WEDGE WATCH

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Playing the Odds in an Uncertain World

"The object of golf is to beat someone. Make sure that someone is not yourself."
–Bobby Jones, legendary golfer and founder of Augusta National Golf Club (1902-1971)

First Quarter 2006 Financial Statistics

DJIA: 11109.32

S&P 500: 1294.83

90-Day T-Bill: 4.60%

30-Yr. T-Bond: 4.85%

As you read this, the winner of the 2006 Masters Tournament, arguably professional golf's most coveted and prestigious major championship, will likely be basking in the early though enduring glow of hard-won victory. In the seventy-two years since Horton Smith edged Craig Wood by one stroke to win the tournament's first championship, many of golf's greatest names, such as Hogan, Palmer, Nicklaus and Woods, have strode triumphantly across the putting green of Augusta National in the moments following what is often an electrifying tournament finish. There, the winner proudly dons the champion's signature "Green Jacket," framed against the backdrop of a fading sun slowly descending behind the towering pines that gently shade the course's hallowed grounds. Though each of these men, via rare combinations of grit, nerve and skill, reached the pinnacle of achievement in their chosen sport, none could ever claim to have achieved golfing perfection. Ironically, however, a relative unknown from the Canadian north may have come closest to achieving this eternally elusive goal.

Murray "Moe" Norman, an eccentric and quirky-mannered Canadian golfer, math savant and high school drop-out, who suffered a fatal heart attack on September 4, 2004 at age 75, zealously pursued golfing perfection (at least in terms of ball striking and accuracy) for nearly six decades. Over the years, golfing luminaries from multiple eras, such as Sam Snead, Lee Trevino and Vijay Singh, went on record to state that Norman, described once by a sportswriter as "a stocky cartoon character with thick Popeye arms and wispy Einstein hair," was, bar none, the purest striker of a golf ball they had ever seen (despite his highly unorthodox sledge hammer-like swing and grip). A rather oddly-dressed individual (he favored mixing brightly colored stripes and plaids) who affectionately dubbed himself "Moe the Schmoe," Norman played competitive golf for more than 50 years, almost exclusively in his native Canada (hence his virtual anonymity in the U.S.), as an acutely shy nature kept him close to home. Witnesses, and Moe himself, claimed that he played 11 of those years - that's approximately 230,000 golf shots - hitting only one ball out of bounds (by just two feet) during that remarkable stretch. In fact, Moe's hand-eye-coordination was so refined that he reportedly once hit over 350 consecutive drives off a standard wooden golf tee without so much as disturbing it from the ground. In reference to this unrivaled precision, Moe liked to boast that he had played with the same tee for over a decade, matter-of-factly stating that he "hit golf balls, not golf tees." For Moe it was all about a singular golfing pursuit - accuracy and repeatability. *"The result - nearly every shot he hit was straight. Not left. Not right." Just squarely down the middle.*

Although Moe could do clever and amazing things with a golf ball, he wasn't just another "one-trick pony" on the driving range (where, as a youth, he was known to practice until his hands bled). Moe's

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nearly infallible and totally self-taught accuracy was a lethal weapon competitively. During his multi-decade career, competing on both the amateur and professional level, he recorded a remarkable 17 holes-in-one (eight on the fly!), nine double eagles, three sanctioned scores of 59 (despite a three-putt in one round), more than 50 tournament victories (though it was speculated that he often let others win to avoid the spotlight of the trophy presentation), and over 30 course records! Early in his playing career Moe became a golfing sensation in Canada by twice winning the Canadian Amateur Championship despite, due to a chronic shortage of funds, having to hitchhike to some tournaments and sleep in bunkers. (He had little, if any, financial or moral support from his family, having grown up under difficult circumstances in Kitchener, Ontario.) Moe was such a skilled ball striker that in 1956 he posted scores of 61 on four different occasions (a rare feat even for a pro). "His finest year as a professional came in 1966, when he won five of the 12 Canadian tournaments he entered, was runner-up in five more and finished no lower than fifth in the other two." In 1979, when he turned 50, he proceeded to run roughshod over his peers on the Canadian senior professional tour, winning seven of eight Canadian PGA senior championships between 1980 and 1987. Amazingly, unlike most golfers, age apparently did little to diminish the effectiveness of Moe's game as one of his sanctioned 59's came at the age of 62!

