Notes from the Road

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Note: This is the inaugural edition of our new "Notes from the Road" series. The updates are intended to provide our clients and contacts an inside look into AMI's research process. We believe that our in-depth level of due diligence sets our firm apart. While we hope to typically keep these missives to just one or two pages, we have a lot to share in our first effort. As always, we appreciate your time and attention.

David and Jacob with activist investor Bill Ackman in New York.

David and Jacob travelled to New York City two weeks ago to meet with a number of investment management firms. The group was diverse, ranging from a domestic equity mutual fund manager with less than $100 million under management to an activist hedge fund with over $11 billion under management. During a jam-packed stay, they had the chance to sit down with investment managers that ran the following strategies: a distressed debt fund, an international equity mutual fund, a domestic equity mutual fund, a long-short hedge fund, a long-short fund-of-funds (a fund-of-funds is a fund that invests in other funds), a private equity fund-of-funds and a large activist hedge fund. Unfortunately, plans to travel to Greenwich, CT on the last day to meet with a private equity fund and an arbitrage fund were upset by winter storm Nemo. Much thanks to Erica, though, the real hero of the trip, who worked late into Thursday night to make sure David and Jacob could get out of New York before the blizzard hit.

Feeling left out from all the due diligence fun, Mike took the opportunity during a trip to Los Angeles the following week to meet with an investment management organization that runs equity and fixed income strategies. In total, the organization has over $20 billion under management. He spent most of his time with the firmõs international equity team. When all was said and done, we could legitimately tell our clients that weõve been travelling ñcoast-to-coastò looking for investment opportunities.

Before we delve into some observations from the trips, we thought it would be useful to briefly review AMIôs approach to portfolio management. We believe, first and foremost, that successful investment management requires advisors to focus on their very best ideas and to never cut corners in the due diligence process. We are also extremely wary of high fees and skeptical of investment ideas or strategies that seem popular at the moment. We never feel the need to do things just because others are doing them.

Across our asset base (different clients have different objectives leading to different risk profiles), our investments are broken down roughly equally into three buckets: our in-house fixed income portfolio, our in-house domestic stock portfolio and our relationships with external investment managers. Our fixed income portfolio is designed to be high quality and well diversified. We are looking for current income, liquidity and the absence of adverse surprises. Our domestic stock portfolio consists of 15-25 stocks that we have heavily researched and believe are mispriced and safe to own. Our portfolio of external manager relationships consists of partnerships with investment managers that we know well, that we follow closely and who have an expertise in a special area (e.g. international stocks, arbitrage, etc.). Most importantly, we believe that our partners have a competitive advantage, or edge, that gives them the opportunity to achieve superior risk-adjusted returns.

It is important to note that our portfolios are specifically designed to allow us to focus on our best ideas while still building a diversified portfolio. In a given year, we are happy if we can find 3-5 new stocks to purchase and 2-3 new partners to add. We probably invest in only 10% or less of the stocks and partners that we review. We greatly prefer long-term relationships, both with our stocks and our partners. Warren Buffett has written:

> [I]f you are a know-something investor, able to understand business economics and to find five to ten sensibly priced companies that possess important long-term competitive advantages, conventional diversification makes no sense for you. It is apt simply to hurt your results and increase your risk. I cannot understand why an investor of that sort elects to put money into a business that is his 20th favorite rather than simply adding that money to his top choices ï the businesses he understands best and that present the least risk, along with the greatest profit potential. In the words of the prophet Mae West: ñToo much of a good thing can be wonderful.ò[1]
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> I donôt get 50 great ideas a year. Iôm lucky if I get one or two.[2]

We believe that the conventional approach to portfolio management common in the investment management industry is fundamentally flawed ï i.e. working with one investment manager who tries to pick 50-60 stocks and funds or more, or worse yet working with multiple investment managers trying to do the same. This goes beyond diversification into ñdi-worsification.ò Costs are too high, the multitude of holdings isnôt necessary to create a sufficiently diversified portfolio and the odds of superior performance are sharply reduced. We believe an investor is much better served by working with an investment advisor who focuses on his best ideas across stocks and/or other focused investment managers. That way, sufficient diversification is achieved without sacrificing idea quality. (Please see our white paper, *The Warren Buffett Paradox*, available on our website, for a further discussion.)

