

**2004 Semi-Annual Letter to Clients
(for the six months ending June 2004)**

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To our valued clients:

We certainly live in interesting times! Many of you may be thinking that I have a gift for understatement, particularly if you have been reading the headlines and following the market in the last few months. Interesting may not be the word that immediately comes to your mind given the performance of the market, particularly in July and early August. Nevertheless, it has been a stimulating environment for intelligent (and other) investors alike.

As is our practice, I would like to use this, our semi-annual letter, to discuss our performance for the first six months of 2004, reflect on a number of these “interesting” factors, share some thoughts on the current environment for investing, remind you about our approach to investing your capital, and talk about some recent Ridgewood Group developments that may enhance our job as your investment advisor.

2004 First Half Performance

The composite of the accounts managed according to the Core approach by The Ridgewood Group advanced 4.87%¹ from December 31, 2003 to June 30, 2004. In contrast, the S&P500 advanced 2.60% during that same period of time. If you included reinvestment of dividends on the S&P500, the performance of the S&P was closer to 3.44%. The Ridgewood Core Composite outperformed the S&P500 during the first half of 2004 and has outperformed the S&P500 by a wide margin since we began the firm and created the composite beginning in December 2002.

Since we have gained a number of new clients during the first half of 2004, I need to pause to make a brief comment about our composite performance. You may notice, especially if you only

¹ Per industry norms, performance is reported before management fees using a methodology known as Time-Weighted Return on Investment which is determined by calculating a geometric average of a series of monthly returns. This process effectively weights each sub-period return equally regardless of the money being managed during any one sub-period. This methodology was developed to allow for a more apples to apples comparison between different managers without the problem of having the performance figures biased by different amounts under management at different points in the cycle. Of course, individual clients care about the actual Internal Rate of Return (also called the Dollar Weighted Return on Investment) that they experience. The Ridgewood Core Composite is defined as all accounts we manage (over \$50,000 in size) that are managed according to the Core style. In our Core portfolios, we seek the best opportunities that meet our investment criteria regardless of industry sector or market capitalization. Additional information about the makeup and performance of our Core Composite is available upon request.

recently became a client, that the above numbers may not completely match your own individual account performance over the first six months of this year. If applicable, you may be wondering why your own performance does not match that of the core composite.

Divergences should be expected for several reasons. First, the composite performance that we report is a mix or average of the performance of each component account (those that we classify as core accounts). All accounts managed according to the core style are included beginning with the end of the calendar month in which we began managing the account. Accounts that we have been managing for over six months to a year are, naturally, more seasoned than others that we have been managing relatively recently. Second, since we manage each account individually and allow our clients the convenience of transferring their assets to us, it often takes time (especially if the environment for investing does not readily offer up many values) for an account to raise cash and/or become substantially invested in the types of business we like to buy. If you are a newer client, your account holdings will, over time, increasingly match that of our core composite and in most cases, the majority of the transition occurs in the first six months or so.

Investing for the Long Run

As intelligent investors, if we are to succeed, it is critical that we give ourselves the tremendous advantage of having a patient, long-term, businesslike approach to investing. Though we can neither control nor prevent short-term market gyrations, we can freely choose to ignore them or even take advantage of them by buying great businesses when they are on sale. A large group of institutional and individual investors who are active and powerful participants in the market cannot or do not take a long-term view. In so doing, they also thereby significantly reduce their chances of a good result.

Our short-term results (whether good or bad) should neither materially excite nor trouble you precisely because we have a disciplined approach to long-term investment success. As we have consistently discussed, short-term performance (either good or bad) can often be misleading. The market action in 2004, so far, has been volatile and in recent months has even turned noticeably negative. The performance of the S&P500 between December 31, 2003 and August 13, 2004 was negative (-4.24%). The Dow and the NASDAQ declined even more at -6.01% and -12.29% respectively. Naturally, these gyrations, especially if markets end up in negative territory (as they have so far this year) may trouble you.

It is natural to respond to a pessimistic consensus accentuated by fear by becoming worried and concerned yourself. As human beings, this is how we are wired to respond and in many other aspects of our lives, this programming is both healthy and adaptive to survival. In investing, however, we need to approach our operations somewhat counter-instinctively. What is the counter-instinctive way to react to market declines? If you are still a net saver, it would be rational and wealth-maximizing to enthusiastically add cash to your investment accounts after the market falls decisively for the reasons explained below. Since most people won't have the courage or discipline to go against the crowd during such times, another more realistic substitute for most investors is to begin or maintain the discipline of a recurring contribution to their investment accounts (e.g. monthly or quarterly) with the intention of sticking to their regular contributions (if not

temporarily increasing them) no matter the gloomy short-term investment consensus for the market.

