

We're Not Dead; Just Resting

With the usual disclaimer that it has been far too long since the last time we wrote, we present our first strategy letter of 2006, beginning with a modest look back at 2005.

At RCB, the latest trip of the earth around the sun was notable for its lack of tangible movement. All three of our institutionally reported equity products (Large Cap, Small Cap, and All Cap) barely moved in 2005. Each ended positive on an absolute basis and somewhat underperformed the usual battery of relevant benchmarks on a relative basis. All in all, 2005 and the early part of 2006 for us almost made the Super Bowl look interesting.

The faint sound of the rational voice would now have us move on to a variety of interesting topics and our well-reasoned explanation of how we might expect to exploit them for our clients' best interests, but alas the "business" of money management does not work like that. Despite the fact that nearly every textbook financial theory as well as a variety of painfully earned anecdotal examples suggest the absolute randomness of any single year's result and the absolute necessity of avoiding the wide assortment of behavioral finance traps (please re-read Beyond Greed and Fear by Hersch Shefrin), we sense the rumble of the jungle drums in certain segments of the population,

the beat of which sounds to us like a chant of "what's up with these guys?"

While it is troubling to us that in the "experienced" market of investment management participants we are still addressing this kind of issue, we would point to the recent Berkshire Hathaway annual report. Warren

Buffett neatly reminds us of Newton's Fourth Law of Motion: "For investors as a whole, returns decrease as motion increase." Our value-oriented strategy has done an excellent job over decades of avoiding the "disaster" scenario and our long-term record is the result of vacillating between mediocrity and wonderfulness. That enables our clients to ride the train named First Wonder of the Investment World - Compound Returns. Unfortunately,

we have a number of new clients who have purchased the RCB ticket for this train, but are still at the station waiting for its arrival. We remain highly confident the train is coming and the ride well worth the wait, but as is always the case in financial markets, we are unable to provide the train schedule. A new book by former Morgan Stanley strategist Barton Biggs entitled Hedgehogging provides a very entertaining and occasionally painful look at the relationship between clients and their money managers. We encourage you to read it. Another good read is The Little Book That Beats the Market by Joel Greenblatt, from which we



appropriate and customize the following statements:

- 1) We have a long-term record of out-performance.
- 2) We do not outperform every year.
- 3) The key to #1 is not getting spooked by #2.

Looking back at 2005, we would suggest that two issues contributed to our lack of another wonderful year. The first is very simple: we were generally unexposed to energy and greatly overexposed to media. At the end of four quarters, here's how that played out:

	<u>Energy</u> <u>Weighting</u>	<u>2005</u> <u>Sector</u> <u>Return</u>	<u>Media</u> <u>Weighting</u>	<u>2005</u> <u>Sector</u> <u>Return</u>
RCB Large Cap Value	0.0%	0.0%	22.5%	-13.1%
S&P 500 Index	7.3%	31.4%	3.2%	-12.8%
RCB Small Cap Value	0.0%	0.0%	19.4%	-15.4%
Russell 2000 Value Index	6.0%	39.1%	1.5%	-22.4%

That clearly didn't help. While we are not fond of what we call "investment sector excuses," and prefer to say simply "we missed it," there is some historical basis in saying that our approach generally has not and does not lean toward overweighting commodity-oriented companies. The downside to our avoidance of commodity speculation is that we sometimes must endure periods where that strategy is the "hot dot" and we are not participating. History has also shown these periods to be generally brief (although it feels like forever) and we rebound nicely. In regard to energy, while we never rule out anything, it seems unlikely that we will load the portfolio with energy issues at current price levels. We have gained much painful experience in this recent period, but little of it is relevant to an enhanced ability to guess the direction of commodity prices. Barring a nuclear winter in Iran, the world remains reasonably flush with available hydrocarbon energy. This suggests to us that intermediate pricing is extremely sensitive to levered hedge fund day-trading and basic economic demand issues, both of which seem firmly wedged in the realm of cyclical forces. In fact, there is a huge and under-appreciated factor operating

in today's oil and gas markets, as well as in commodity markets in general. The creation of publicly traded, liquid financial instruments that represent direct commodity representation has greatly increased the ability of our highly levered friends to take immediate positions in energy and commodity markets without the hassle and cost of dealing with the actual commodity. This has created a huge financial tail wagging a relatively illiquid commodity dog. Whether or not you are talking about exchange-traded funds in gold or the standard bearer Goldman Sachs Commodity Indices, the ability to achieve "must have" demand for commodity exposure through these financial instruments creates demand for the underlying commodity, which in itself sparks more short-term momentum demand for the financial shares or futures contracts and so on and so forth into a neat little price spiral. Throw in the historically poor equity performance of "inevitable" headline hogging trends and that moves our gaze elsewhere.