Despite the remarkable nature of Moe's golfing acumen, you may wonder why we've taken the time to tell his story here. A little background information will help explain. In recent weeks, as we casually reviewed a stack of articles about Moe, it struck us that his unique and highly successful approach to the ancient game of golf carried with it valuable lessons of considerable import to the serious investor. Throughout the course of his career, when delineating the rationale behind the mechanics of his highly unorthodox but remarkably effective golf swing, Moe urged those eager to learn his secrets to "***try smarter, not harder***." He had discovered, through years of trial-and-error, that he could make *probabilities* his friend by hitting the ball straight; therefore increasing the odds of posting a low score by keeping the ball consistently in play and out of trouble. His unconventional swing, which some golf purists found disarming and unpalatable, consisted of *fewer moving parts*, by design, than that of the traditional golf swing. The goal, according to Moe, was to create a sound, dependable (i.e., repeatable) swing that would dramatically increase the odds that he could hit the ball straight, on demand, whenever he wanted. In other words, it was *process* and *probabilities* that mattered most to Moe and that, in turn, led to him achieving the far above-average number of below-par scores he so desired. In describing his methodology, Moe liked to say that, *"I gave myself a chance. I keep it simple."* A successful investment strategy, in our opinion, shares distinct commonality with this well-conceived approach.

In value investing, given the plethora of uncertainties that typically abound, one must, like Moe, focus first and foremost on developing a disciplined *process* (which, in his case, was a highly dependable and repeatable golf swing) that "tilts-the-odds" in favor of the investor. *Process*, not outcomes, should drive the framework for decision making. In the intensely competitive arena of professional poker, a hard-core battle of wits and emotion where, as in investing, *process* and *probabilities* often determine outcomes, champion players know from experience that "decisions, not results" matter most over time. The astute investor, like the savvy golfer or poker player, also understands that sound *process* leads, on average, to favorable long-term outcomes. In other words, "do the right thing enough times and the results will take care of themselves." It's nature's basic law of *cause and effect*. Unsound *process*, to the contrary, leads, more often than not, to outcomes that disappoint. Successful and dedicated value investors, who by design endeavor to profit from the persistent force of *mean reversion*, pay particularly close attention to both *process* and *probabilities* (more on this in a moment), as both are inextricably linked. Professional poker player David Sklansky highlights these two concepts, with a specific emphasis on *"the importance of discipline,"* in his book *The Theory of Poker*:

> Anytime you make a bet with the *best of it*, where the odds are in your favor, you have earned something whether you actually win or lose the bet. By the same token, when you make a bet with the *worst of it*, where the odds are not in your favor, you have lost something, whether you actually win or lose the bet.

For nearly every golfer, with the possible exception of the most skilled professionals, a highly focused and disciplined approach geared directly at playing only the shot with the most *favorable odds* is paramount to maximizing results. Successful investing, especially in the value realm, is no different. The key is to methodically and carefully identify favorable risk/reward *probabilities* (an analytical process that is part *art* and part *science*), one stock at a time. In doing so, it's imperative that the analyst consciously ignore the distractions of irrelevant background noise (i.e., interest rates, economic forecasts, analyst buy/sell ratings, etc.) and focus on what really matters (*keep it simple*), which, in the case of out-of-favor and/or mispriced value stocks, is the upside/downside ratio (3:1 or more is best). In other words, *play the probabilities and*, like Moe, *give yourself a chance to win*. *Patience*, however, is needed, and often much of it, in order to extract the maximum value from such a carefully crafted approach. Seasoned practitioners of the *value style* know that *mean reversion, like Mother Nature, is prone to being fickle; evolving in its own "sweet time," sometimes quickly and other times over agonizingly extended durations*.

