines to 7%. You can't "eat" that 2% advantage because what you are actually going to earn is 10% and 8%.

But, and this is a very big but, *that is only true if you stick with each portfolio throughout that entire period.* No jumping out of the market during sharp declines, to wait until conditions improve before getting back in.

And with the more aggressive portfolio, those declines will be a lot sharper, a lot more emotionally straining, and a lot harder to resist. In short, the more diversified, lower risk portfolio approach greatly enhances the probabilities that most investors will be able to "stay the course" through market thick and thin and ultimately reach their long-term objectives.

Obviously, each individual has their own combination of investment considerations, including investment objectives, risk tolerance, time horizon, etc., and therefore the risk level that may be deemed appropriate for their portfolios may be different. But numerous studies have shown that investors are better served with diversified, lower volatility portfolios, than by trying to chase the hottest performing sectors in a higher-volatility mix.

The most recent study that backs up this notion was presented at the Morningstar conference by Morningstar's Don Phillips. They divided each category or peer group of mutual funds into two buckets. The first bucket contained those funds that had the most volatility. The second bucket contained the less-volatile funds from each category or peer group.

Looking at returns going back ten years, high-risk funds returned 8.3% while lower risk funds performed slightly better, returning an annualized 8.7%. However, when they examined the returns actually earned by investors in those funds, the difference became magnified. On average, investors in the high-risk funds earned an annualized return of only 5.1%, while investors in the lower-risk funds netted 8.5%. Poorer returns achieved by investors in higher-risk funds is explained by the fact that they 'buy high, and sell low,' versus investors in lower-risk funds who are less prone to sell their funds during market downdrafts.

As Phillips noted, (and as we have long warned against) investors tend to chase performance, which is easier to do with higher volatility investments and portfolios. Investors too often buy after an investment has already been hot, and sell after it has been cold.

Many in the industry may cite that investment costs are the biggest problem that investors face, and while we agree it is indeed an important consideration (please see our recent *Research Perspective* on investment costs located at www.kobreninsightmanagement.com), it is a distant second to the problem of chasing performance.

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Yes, you can "eat" risk-adjusted returns.

In short, while a well-diversified, lower-volatility portfolio may not be "sexy," you will likely "eat better" ... and sleep better as well.

Sincerely,

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