Our trips to New York and Los Angeles allowed us to visit with some existing investment partners, meet some potential new ones, discuss investment ideas and deepen our knowledge of alternative investment strategies, such as distressed debt and private equity. When evaluating investment managers, we employ a decision system consisting of what we call higher-order principles ï we have first-order principles, second-order principles, etc. Under first-order principles, we are looking for investment managers that meet a list of fundamental, objective criterion, including:

- An alignment of interests, typically signaled by a sensible fee structure, an independent, employee-owned organization, an appropriate amount of assets under management and a significant level of co-investment
- An investment portfolio focused on a managerôs best ideas and supported by a significant amount of research
- A commitment to value investing philosophies, which are based on purchasing assets for less than a conservative estimate of their value (we donôt understand how there is any other way to invest, but many managers follow alternative approaches)

[1] *Berkshire Hathaway 2003 Shareholder's Letter*, March 1, 1994.
[2] Kenneth Labich, ñGuess Whoôs Bought Whoops Bonds?ò *Fortune*, April 19, 1985.

Surprisingly, this concise list of what we believe to be simple, basic principles weeds out the vast majority of potential investment partners. If we had to guess, we would estimate that as much as 80-90% of investment managers fail these tests (the ratio is worse in more mainstream investment vehicles like mutual funds, likely due to their lack of an institutional client base that might insist on such principles).

Thereafter, we are left with a group of investment managers that look, at least on the surface, to be aligned and committed to sound investment philosophies. Then the more challenging work begins, transitioning to higher-order principles, which are more subjective and difficult to determine. Key questions include:

- Is the investment manager conservative? Does he or she have a robust approach to risk management?
- Does the investment manager have the fortitude to stick to his or her investment beliefs, even when confronted with market irrationality or the inevitable bout of underperformance?
- How well does the investment manager know his or her investments? Is it clear that he or she has a comprehensive and uncommon approach to investment research?
- Is the investment manager ethical? This is an incredibly important and sometimes overlooked characteristic. There are too many opportunities for investment managers to take advantage of their partners to risk working with an unethical manager.
- Finally, does the investment manager have a competitive edge and is that edge sustainable? What is their approach to identifying investments with superior risk-adjusted return potential?

Mike documents his trip to L.A. for our records. Needless to say, he had slightly better weather than David and Jacob.

In exploring these subjective areas, we believe that we are greatly aided by the fact that we select individual stocks and bonds in-house. Many investment managers do one or the other ï they buy stocks or they select external investment managers (e.g. mutual funds, hedge funds, etc.). Because we do both, we are able to bring insight from one area into the other. By being familiar with specific stocks and companies, we can bring our own due diligence insights into meetings with other managers and benefit from the knowledge we gain from these managers to inform our stock research process. Indeed, one of our partners that we visited during the week has employed this process within their own firm. They have a world class long-short hedge fund as well as a fund-of-funds that selects other long-short hedge funds. Each side of the firm relies on the other during their due diligence process, an approach that we obviously appreciate.

