

## Brad and Jennifer on Wall Street

“We are not making a cent, but we’re doing pretty well” would be as good a summation as any of the early goings in 2005. In our book, performance relative to an index or other investment managers is only worth something if our number is north of zero and at the end of the first quarter we were hovering around that line. As detailed in previous communications (frequency issues are noted and apologies offered), the environment in which we operate remains far from ideal. It used to be that investors were fearful of everything and corporate executives could pretty much guarantee themselves an eight figure net worth by just showing up. Now it appears investors of all stripes are boldly treading where few dared to venture and it is executives who sit by the phone cloistered with legal counsel waiting for the next call from “His Highness,” the Attorney General of New York.

Aside from the usual vagaries of the macro-environment, we continue to be humbled by the distinct lack of attractive investment opportunities available in either the stock or bond markets. As we watch complex companies brought to their knees by “glass half-full” regulatory bodies, we yearn for simplicity, so here is something reasonably simple that neatly summarizes the investing world. (Please refer to graph on page 2.)

Regardless of the minutiae of earnings quality arguments, the simple picture is that “after” stocks have materially risen and thus represent at minimum a fair proxy for underlying value, subsequent returns are muted at best. On a bottom up basis, trolling through new companies as well as our own existing portfolio holdings every week and comparing their intrinsic value with quoted prices, we see dozens of confirmations of this big picture.

This is where it gets tricky. Should we sell the stock of a company whose business we like and management we admire when it reaches our estimate of fair value? While we might trim a position if it represented an outrageous percentage of a portfolio, we are loathe to make this kind of sale for two reasons. The first is that investment analysis is not a point-to-point business and there is no such thing as a

stock worth \$46.28. Based upon a series of reasonable estimates, a stock might be worth \$42 to \$48 per share, which means selling every \$47 stock you own is NOT a recipe for success. Ideally, you are looking for “better” businesses whose intrinsic value is conceptually increasing daily so that your current \$42 to \$48 range is \$47 to \$53 in 2006 and so on. “Time” is a key variable in wealth creation and its use in valuation references is obviously and often ignored or misused, as judged by the three billion or so shares traded daily on U.S. stock exchanges. A company is worth X today, but what will it be worth reasonably in three years or five years?

Smart, shareholder-oriented management can also rescue you from the “fair value” blues. White Mountains Insurance was a beautiful example of this for our clients. Originally purchased at \$125 per share as a liquidation strategy with a 12% annualized return target, the stock gradually traded up to \$175 and represented “fair value.” Two days later, management gracefully accepted the European fire sale of a top ten U.S. insurance company, which transformed the company overnight and now we are sitting on a fairly valued \$600 stock. We are inclined to give this management team the benefit of the doubt to navigate to higher value over the next five years.

The second issue is that a “fair value” sale requires an additional decision: what is an appropriate replacement? This can beget a vicious cycle requiring more and more investment decisions of inevitably worse quality and voila, you end up like the typical 120% turnover mutual fund, consistently underperforming your benchmark by 200 basis points a year. This is particularly dangerous in the current environment, where the common refrain heard around our halls is “nice business, fairly valued, what else do you have?”

While we do have a slowly revolving core of these types of “better businesses,” the danger in this position is that we conceptually can be down 15% pretty easily if every fairly valued stock followed this route. That raises an ongoing question: what level of short-term pain is “acceptable” within the confines of a successful long-term investment strategy

predicated on the irrefutable mathematics of the laws of compounding? The only honest answer is really “less loss is better than more,” but that’s as far as one can really nail it down. This is why investing, much like dieting, is fiendishly simple in theory but extremely difficult in practice. (Getting both right seems to be near impossible.) The long-term investor must implicitly recognize the obvious math in this process: our “expected returns” from this starting point almost CERTAINLY will be lower than the point-to-point returns achievable from a level 20% lower.

That not really said, we have a number of issues inherently at work in our investment discipline which have historically helped mitigate pain for our clients. (Calendar year 2002 was the first down year for our large cap composite in 22 and for our balanced composite in 27.) First off, our approach IS different from a style of simply viewing stocks as numerical pieces of paper that can be statistically determined to be cheap or dear, and mechanically bought and sold accordingly. While there are many ways to skin the cat to produce superior long-term returns, we have seen very few firms that seem to

possess a quantitative model that consistently can process canned database information and effectively translate it into results. Our experience is that the “third leg” of qualitative analysis, while subject to a Nobel Prize-winning set of behavioral pitfalls, collectively adds value over the long run.