The second issue partially relates to the general state of value to be found in the market. We continue to find it difficult to identify the "fat pitches." Some would argue that this is secular as we are in an extended low volatility, low interest rate environment with perfectly reasonable economics and huge amounts of newly raised money willing to accept historically low returns. We couldn't disagree more and remain patient in our search to find either great businesses at a reasonable price or reasonable businesses at a great price. The huge run in "value" and high yield has nearly eliminated the latter category, which has led our efforts to be more focused on the former. In fact, we are looking at a number of large cap "quality" names that we have not considered in a decade, if ever, and recent purchases include 3M and Symantec. That we are nibbling in this arena suggests reasonable returns for the intermediate future, but the lack of huge ideas makes it unlikely that we or the market in general will be putting up huge numbers. The fundamental math is not everything, but it can be one heck of a headwind.

This brings us to 2006. One of our better guesses is that this year will look a lot like the last one, with the obvious exception that our relative performance will be a lot better. In almost every case, the value of what we own has increased over the past twelve months, yet the market price has not moved. Think of a portfolio as a value spring: our coils have tightened and while there are no guarantees that they will not coil further...and further, we can see at least ten stocks that we own that are cheap enough at current levels to deliver 50% plus

returns over the ensuing two years, which is plenty of firepower in a relatively concentrated portfolio to generate excellent portfolio performance if we keep our mistakes to a minimum.

The inevitable “other hand” scenario, which we also see as beneficial to our long-term performance, has its origin in the chart below.

The “VIX” is a depiction of volatility in the equity markets and a very similar situation exists in the fixed income world as well. What it says is that the world has become significantly less volatile over the past few years.

There are any number of reasons that can be suggested for this: an open Federal Reserve policy, steady economic growth and a lack of domestic terrorism, for example. We remain

utterly convinced that volatility in both financial markets and life itself is the essence of mean reversion: complacency and success lead to mistakes and ensuing high volatility and the world that follows a period of fear and panic seems to be remarkably sanguine. What that means to us practically is that the odds suggest that a period of more “normal” uncertainty lays ahead and that means more dispersion in the performance of stocks, all of which is good for us. We need more stocks wilting under short-term disappointments compounded by panic selling by short-term investors, and vice versa, unbridled enthusiasm that provides opportunities to sell at advantageous prices. Short-term pain and suffering today sets up our performance for the ensuing years.

Our largest sector concentration remains in “old school” media, with Time Warner, DirecTV, Comcast, Clear Channel and Disney representing 20% of our large cap equity holdings and a similar percentage of their smaller brethren held in our small cap portfolios. It is difficult to recall a more battered group

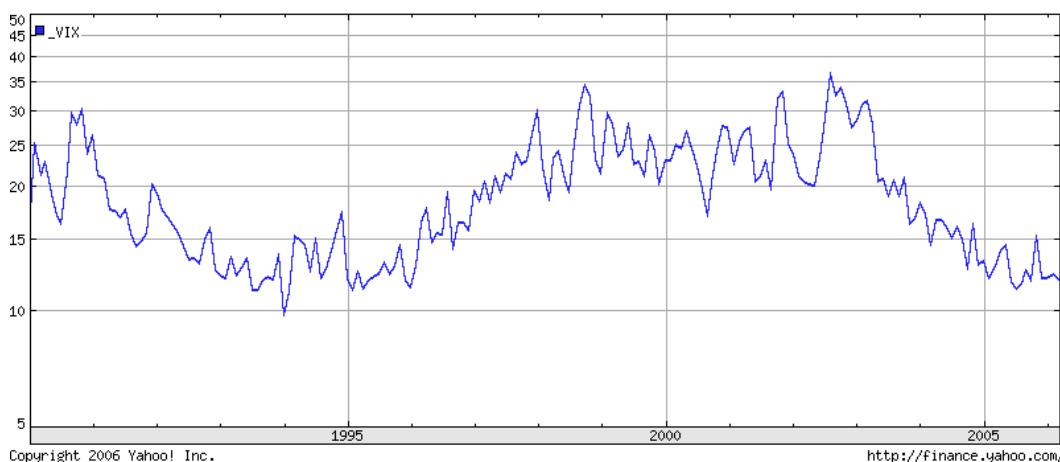
psychology than that represented here, which combined with large free cash flow and in our opinion distinctly inexpensive valuation, suggests excellent future performance. That said, we are not blind to the conceptual “value trap” arguments that represent in total the makings of a big fat portfolio mistake. The larger arrows at our media targets are technology based: the increasing ubiquity of high-speed broadband access coupled with nearly free digital storage is breaking the franchise strangleholds of the gatekeepers - satellite and cable - as well as threatening the value of content which has been supported by a buffet-style pricing model. Throw in tens of billions of dollars of desperate