One aid in taking a long-term view is to measure performance like we do - in terms of average annual compounding of our money over rolling three to five year periods. This time horizon is critical because it is only over this longer period of time that we can confidently predict that the quality of the businesses that we own and their underlying business performance as reflected in metrics like owner earnings and book values will be the dominant factor in our investment results.

Unlike some, you will not see us invoke long-term investing only when it is convenient or expedient. Rather, this approach to long-term compounding is a cornerstone of our approach to investing and has been a consistent theme. Though it is not foolproof, taking the long view in conjunction with the other important elements of an intelligent investment program means that the odds of a good result are in our favor. The more the market and its component securities decline, the greater is the likelihood that we will be able to deploy new or existing cash in increasingly attractive opportunities. Even though market declines will simultaneously reduce existing portfolio quotations, this short-term negative will be balanced (probably outweighed) by the long-term positive of our contrarian buying of attractive bargains with excess cash.²

In contrast, a period of generally rising securities prices may feel good based on short-term portfolio appreciation, but could ultimately detract from the long-term value of our investments as bargains become hard to find while cash is available to invest. This difference will not usually be apparent immediately, but the wealth effect is very real in the long-term.

The Joys of Cash

This is not to say, however, that the volatility and performance of the market in 2004, so far, has been a complete surprise. Given the breadth of our advances in 2003, we expected and cautioned you that it would not be reasonable to linearly extrapolate the outstanding performance we experienced last year. Specifically, in our 2003 Annual letter, we said:

² The one obvious exception is an investor who cannot or will not take a long-term view. Typically, we like to make sure that the funds we handle can be patiently invested over the next three to five years. If an investor needs funds to live or make a major purchase and can anticipate such a need in advance, that portion of his or her funds should not be used to purchase businesses but should preferably be invested in cash or short-term fixed income securities that can provide liquidity to meet those needs. However, importantly, just because an investor is more mature (approaching or in retirement) ought not to automatically imply that he or she needs a large allocation to fixed income securities. In time, such an automatic allocation can reduce returns and still expose the investor to significant volatility particularly if the investment includes a significant allocation to long duration bonds that tend to be particularly volatile in response to interest rate fluctuations (given the generally low interest rate environment, investors seeking yield often end up in the longer end of the duration spectrum). Unfortunately, an automatic age based (even mindless) allocation to fixed income is often the status quo advice given to many unsophisticated investors by a large number of financial advisors and brokers.

“Before you get too excited about the above returns . . . remember that it is the average performance over three to five years that we consider more indicative . . . while the market and some of our investments achieved extraordinary performance in 2003, some important portion of these gains probably occurred by accelerating gains that might otherwise have occurred in 2004, 2005, and in some cases even 2006. Before you start counting all the money we will have if we only linearly extrapolate last year’s gains, we face the sobering likelihood that . . . we have perhaps borrowed against the future.

Our Composite portfolios today have a significant cash component because it is harder to put the money to work in places that meet our criteria for quality and value. While having cash earning extremely low rates is never pleasant, good investors know that they have to wait for the right opportunities which tend to arise on an unpredictable schedule. We think of cash as an option with which to participate in future opportunities if and when they arise, and believe that over a cycle this approach will help us achieve our stated objectives.”

Consequently, we came into 2004 with significant cash balances in our investment accounts and this cash has served to cushion our portfolios against declines. Consequently, though our portfolios have, naturally, been affected by the declines in July and August, the impact has generally been less severe than the market overall. Moreover, as values appear, we begin to put cash to work.

As usual, we own and continue to look for a handful of quality businesses whose prospects we feel we understand, with good management teams, and which we can purchase at favorable or at least reasonable prices. Just because a business meets all our criteria, however, does not mean that the quoted price of the business cannot continue to decline in the short-term, even though we purchased it at a price that we considered attractive for the long run. In addition, we will make some mistakes and sometimes fail to anticipate surprises. Given the nature of the businesses that we like to buy, such surprises will, usually, not be fatal mistakes, but rather inconvenient bumps on the road to prosperity. In investing, quotational and sometimes actual losses are part of the path and intelligent investors know that it is the average performance of their entire portfolio over time that they need to both monitor and optimize.

Our stated goal in our portfolios is to compound your and our funds in excess of the market benchmark (generally the S&P 500 over rolling 3 to 5 year periods of measurement) such that net of fees to the Ridgewood Group, you will come out ahead of the game. I hope it is reassuring to you that we continue to have a disciplined approach to investing. Despite the many legitimate (and some illegitimate) concerns cited by others, the good businesses we seek to purchase and own should do fine over our stated three to five year timeframe.