In the first chapter of his classic 1975 treatise on investing, *Winning the Loser's Game*, Charley Ellis, founder and former long-time managing partner of Greenwich Associates, describes a calculated strategic approach to the fast-paced game of tennis that, in a key sense, mirrors that of Moe's low risk, probability-weighted approach to the more methodical game of golf. Ellis cites *Extraordinary Tennis for the Ordinary Tennis Player*, a 1970 book by Dr. Simon Ramo, a leading post WWII-era physicist and engineer, in an effort to persuade the reader that *a sound, consistently applied, probability-based approach is a vital ingredient underpinning long term investing success*. In the book, Ramo articulates "a complete strategy by which the ordinary (amateur) tennis player can win games, sets and matches again and again by following the simple stratagem of losing less, and letting the opponent defeat himself." He explains that "if you choose to win at tennis - as opposed to having a good time - ***the strategy for winning is to avoid mistakes*** (*and therefore lose less*)." More specifically, according to Ramo, "the way to avoid mistakes is to be conservative and keep the ball in play. Avoid trying too hard." By doing this you "give your opponent as many opportunities as possible to make unforced mistakes because he, being an amateur, will play a losing game (by trying too hard to proactively win points) and not know it." Legendary poker player and gambler "Nick the Greek" Dandalos (1893-1966) had this concept in mind when he uttered the following words to the wise: *"Remember this: the house doesn't beat the player. It just gives him the opportunity to beat himself."*

In the high-stakes game of investing, excessive turnover/activity (like the tennis player intent on winning points through aggression), more often than not, leads to increased error rates. A more restrained long-term oriented approach ("keeping the ball in play" by sitting patiently with carefully-selected holdings) tends to serve the investor much better over time. The old saying "control what you can and don't worry about what you can't" speaks volumes, especially as it relates to portfolio management. Unlike so many other uncontrollable externalities, such as market psychology and the direction of interest rates, *portfolio turnover*, like an intentionally soft return lob in tennis, is a variable that can, for the most part, be carefully controlled by the portfolio manager. Even more importantly, ***although portfolio turnover receives far too little attention from investors, its direct and distinct impact on long-term performance results should not be ignored or understated***.

In the game of golf, *"what distinguishes the winner is that he made fewer bad strokes than the rest."*
–Tommy Armour, winner of three of golf's major championships and the preeminent teacher of his era (1894-1968)

In recent years, one of the most profound trends that has emerged in the investment management business is *time horizon compression*. The remarkably robust and extended nature of the 1990's bull market led to a proliferation of new mutual funds, wrap-accounts, variable annuities and, of course, long/short-oriented hedge funds, amongst others. An unfortunate by-product of this dramatic increase in competitive intensity has been an increasingly shorter-term focus by trustees, consultants and portfolio managers alike (as even these well-informed and good-intentioned fiduciaries are prone to the pull of "human emotion"). Performance evaluation, which in decades past was typically measured over years, not quarters, has become, in a sense, the proverbial "tail that wags the dog." The focus, at least at the margin, appears to have shifted to *outcomes* (versus *process*) and increasingly shorter-term *outcomes* at that. As a result, *the*

*intensified pressure to generate consistently superior short-term performance numbers has contributed to the average portfolio manager developing **a distinct and measurable case of myopia**; good for the business of optometrists perhaps, but decidedly counter productive in terms of long-term compound returns*.

Early last year, John Bogle, a seasoned industry executive with a particularly unique (although arguably biased) perspective on the mutual fund industry's history, highlighted the historical evolution of fund manager holding periods in a *Financial Analysts Journal* article titled: *The Mutual Fund Industry 60 Years Later: For Better or Worse*. In the article he states that "in 1945, mutual fund managers did not *talk* about long-term investing; they simply *did* it. That's what trusteeship is all about. But over the next 60 years," according to Bogle, "that basic tenet was turned on its head and short-term speculation became the order of the day." Citing turnover statistics all the way back to the end of World War II, Bogle points out that "between 1945 and 1965, annual portfolio turnover averaged a steady 17 percent," an average holding period of nearly six years. From that point however, "turnover then rose steadily," with average annual turnover exceeding 110% by late 2004 (the last date measured for the article). The result, according to Bogle, is that "the average stock is now held by the average fund for an average of only 11 months." Although we have too little space here to fully flesh out the supporting evidence/data presented by Bogle, one of his primary messages was that *the dramatic rise in turnover since the 1960's (and concurrent shortening of holding periods) has worked decidedly counter to investors' best interests despite the good, albeit overly hyperactive, intentions of the average portfolio manager*.