upcoming R B O C investment that has little chance of ever earning a return, iPods, satellite radio, and Wi-Fi, and you create a scenario that would frighten institutional investors more than a

friendly visit from Eliot Spitzer. We also recognize the possibility that a qualitative Moore’s law is in effect as digitization is hurling bad news at our old media at a geometrically faster and faster rate. This may not be a “yes, fewer people may be smoking, but look at the cash flow and in the meantime buy Philip Morris today” argument.

Our premise is frankly different for each of our holdings, but the over-riding theme is based on three general tenets. The first is that the fear and negative hype as suggested by our valuation, which we feel is based upon very reasonable assumptions, greatly outweigh the intermediate reality. Secondly, it seems inconceivable to us that the largest media companies with cross-platform sprawl are sitting around in dark basements with canned food waiting for the inevitable to happen and their lives to fall to pieces. In fact, every one of our holdings is spraying financial and intellectual capital at nearly every angle of the possibilities of different forms of distribution, technology and pricing and is likely to participate in

Too Quiet? VIX - S&P Volatility Index



some degree in whatever radical changes, if any, occur in media over the next decade. Immediate obsolescence, which is suggested by current pricing, seems to us unlikely. Lastly, while Carl Icahn has no business running Time Warner, nor does he have any real crystal ball on the issues noted above, he does have the right idea. Large media companies are cheap, they have huge financial resources with which to improve returns to shareholders, and they should get to it. We expect further dividend increases (The Radio REIT?), share repurchases, asset swapping and outright ownership changes in 2006 which should be beneficial to our performance.

While anything is possible conceptually, we think a catalyst for the whole group revolves around the valuation of Comcast, which is the largest cable provider. It has disappointed "Wall Street" in the short-run with lackluster results in the marketing of its phone service, a key part of cable's bundled offering of services. At current prices, Comcast sells at 7.4 times cashflow, implying that Time Warner is really worth its current price of \$17.50 and Carl Icahn and Lazard Freres have wasted precious timberland with their 300 page report on Time Warner's valuation. Comcast has had residual issues in dealing with its acquisition of the former AT&T's cable systems in terms of its phone offering and now appears to have its operations and roll-out plans in order. While we frankly hate to quote Wall Street research, a Sanford Bernstein analyst recently published an interesting statement about the value of telephony to the cable companies. "What's astonishing about the Cablevision results is that the numbers are head-spinning in how good they are. This is a company that has by far the highest penetration of basic cable in the country, yet they are growing faster than any other operator. They have by far the highest penetration of digital and yet they're still accelerating their digital penetration. They have by far the highest high-speed data penetration, and just put up the best high-speed data growth quarter they've had in four years. All of that points back to the power of VoIP (telephony) to pull through consumer demand for the rest of the product."

We could go on for some time in our discussion of the other "coiled springs" in our portfolio, but the burden of space weighs upon us. The core tenets of our firm and investment philosophy remain firmly in place as we have never lost an investment professional for any reason other than natural causes in our forty-seven year history. This also provides the intestinal fortitude to stick to our guns through any number of odd market

cycles when in the short run we appear not to be the sharpest tool in the box.

The stock market is generally efficient and annoyingly even more so now than usual, which further buttresses our case for concentrating on fewer investment ideas derived from research at the security level rather than 30,000 foot guesstimates as to the future of the planet. With the investment world seeming to be ever more fixated on short-term results, there is enormous value to be added by accepting the majority's fear of "quarterly benchmark risk" and thinking longer term. The cheapest "idea" we see is long-term investing and we are happy to own it in size.

In closing, we ran across an interesting quote from noted investment thinker Martin Leibowitz. Writing in the September 2005 Financial Analysts Journal in a rare moment of non-mathematical exposition, Leibowitz reflected on the character of investment management firms to which we humbly aspire: "The great ones share a number of positive characteristics – focus, patience, a clear-cut philosophy, a willingness to go beyond the diversification mantra and accept high concentration risks, an innovation-prone attitude, the organizational sponsorship and personal fortitude to endure significant periods of underperformance and a disciplined process for pursuing goals."

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