The Environment for Investing

By now, you may be wondering what factors are causing the above referenced volatility in the market. Though no one can identify the key reasons with complete certainty, the recent market volatility can probably be traced to a number of factors including the following:

- Presidential election year uncertainty
- Contradictory indicators on the health of the economic recovery
- Rising oil prices
- Ongoing fears and threats of terrorism
- Concerns about the progress of the campaigns in Iraq and Afghanistan
- The rising fiscal deficit and government debt
- Concerns about the integrity of the US Dollar (related to the above point)
- Rising and high consumer debt levels
- Unemployment worries (perhaps affected by an increasingly visible trend towards outsourcing of manufacturing jobs to China and service jobs to India)
- Fears (and even some indications) of rising inflation
- Rising interest rates

It may surprise some of you to hear that while we read the press reports and commentaries citing the above factors, we spend little time trying to make predictions about the impact or direction of these forces, especially in the near term. The only partial exception would be that we do pay attention, in broad terms, to the long-term interest rate outlook (as it materially affects an important input to our valuation methodology). Despite the doom-monger's warnings and Mr. Market's gyrations, we continue to go about our daily business with discipline and the above mentioned long-term approach to intelligent investing. We have not modified, and have no intention of altering, our approach in any way to respond to these fears and concerns.

The History You (Do Not) Know

It may help you to remember some recent history for further perspective. During this century, one which has been outstanding for long term investors, we have fought and won two world wars (against formidable opponents), survived a cold war against a nuclear power, faced the ever present threat of nuclear conflict, fought conflicts in Vietnam and Korea, worried about the Soviet invasion of Afghanistan and the Cuban Bay of Pigs nuclear crisis. These are just the major negative geopolitical events that come immediately to mind. Economically, we have had the Great Depression and a number of significant recessions and market corrections, including the short corrections in 1987 and the early 1990s and the more protracted correction in the early 1970s.

As you can see, we are not, from a historical perspective, facing anything new in the various fears and challenges of our day. As Harry Truman once said, there is nothing new under the sun except the history you do not know. At almost any point in market history, there have usually been a number of obvious negatives looming on the horizon. Or as my eloquent Harvard Law School professor, Arthur Miller, would say: this is just old wine in new bottles.

As always, the immediate future is hazy and unpredictable with a number of both positive and negative factors to consider. The factors listed above are legitimate concerns and may continue to anchor market results for some time to come. However, as long-term investors looking for good businesses to own at good prices, we should not be (overly) fearful.

This is so because countervailing the many current negatives, there are some notable positives that the media does not emphasize as vividly as the negatives. First among these positives is that we

live in a free and open society and a (generally) efficient economic system; one that is progressive and self-regulating since consumers vote with their money and prices efficiently communicate the information necessary to enable economic participants to regulate and allocate scarce resources efficiently (in the aggregate and on average). As Richard Rainwater said at a recent conference, “Democracy is the magic elixir.” He went on to explain that at any given time, there are usually storm clouds as well as opportunity clouds on the horizon. As intelligent investors we need to think about these forces and look for opportunities to take intelligent calculated risks when the odds of success are very much in our favor.

We live in a wonderful age of innovation, information and technology. These forces are transforming our lives in unpredictable, powerful, sometimes wonderful and occasionally unpleasant ways. To cite one obvious but important example of these forces, the Internet is in its early stages of transforming our lives. The velocity and efficiency of information has permanently increased in our economy with many profound implications for consumers, producers, and investors. Previously unassailable business franchises are under siege while others are being created seemingly overnight. Comparing each decade in the last half of the 20th century with the prior decade leads us to one undeniable conclusion: change is changing at an increasing rate (for all you calculus majors, the second derivative of the reality function is increasing) and both the storm clouds and opportunity clouds on the horizon continue to multiply.

Can you Google?

Current headlines provide us with a vivid and powerful case study to illustrate our point. If all goes well, the Google IPO³ could debut in the next week or two. At the beginning of 1998, Google did not exist. Moreover, Internet search was considered a lock for the established leaders like Yahoo, Infoseek, Lycos, and Altavista. Five short years later, Google is the most popular search service and is used more than twice as often as Yahoo, the previously leader, with millions upon millions of users and fans around the world.

Google has also grown in financial terms from approximately \$220,000 in revenues in 1999 to become a company with over \$1.4 billion in revenues in 2003. Based on its revenue in the first half of 2004, Google’s revenue should be close to \$3 billion for the full year ending in December 2004. Google also actually makes profits; it enjoys high margins and outstanding returns on equity and invested capital. The Google IPO is expected to value the company between \$30 and \$40 billion. As far as I know, there has been no previous time in human history during which it would have been possible to create so much value so quickly.

³ As an aside, the Google founders deserve praise on at least two fronts. First for creating a thoughtful, engaging and readable prospectus and offering process that clearly outlines the good and bad aspects of their business in plain spoken terms. Second for having the courage and foresight to use their marquee initial public offering to cast a vote for a more fair and democratic IPO process in the form of a transparent Dutch auction open to all comers. The press has recently featured a number of negative articles on the IPO but Google is to be commended for its interest in fairness for all investors. This is no mean feat because the Company’s path pits it against the interests of the Wall Street establishment IPO oligopoly. By being principled, they are reducing Wall Street interest and ability to promote (read: hype) their offering and correspondingly also probably reducing the deal’s short-term price maximization potential (don’t feel too bad, they can afford it).