In investing, unlike in organized basketball and competitive golf, there is no shot clock or time clock. One can often take as much time as necessary to assimilate and gather information before a decision is made on whether to buy or sell a stock. A few days, a few weeks and even a few years are perfectly acceptable time frames if a satisfactory outcome is ultimately achieved. Echoing this essential truth, Warren Buffett, *"the Oracle of Omaha,"* candidly revealed at last year's *Berkshire Hathaway* annual meeting that he had "read the annual reports (of Anheuser-Busch) for the best part of twenty-five years" and, as a result, "the decision to buy the stock (which he did in considerable size for the first time last year) took him all of about five-seconds," a classic and illustrative example of *preparation* fortuitously meeting *opportunity*. Buffett, a uniquely high profile and purposely repetitive advocate of *waiting patiently for the "fat pitch,"* knows, possibly better than any other, that one of the most indispensable secrets of investing success is to ***move, and move aggressively, only when you deem the odds decidedly in your favor***.

Though few have written extensively over the years on the dangers of *high turnover*, Charley Ellis, whose work we referenced earlier, has addressed it on more than one occasion. In fact, he returned to the subject in the September/October 2004 edition of the *Financial Analysts Journal* where he delightfully recounted the teachings of depression-era golf great Tommy Armour, advocating that investors apply Armour's golf lessons to the game of investing. Of particular interest to us was his reference to the following quote from Armour's long-time bestseller *How to Play Your Best Golf All the Time*, "Action before thought is the ruination of most of your shots." Ellis makes the case that "there is at least a good chance that institutional investors, with an astonishing 100 percent turnover, would benefit from more careful consideration before taking action - and *slowing the whole process down*." In driving home this important point, he intimates that there may be no better example of discipline, selectivity and patience than *Berkshire Hathaway, where typically only a few stocks are bought and sold in a given year and where holding periods tend to cover years if not decades*. He goes on to suggest that it is not mere coincidence that *the mutual fund industry's best performing fund family has, over the years, consistently maintained low turnover in its portfolios*.

Although we could certainly say more on the subject of *process, probabilities* and *turnover* if space allowed, we believe the following thought-provoking excerpt from Mr. Buffett's just-released annual letter to *Berkshire Hathaway* shareholders cleverly sums up our views on *keeping it simple* and *giving one self a chance* via the imperative of *discipline* and *patience (low turnover)* in portfolio management:

> Long ago, Sir Issac Newton gave us three laws of motion, which were the work of genius. But Sir Issac's talents didn't extend to investing: He lost a bundle in the South Sea Bubble, explaining later, "I can calculate the movement of stars, but not the madness of men." If he had not been traumatized by this

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loss, Sir Issac might well have gone on to discover the Fourth Law of Motion: *For investors as a whole, returns decrease as motion increases.*

Were he alive today and read or heard that quote, we feel sure that Moe Norman, perhaps the most focused and dedicated *"player of the odds"* in the history of golf, would crack a wry smile and enthusiastically nod his head in agreement. *Keep hitting 'em straight Moe. R.I.P.*

Index	03/31/06 Price	1st Quarter Price Change*	Year-to-Date Price Change*
Dow Jones Industrials	11109.32	3.7%	3.7%
S&P 500	1294.83	3.7	3.7
Value Line Composite	446.85	8.3	8.3
American Exchange Comp.	1935.99	10.1	10.1
NASDAQ Composite	2339.79	6.1	6.1

*Does not include dividend income.

Fixed Income

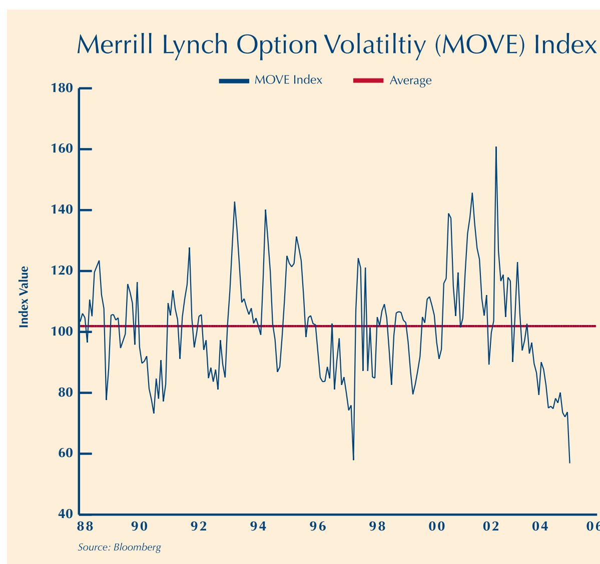
A Volatile Mixture?