While we don’t have an entire portfolio of outstandingly cheap stocks primed for takeoff, we do have enough of them and this should be sufficient to create decent returns in the intermediate run, if we keep our mistakes to a minimum. This is the key advantage in running concentrated portfolios: we don’t need 128 good ideas to create value and thus are more dependent on our own wits than general market trends. (Yes, that’s an advantage!)

Additionally, we are grossly underinvested in what has been considered “hot” over the past six months, that being energy and basic materials stocks. We accept our limitations in commodity pricing gracefully, and unless there is a compelling valuation that does not rely on heroic macro explanations, we generally look elsewhere to add value.

While it is fun to attribute nearly every market move to hedge fund activity, it is accurate to say that an enormous amount of money in effect is practicing leveraged momentum day-trading, and by selectively selling and buying into its excesses in a contrary fashion, one can grow and protect capital. We do not think levering up tough markets is the solution to creating higher returns.

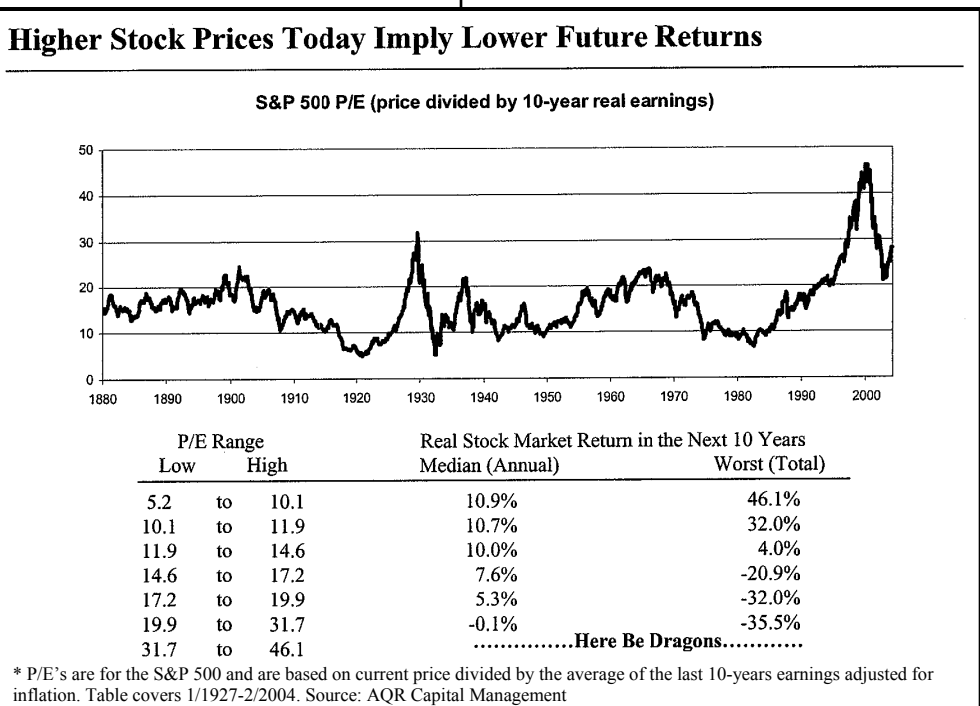
We also have a fair amount of cash, particularly for newer clients, and we have been successful to date in resisting scattered calls to “do something” even if its OBVIOUS outcome is to do something dumb with a client’s money. The “price” an investor pays for his portfolio is of equal importance if not far greater than how much he has invested.

Oh, by the way, who said the market is going down? We frankly have no idea where it is going, but we are simply pointing out once again that where there is little margin for error, the investor seems to find error in abundance. Despite the crowd now sharing this view, it still seems as if we are firmly in the midst of a cycle of higher interest rates, a

slower economy, and harder to come by corporate earnings growth which is the go-slow solution to our foreign exchange/trade issue. We fee-based “stock jockeys” are often mocked in certain circles, the publications that cater to them and the Berkshire Hathaway annual report for the pretense of benign neglect of the

horrendous possible outcome of a 1987-like spike in interest rates to stem a run on the dollar. As is usually the case, we think the most likely outcome is the “muddle-through,” recognizing that we share the same lack of ability to forecast macro-economic events as the overwhelming majority of financial market participants. All other issues being equal, it is difficult to suggest this turn of events as being a positive for equities. These issues are exacerbated in small cap value investing, which has simply crushed nearly every asset class for almost five years. This kind of record is unsustainable and we are hopeful our caution will play out in our clients’ favor. We welcome being “wrong” and trudging ahead.