With that background, we highlight some of the key take-aways from our recent trips:

- In evaluating managers, we want to understand how well they know their investments and how they determine what is suitable for purchase. As we mentioned, because we do our own work on individual investments, we can bring this insight into the interview. For example, we asked one investment manager to detail his thesis for a stock that he had purchased. After the managerøs initial pitch, we asked him what he thought of a recent large acquisition the company had made. The manager said that because the acquisition target was private, it had been difficult for them to get much information on the business. However, because we were familiar with the stock we were aware that the acquisition target had filed comprehensive public documents with the SEC for a number of years in anticipation of an initial public offering prior to the acquisition. These documents had a wealth of information on the company. The managerøs apparent failure to dig into these documents was a red flag that perhaps the manager wasnøt doing the kind of deep due diligence that we look for.
- Meeting with investment managers is also a good chance to discuss our stock ideas. We have recently done a lot of work on an industrial company in the commercial vehicle space, establishing a small position before the price ran up on us. Whenever we look to purchase a stock, we always want to understand why the given opportunity to earn above-average returns might exist. In this case, even though the business appears to be high quality, two

private equity firms still hold 80% of the stock outstanding. Because investors are afraid that whenever these firms decide to sell their holdings the stock will come under pressure, the current stock price is likely depressed. One manager that we met with in New York recently had the chance to sit down with one of the private equity firms that still owns a portion of the company. The manager told us that the private equity firm stated that the industrial company was one of the best businesses his firm has ever owned, supporting our research on the stock. The manager also told us that he wasnõt interested in owning it right now because of the private equity ownership overhang, which verified the second part of our thesis. Hopefully we will have a chance to purchase more stock in the company in the future if the price recedes.

- Each time we meet with an investment manager, we try to make an important distinction ï is the manager arrogant or self-confident? There is a huge difference between the two. Investment management is an endeavor where the individual is bound to make mistakes. If a manager is too arrogant to admit when he is wrong and cut his losses or to learn from his mistakes, the investment management process is severely debilitated. We make sure to be aware of some of the larger mistakes that investment managers have made and ask them to walk us through the life of the investment. We are much more interested in their worst investment then their best investment. Great investment managers have a unique blend of humility in the face of difficult and complex investment markets and resolute confidence in their ability to succeed over the long-term.
- Details matter. Investment markets are too competitive with too many varied investment alternatives to cut corners during the due diligence process. The private equity fund-of-funds that we met with had recently passed on what appeared to be an interesting private equity fund because they felt uncomfortable with the key-man provision outlined in the offering documents, a detail that some investors likely ignore.[3] The decision proved to be prescient, as the investment went on to perform poorly. Another investment manager we met with invests in only ~10 companies at a time and was busy the week before we met with him pulling documents from a 1986 legal case relating to one of his investments. The international equity manager that Mike met with in L.A., who we have been researching for six months, sends each analyst on four due diligence trips each year. They had recently returned from Korea, Japan and China and were in the process of preparing for a trip to Latin America. They try to invest only in stocks where they have been able to meet and grade the management team.

Our own assets are invested right alongside those of our clients and we feel an immense amount of responsibility managing their hard-earned wealth. Luckily, we love the details. We love grilling investment managers about their 14th largest holding. We love reading the footnotes in a legal document trying to find something that perhaps other investors missed. And we love working in an industry where every day we get the opportunity to learn about something new. The week before we travelled to New York, David was questioning commercial truck distributors and trucking executives about the pros and cons of automatic versus manual transmissions. Jacob was reading academic papers on merger arbitrage spreads and private equity returns. Mike was running studies on our fixed income portfolios.

Our recent trips were an affirmation of the value of our work. One manager told us ñyou guys ask the best questions.ò Another recently communicated that our level of diligence was way above and beyond what other investors in the fund had performed. We caught one fund by surprise when we asked them about the name of a partner, no longer with the firm, who had appeared in a 2002 letter outlining the investment strategy. When we returned home, one of the managerõs that we met with requested a list of our questions to use as a template in meetings with other investors. We try to achieve the right balance of humility, confidence and tenacity internally, and believe that over time our research efforts and passion for the field will lead to attractive investment results for our clients.

As always, we appreciate your continued confidence and look forward to bringing you more *Notes from the Road* in the near future.

Sincerely,

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David J. Manger, CFA

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[3] Key man clauses are provisions that trigger certain requirements and protections in the case where a key member of the investment management team ceases to be involved with the management of the fund.