First Letter to Clients (and Potential Clients)

From: The Ridgewood Group
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Tel: 973-409-9764 August 2003

As there are now a sufficient number of existing clients (and potential clients) on our mailing list, I will begin our practice of distributing occasional missives (hopefully these are not aptly named) to some of our existing clients and potential clients who have asked to receive our communications from time to time.

First, I would like to thank many of you who have been supportive in helping to get The Ridgewood Group through its first year as a business. Your support has come in many forms, including those who have become clients, referred clients, or generally been helpful in many ways. Whatever the form, we are grateful for your confidence in us and are working hard to repay that confidence by providing our brand of intelligent investing and service with a smile.

The past year has brought more than its share of ups and downs from a market point of view as we saw two severe market lows (in October of 2002 and then again in March of 2003) and some more recent highs. Not to suggest that we pay too much attention to these fluctuations given our focus on buying good businesses at good prices.

Our portfolios have generally performed well though these fluctuations - and whenever possible we have attempted to take advantage of these fluctuations. If we have any complaint, it is simply that the market has moved up so decisively of late that our brand of bargains (especially of quality businesses) is increasingly rare. However, if history is any guide, we will find a few opportunities (in any environment) and new opportunities will present themselves soon enough if we are prepared to meet Mr. Market when he comes again bearing gifts.

Those of you for whom The Ridgewood Group is handling your money know that we generally like to own a handful of businesses whose prospects we feel we understand, with good managements, and which we can purchase at favorable prices. Our goal in our portfolios is to compound our funds in excess of the market benchmark (generally the S&P 500 over rolling 5 year periods of measurement) such that net of fees to the Ridgewood Group, you will come out ahead of the game. Given our objectives, we tend to hold ownership interests in a handful of companies (generally 10 to 30 securities) at any one time. Most of our investments will provide opportunities to compound our capital invested at the above rates over a multi-year period (though not necessarily or usually in a straight line).

In future communications, I will occasionally discuss current or past investments to give you a sense for our thoughts about particular companies and our reasoning regarding their place in the portfolio. For now however, I would like to leave you with some interesting thoughts regarding mutual funds. For many reasons (including excess and double fees), we generally do not include third-party funds in our investment accounts (we prefer to own equities directly). However, as you probably know, equity mutual funds are a big business and a large number of investors (and even many advisors) invest in funds.

While there are some excellent funds and fund managers, it is astounding and more than a little bit interesting that according to Lipper Inc., less than 50% of general equity mutual funds outperformed the S&P 500. In fact, over the last 5 years only 49.4% outperformed the S&P500. The proportion of outperforming funds drops down to 26.6% over the last 10 years (and this is probably with the benefit of a survivorship bias built in). With the prevalence of such statistics, it is no wonder that many investors simply throw in the towel and choose to index.

As a individual investor, the few personal accounts that I handled using the same strategies (but with much less time devoted to their application) have significantly outperformed the S&P500 over the last 5 years and are in significant positive territory over that period of time. So it is interesting to ask how a bunch of highly paid professional managers fail to do what a disciplined (though given my background arguably sophisticated individual investor) was able to implement (on a very part-time basis) in terms of success versus the S&P. While size could be a potential answer, it turns out in this case that each of the portfolios could have been duplicated in much greater size since most of the components were large liquid stocks.

To answer the above question, I would like to paraphrase perhaps the best summary of the common mistakes made by portfolio managers that was recently provided by outstanding fund manager Bill Miller at the Morningstar Investment Conference. Among his reasons for the relative underperformance by the majority of managers were the following:

- Too much trading
- Owning too many stocks
- Being too reactive rather than proactive in analyzing information and opportunities
- Following trends (following the herd)
- Using oversimplified valuation techniques (i.e paying too much)
- Spending too much effort tying to forecast macro events

In many cases, the above issues are not necessarily the root causes, but rather symptomatic of a few more fundamental mistakes made by many of these professional (and unprofessional) investors. In particular, they indicate too much emphasis on shooting for favorable “short-term” results (generally at the expense of favorable long-term compounding). Secondly, they do not place sufficient emphasis on the notion of investing as ownership of businesses (as opposed to temporary ownership of pieces of paper which come associated with a certain number of dollars that fluctuate in an apparently random walk).

It should be instructive (and hopefully interesting) for you to note that The Ridgewood Group generally takes exactly the opposite tract vis a vis both the fundamental principals and each of the resulting common mistakes above. And while outperforming the market may sound simple, we don’t want you to come away with the impression that it is easy. Nevertheless, we want you to know, that we follow a set of tried and true principles and a framework for owning fundamentally good businesses when we can buy them at good prices. So while past is no guarantee of future results, you can be confident that we are focused on those elements within our control to achieve the results that we have set for ourselves.

With that, I would like to invite each of you to visit our site (at www.ridgewoodgrp.com) and/or call us with any questions or comments on this letter or any other issue. As is already the case, word of mouth is our single greatest source of clients. So if you know anyone that many need assistance or guidance with handling their investments a bit more intelligently, please let us know. You can add them to our mailing list and/or we can introduce ourselves and have a conversation with them about our brand of intelligent investing.

In the meantime, we would like to welcome you to call us with your questions and comments at 973-409-9764. Better yet, please stop by and visit us at our world headquarters (in Short Hills, NJ). As an extra incentive for those willing to make the trip, we promise to take you out to have some of the best pizza you have ever tasted!

Warm Regards,

Kaushal

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