This is an exceedingly difficult time to be managing money,



whether or not you are looking at things within the confines of a specific “box” or from the mountain-tops of global asset allocation. We continually hear moaning from sophisticated players in real estate, private equity, and the high yield markets in regard to the lack of investment opportunities. There is very little that seems “obvious,” at least to us, and thus the most undervalued asset we see is patience. As the great Oracle from Manhattan, Woody Allen, noted, “More than at any time in our history, mankind faces a crossroads. One path leads to despair and utter hopelessness. The other leads to total extinction. Let us pray we have the wisdom to choose correctly.”

Which brings us to Brad and Jennifer, Hank Greenberg, AIG, Elliot Spitzer, the analysis of insurance stocks and another look at trends in the American corporate governance debate. Before we start, in this enlightened age of full disclosure, we must make certain statements: we are the new owners of roughly one million shares of AIG on behalf of our clients with an average cost in the mid-\$50s; our stated interest is for these shares to be valued at much higher levels and we can and will make statements laden with conflicts of interest in order to further our goal; we may or may not have had dinner with a college girlfriend whose husband may have worked for AIG, but since we have never met with or talked to him we are not quite sure; we once went to an insurance conference at which Hank Greenberg spoke three years prior; and we may or may not have had lunch with an AIG employee at a hot dog stand outside of the New York headquarters, but it was crowded and the security badge was hidden by the overcoat, so we cannot promise that we did or didn't.

Let's state some obvious issues. We do not in any way condone illegal or unethical activity and in the last few years there has been some terrific and long overdue attention focused on a variety of weasel-like activities promulgated by the industry in which we work, as well as other financial areas. However, it can be argued that the “investigative process” employed by certain government officials and their offices has an increasingly questionable methodology; the collateral damage is increasingly large and unnecessary; it is full of its own conflicts of interest; and along with a variety of other “do-good” legislative issues, is creating a classic and negative balloon of unintended consequences.

Now, let's work backwards from AIG. Very briefly, more than 35 years, mostly led by former CEO Hank Greenberg, AIG has grown from a company with a market cap in the tens of millions to nearly \$200 billion at one point. AIG is legendarily tough, profit-driven and it can easily be said to have reinvented how the modern insurance company operates, much less the global financial services company. We are happy to gush and say AIG is a magnificent success of entrepreneurship and global capitalism.

If you gush about AIG, you are de-facto gushing about Hank Greenberg. He has almost single-handedly built the company with a personal intensity and focus on detail that should make most CEOs blush. In fact, it can be argued that this

intensity and personal identification with AIG is at the heart of their problems: it is the house that Hank built, and it is questionable whether anyone else can live in it after him, which could be both good and bad for a stockholder at \$55 per share. As written by David Schiff, a self-described insurance sleuth who pens the aptly titled Schiff's Insurance Observer (a publication worth buying, in our opinion), “AIG has accomplished what no other company (insurance) has. Watching Greenberg's performance is akin to watching a sleight-of-hand artist who appears to make cards appear and disappear. Although you know the legerdemain isn't magic – it's the result of practice and hard work – it seems like magic.” Hank is feared in many places in the insurance industry and we are sure there is a palpable sense of glee in the comeuppance of a guy who was simply smarter and tougher and for longer than any of his peers.

We would suggest that this “personal identification” issue is generally a long run positive for any business enterprise and anyone who doubts that should probably not have their money managed here. It seems to be very common human experience in any field—business, science, the arts or athletics—that the focus and drive derived from “living” the endeavor rather than showing up at appointed times, is the key to long-term success or, dare we even suggest it, greatness. In fact, one giant negative to come out of the unholy alliance of Sarbanes Oxley, Eliot Spitzer and Institutional Shareholders Services is the new role of the emasculated CEO who surrounds himself with corporate strategists, lawyers and PR flacks and thinks it's more important to be properly represented at Davos than it is to know the people and numbers of a small division of his empire. But we digress for a brief moment...

To say that AIG is a complex company is to state that water is wet. There are \$800 billion in assets and \$80 billion of shareholder equity spread over nearly every product line imaginable in insurance (and then some, as it turns out), as well as a whole host of Goldman Sachs/hedge fund-like financial services ventures in over 130 countries via hundreds of subsidiaries. We were long-term holders of AIG throughout most of the 1990s and were delighted to sell the stock some years ago at north of \$100 per share at a preposterous valuation of nearly 30 times earnings. We repurchased the stock this year in the midst of the chaos involving Mr. Spitzer's investigation of Marsh McLennan, when it appeared that any industry that had an “I” in it was considered fair game for bashing by short-term investors. After a brief window of shining short-term success, we are right back to cost in the wake of the Entertainment Weekly expose reporting in the Wall Street Journal and elsewhere.

