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THE RECOVERY CONTINUES

WHAT'S CHEAP? *On September 11th, we will recognize the fourth anniversary of 9/11. It is worth reviewing what we all thought back then, and what has happened since.*

Can you remember the bleakness of the days following the attacks? Certainly as a nation we have not felt safe since. Yet we have recovered despite our losses and our fears. The lesson in this is that we can succeed regardless of how undone we feel during our darkest moments.

Since then, the S&P 500 Index, which is our index of large cap stocks, has delivered a return of 16%, which is about 4% per year. That is appropriate for our original dismal expectations. But would you have predicted that First Eagle Global Fund would deliver a return of 94%? Or that Dodge and Cox Balanced Fund, the epitome of the boring balanced mutual fund, would give us 44%? And how about that Matthews Asian Growth and Income?

Clearly the managers of these mutual funds are doing something right. And that something is contrarian investing, swimming against the tide. *Here's what sets them apart: value investing.*

It's like the old saying: If everyone could do it, we'd all be millionaires. Picking undervalued stocks or bonds is as much art as science. In fact, good long-term stock-pickers are relatively rare.

Studying the long-term track record of stock mutual funds suggests that over longer periods of time, the *average* stock mutual fund performance tends to correlate, and in fact underperform, the S&P 500 Index. That is because most stock fund managers tend to use the 500 large stocks of this index as their stock-picking universe. We try to avoid these *average* performing funds except when we are facing an irrationally bullish market.

Fund/Index	Total Return %	Annualized Return %	Amount at End of Period \$
Longloof Partners	33.77	7.71	13,377
First Eagle Global A	95.41	18.85	19,541
Standard & Poor's 500	16.34	3.94	11,634
Dodge & Cox Balanced	44.50	9.85	14,450
Matthews Asian Growth & Income	121.50	22.51	22,150

GRAPH 1
Investment performance since 9/11/2001



To avoid this trap, we should look for mutual fund managers who are really different, who seek investments beyond the 500 large cap stocks. Some mutual funds, such as First Eagle Global, Longleaf Partners, Mutual Shares, and Dodge and Cox Balanced, have produced long-term track records which clearly *outperform* the S&P 500. (SEE GRAPH 1)

How do they do it?

These managers tend to have several attributes.

1. An affection for numbers. These managers don't care if WidgetsRUs has a hot new product which will revolutionize the world. They care that the profits from this hot new product migrate to the bottom line. Remember: a good story or a hot product does not necessarily make a good stock. Check out the returns for Hewlett Packard, IBM, or Cisco for the past five years.

2. A taste for trash. These managers are willing to take a closer look at what the rest of us think is garbage. Longleaf Partners' willingness to buy refuse collector Waste Management in the 1990's after it was destroyed by faulty accounting is one example. In the 1980's, manager Michael Price of Mutual Shares bought Sunbeam-Oster at a giant discount when the company went bankrupt from excessive debt. He then participated in restructuring the company, made a fortune for his shareholders and himself, and earned his reputation as a superb stock-picker.

3. High risk individual investments. What investments like Waste Management and Sunbeam-Oster share is that individually they are colossally risky. A market-beating value manager is willing to expose his or her portfolio to this risk in order to make money in the long run. A good manager has the ability to use data to quantify risk. Once the risk is measured, the manager should be able to risk a measured amount for a probable gain, rather than simply participate in rolling dice.

4. Diversification. A market-beating manager will often accumulate a portfolio of investments with a high degree of individual risk. However, these individual risks are different from stock to stock. In other words, a good manager will make sure that the mutual fund's success is not dependent on one single economic outcome. For example, a good manager will avoid packing his or her portfolio with stocks that might collapse if interest rates rise. He or she would probably avoid an entire portfolio of stocks which demand a high price for oil.

5. Ethics. These include shareholder loyalty, closing the mutual fund to new investors when it becomes too large, personal honesty to self and to others, and investing in their own mutual fund rather than allowing market timers to abuse it. Market-winning mutual fund managers tend to have a sublime sense of these realities that keep short-term scandals and diversions from derailing the fund.

6. Patience. The final winning attribute of superb mutual fund managers is the ability to wait for results. Sometimes it takes years for a winning strategy to mature. In 1999, Longleaf Partners fund diversified into alternative investments and produced 2% while the S&P 500 gained 20%. However, in the following five years, the S&P 500 lost 7% while Longleaf Partners delivered 70%. In 1999, the managers of this fund had to possess supreme courage to stay the course when so many shareholders were utterly dissatisfied. Patience pays.

So what's cheap now? Actually, I tend to avoid that question and simply seek out a diversified portfolio of value mutual funds with proven track records and clean ethics. I pay special attention to how the fund managers handled the 1999 to 2004 time period. This statistic shows me how they dealt with severe adversity.

As always, the cheapest investments are cheap for a good reason. Many overseas markets are currently inexpensive due to geopolitical concerns. The Korean stock market is profoundly undervalued because investors fear the North Koreans and their rogue nuclear program. Likewise, investing in the Russian stock market is like watching a two-year-old child play with a claw hammer. Putin may want to be a capitalist, but he just doesn't know how. China and India are bargains if you believe in the prospects of an Asian century and you are willing to overlook the political risk. All these markets may deliver superlative returns in the next decade, but they entail incalculable risk.

In the American markets, I am tracking the latest news. Where are the despised stocks of 2005? Following the latest legal panic about Cox-3 inhibitors, and the resulting stock declines in pharmaceutical giant Merck and similar stocks, health care stocks look interesting. Based on my recent phone calls, I know the best mutual fund managers are already crunching the numbers.

Our intention is to seek out mutual funds which have long-term market beating track records, unblemished ethical histories, and traditions of managing tough times. We should let the funds' management teams find the undervalued stocks. They've proven they can do the job. 