Some may scoff that this value is illusory, reflecting the same misguided bubble mentality that burned so many investors only a few years ago. However, Google is no flash-in-the-pan “.BOMB” like the many initial public offerings that were so common in 1999 and 2000. Instead, it is a real business franchise, more analogous to eBay than to eToys, with brand recognition, network-based barriers to entry, thoughtful and impressively intelligent young founder-owner-managers, and probably a promising future.

How did Google become so successful? By sticking to the basics and staying focused on an important mission relevant to millions of people. Google focuses on helping the world find its information in a targeted and timely way. Millions upon millions of users per day are able to more efficiently find and process information due to this free service and the goodwill that has been created is both large and valuable. Google has also created many second and third order benefits for its users, customers, and the economy as a whole.

Before you get too excited, I would like to make it clear that we will not be investing in the Google IPO because the price makes an otherwise attractive business less compelling as an investment proposition. It is not enough to identify an excellent business, we must buy it at the right price (which generally arises when others are negative on the near-term prospects in spite of long-term promise). Moreover, there is also the possibility that someone will come along five years from now and out-google Google, just as Google has, so far, outsmarted the last generation of search leaders. So, we will not be investors in Google at these prices.⁴

However, the Google story is a cause for optimism and a concrete reminder that we live in a unique age in which innovation and technology fueled by human imagination, creativity, and wonder will probably lead to a growing pie for some time to come. For those intelligent investors attuned to looking for the opportunity clouds, we do live in interesting times indeed.

Other Recent Developments

As was the case last year, we have attracted a number of new clients to the firm so far this year as well. These clients live around the country and have found us, largely, through word of mouth from our existing clients. I would like to take this opportunity to thank each of you for your support and continued faith in our approach to intelligent investing. Thank you also for your ongoing referrals and introductions to potential new clients.

As we mentioned in our last letter, we were invited last fall to write a chapter in a wonderful new book just published by Mission Publishing called “Create the Business Breakthrough You Want – Secrets and Strategies from the World’s Greatest Mentors.” Though delayed, the book has finally been released. The book has been endorsed by renowned figures like Dr. Steven Covey and Ken Blanchard, the latter of whom noted that our book contains “Powerful, perceptive, and practical advice from some of the best business minds today.” I just received my copies and have been fascinated by the many useful ideas and tactics explained by these many experts in areas like Business Strategy, Leadership Development, Marketing and Sales, Personal Growth and Wealth Building.

⁴ As I write this letter, other select opportunities within the technology space are beginning to appear in light of the severity of recent declines in that sector.

If you are a current client, we will be mailing each of you (one per family) a signed copy of our book. The book contains advice and strategies from over 60 experts and mentors in a variety of fields (including yours truly on intelligent investing). My contribution is in the “Wealth Building” section and discusses “The four timeless principles of intelligent investing.” This article summarizes the principles that outstanding investors like Warren Buffett recommend and follow when it comes to investment commitments. These are the same principles that we apply on your behalf. We look forward to sending you this book and hope you like it. Others reading this letter can also request an electronic copy of our chapter on Intelligent Investing by emailing us their contact information and basis for their interest.

We would also like to let you know that the Ridgewood Group is now affiliated with a national alliance of professionals specializing in a number of advanced wealth planning techniques including experts in fields like asset protection and estate and tax planning. When applicable, these techniques can be quite helpful, especially for those with substantial assets, complex needs or special concerns. For example, if you have a sizable estate that will be subject to estate tax liability, are a professional (e.g. a physician) or business owner in a field where legal liability is a concern, or have a high income career or business (over \$500K income or profits per year) and pay significant taxes, some of these advanced techniques may be both applicable and valuable. If you think you may qualify, we invite you to contact us to discuss your unique situation and concerns and learn more about this unique alliance and its advanced solutions.

Finally, I would like to remind you that we continue to welcome your support, questions, comments and suggestions. Also, please visit and tell your friends about our website (at www.ridgewoodgrp.com) since we continue to regularly revise the website and update its contents. If you have not seen it, check out our “Philosophy” section, which discusses in even greater detail the philosophies behind our approach to investing your hard-won money. Better yet, if you are going to be in or near northern NJ, please let us know. We look forward to seeing you and working with you during the balance of 2004 and beyond!

Warm Regards,



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(Note: clients also have access to my personal email which has not changed)

The Ridgewood Group is a value oriented money management firm based in Short Hills, NJ. For more information on The Ridgewood Group and our approach to intelligent investing, please visit our website at www.ridgewoodgrp.com.