The analysis of any financial services company in general and insurance companies in particular comes down to a specific decision: do you trust these guys or not? The assets walk out the door every day and the very basics of the insurance industry at its finest are a continuing series of well-meaning guesses as to what the cost of goods sold for your revenue will be years and years ahead. Do you trust senior

management to have built a culture that will strive toward underwriting profit and reporting a semblance of reality or don't you? We read the same papers you do and what we have concluded is that after decades of scrutiny as a public company, in the eyes of both buy and sell-side investors, insurance ratings agencies, debt ratings agencies, and state and federal regulators, it is preposterous to suggest that AIG is some kind of full-blown accounting sham...or worse, as has been suggested by hungry reporters or fearful investors. As veterans of Tyco (a mid-teens purchase, for the record) and the gleeful zest with which the financial press went after every anecdotal and juicy tidbit, borderline true or not, and often ENTIRELY irrelevant to the business of valuing an investment, we are not surprised but still dismayed at what we are witnessing with AIG and Hank Greenberg.

What does it say about our system of law when government officials utilize a Soprano-like practice of instituting and settling investigations for cash with no formal charges, no admission of guilt and little restitution to the alleged victims? That has really been the de-facto practice of the New York Attorney General's office as it rumbles through the financial industry. There is a HUGE difference between going after specific individuals accused of wrong-doing and threatening the existence of an entire corporate entity, and a huge difference between the full regulatory and prosecutorial power of a government entity compared with two private parties going after each other in private litigation. The difference is that you CANNOT say no to a government official who has the full authority to shut you down tomorrow or at least create a sequence of events involving ratings agencies, securities pricing and investor psychology that de-facto has the same outcome. So, although Spitzer crows in a recent Wall Street Journal editorial, "the nation's two largest insurance brokers admitted wrongdoing and agreed to settlements that implement sweeping reforms and provide restitution totaling more than one billion dollars," what choice did they really have with the ghost of Arthur Andersen looming over them? (For your information, his assertion is factually inaccurate – check the Marsh McLennan website for their press release: "the company neither admits nor denies the allegation.")

Does the Spitzer process make him a solution to corporate governance problems or part of the problem and the creator of a different problem if his team of lawyers can rumble into an industry they barely understood yesterday (go look at his website and actually read some of the press releases), declare the alleged wrongdoing in the press, dictate the practices and management structure of companies, take cash from settlements privately negotiated, trumpet some hastily put together reforms and then move on leaving "whatever" in their wake on their way to their next public office? He is entirely right to prosecute wrongdoing criminally or otherwise, but we suspect there is something else afoot when the targets seem to be huge companies viewed as criminal enterprises run by prominent scalps. For our own Brad and Jen bit of sensationalism, we personally think the disclosure that his campaign office paid for a sponsored link

on Google to connect a search for AIG to a website for his gubernatorial bid to be a particularly juicy bit of insight. What is even more annoying is that Mr. Spitzer has lit a God-given fire under the other 49 AGs and their brethren. Phil Angelides, the state Treasurer of California who "coincidentally" is also running for governor in our fine state, noted that "we are deeply concerned with the damages and losses at AIG...and we have the right to do anything we can to get our money back." Let's see, overzealous public officials announcing high profile and media-laden investigations; hiring prominent outside counsel to sue the companies they still own in their massive index funds; and damages may or not may pass from the left hand of the aggrieved pension fund to the right hand of the fund minus said attorney's fees, a portion of which are funneled back into the campaigns of said public officials. This is a corporate governance progress?

We have lots more to say on this and AIG, but our room here is running out. We recognize that there is more "headline" risk in AIG as investigations are ongoing and we are fully expecting some more obvious assertions that a review of how \$800 billion in financial assets accounts for itself can easily have many moving parts and revisions. How AIG produced "earnings" has been a thirty plus-year example of the best and now possibly some of the worst financial sausage-making. Our opinion is that in the low to mid \$50s, much of this is reflected in the stock price and the downside is dead money for the next two years as this saga plays out. Longer term, AIG truly has some exceptionally good global businesses that will grow and command a higher valuation once the eyes of investors are focused on what we hope will be a more agreed upon set of financials. We have often said that our best investments are usually made in the worst of times. We think AIG fits this bill.

In closing but perhaps most importantly, Reed, Conner & Birdwell has never been in better shape personnel-wise as we move into our forty-sixth year. Our assets now exceed \$3.7 billion and we have strategically staffed research, operations, trading, and client service to maintain our traditional standards of excellence. Our small cap efforts are closed to new business, fulfilling our promise to existing clients to refuse new assets beyond a level that would effect our ability to deliver performance. We remain focused on providing a smaller number of larger institutional and private clients superior long-term results and tailored service to meet their varied needs.

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