One of the more fascinating trends in the bond and equity markets in the past several years has been **the continued decline in volatility**. Both interest rate and stock market volatility have declined to levels not seen since the late 1990's. Although we see no definitive signs of change on the immediate horizon, we have become increasingly concerned that this lower level of volatility may reflect an all too familiar **abundance of complacency**. *History has shown that sooner or later such patterns typically experience a violent break.*

What do we mean when we refer to volatility? Volatility is simply a measure of the fluctuation in price of a security (a stock, bond or even an index). While no one can know the *future* volatility of the price of a security, we can observe the *implied* volatility of that instrument in *options markets*. An option, of course, is a contract that gives the holder the right to buy or sell an amount of a security at a specified price over a fixed period of time.

Chart 1 shows one measure of interest rate volatility over time. Developed by Merrill Lynch, the "MOVE" index is a weighted average of the implied options volatility on Treasury securities across the yield curve. **Note that this index has declined to a level not seen since July 1998 - just a month or so before financial markets were jolted by the Russian debt default and**

Chart 1



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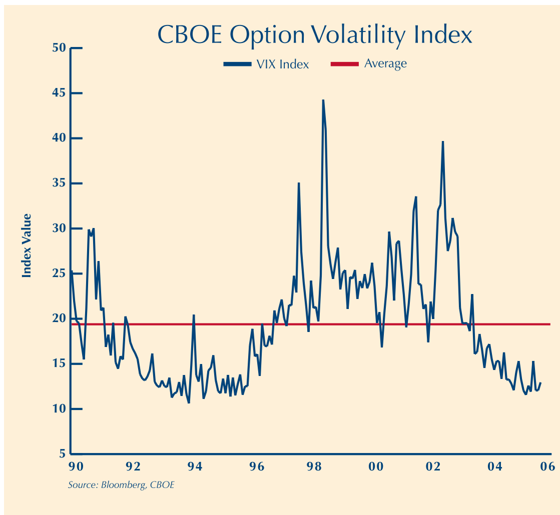
the collapse of Long Term Capital Management. We are not, however, predicting another market disruption on that order; indeed events such as those are by definition unpredictable. *We are only pointing out that, at least by this index measure, volatility has historically not remained at such low levels very long.*

Turning our attention to stock market volatility, **Chart 2** shows the Chicago Board Options Exchange (CBOE) implied volatility for the S&P 500 index. This measure, called the "VIX" index, is also commonly known as the "investor fear gauge." Note that the VIX displays a similar pattern of declining volatility, a trend that has been in place since the last major episode of heightened market turmoil in late 2002.

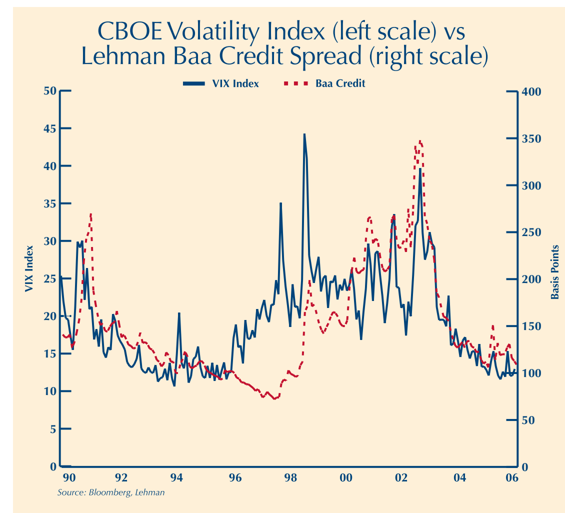
Chart 2



What relevance does this measure have to the fixed income markets? **Historically, the VIX has been highly correlated with credit spreads (Chart 3).** This stands to reason - both the VIX and credit spreads are measures of risk and therefore should display a fairly similar pattern over time.

Again, we are not suggesting that this low volatility environment is about to abruptly come to an end. However, while we are not in the business of forecasting market disruptions, we are in the business of attempting to position portfolios to maximize returns while controlling risk. **Part of this process is reducing risk when it is inexpensive to do so.** *Therefore, we have chosen to position portfolios conservatively in the event the current low interest rate volatility and narrow credit spreads return to more typical levels.*

Chart 3



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