Second Annual Letter to Clients
(for the Year ending December 2004)

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To our valued clients:

We hope each of you had a great year in 2004 and in the first part of this new year of 2005. As you may be aware, we have recently passed our second full year anniversary as a firm, and it is once again time to review our annual results and our performance since the inception of our firm's core composite.

Some of you may recall that we had just passed the $10 million mark around this time last year. As I sit to write this letter, we are now managing over $20 million in assets across our primary investment vehicles. Thanks to clients like you, the firm experienced over 100% growth in assets under management in approximately the last 12 months. Of course, we remain far from both our own goal and the likely limit of assets that we are equipped to comfortably manage.

Before we move on to the details of performance, etc, we would like to thank each of you for your continued support and patronage. Given that we are busy researching ideas, managing your money and also servicing your calls and queries, we may not get to express to each of you individually as often as we would like (or as often as we think it to ourselves) how much we really appreciate all of our many clients like you who have supported our young firm. We have tremendous gratitude to each of you and your families for placing your confidence in us.

As is our practice, I would like to use this, our annual letter, to discuss our performance for the full year of 2004, talk about the role of cash in our current investment accounts, and review in detail the fundamental principles that we use to manage your money.

2004 Performance

The CORE composite of the accounts managed by The Ridgewood Group advanced 17.2%[1] from December 31, 2003 to December 31, 2004. In contrast, the S&P500 including dividends reinvested advanced 10.88% during that same period of time. The Ridgewood Core Composite outperformed the S&P500 during 2004 after outperforming it in 2003. As a result, it has outperformed the S&P500 by a decent margin since inception of the composite in December 2002. To be more precise, our Core Composite advanced 60.42% in the two years ending December 31, 2004 versus 42.69% for the S&P 500. This performance was achieved with significant cash holdings during the entire period (as we address in a bit more detail below), so we outperformed our benchmark on both an absolute and a volatility adjusted basis. Since the S&P 500 likely outperformed many mutual funds and other active managers over the last two years, our performance has been good compared to many of your investment alternatives.

As we discussed in our 2004 mid-year letter, your individual account performance, especially if you only recently became a client, may not completely match these figures since the composite performance that we report is a time weighted mix or average of the performance of each component account that we classify as a core account. Recently opened accounts are less seasoned and since we intend to stay disciplined, it will take time to invest cash, especially in an environment like the present one in which compelling values in the types of business we like to buy are hard to find - almost across the board.

While our first two years of performance, as summarized above, have been respectable, we hope you realize that quotational and sometimes actual losses come with the territory and so you should not be too surprised or disappointed to face a year or even several years in which we under-perform the markets as a byproduct of our disciplined approach. During such periods, which are bound to arise on an unpredictable schedule, we hope that you will monitor your portfolios and measure them using the same long-term yardsticks by which we measure ourselves – that is by our ability to compound your funds over rolling 3 to 5 year periods of measurement.

We ask that you consider adopting the above approach not as a favor to us, but as a gift to yourselves, since it is an attitude that, if cultivated in advance, will allow you to capture the full benefit that is yours to claim from our strategy of long-term investment in superior businesses purchased at attractive prices. We continue to focus on finding individual investment opportunities (i.e. good businesses at good prices) that are likely, over time, to provide good absolute rates of return. A portfolio assembled from a number of such opportunities should, net of

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[1] The above 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.

fees you pay to us, have a good chance of delivering a decent rate of compounding with a margin of safety against the long-term impairment of your capital.

Why We Hold Cash

Now, in one way or another, more than a few of you have recently asked why your investment account holds the proportion of cash and/or cash equivalents that it does. For most of you, this proportion will be in the 20% to 30% range at the present time. However, if we have been managing your account only more recently, the proportion may still be near 50% in cash. Relying on the dual principles of sampling and of psychic inertia, the fact that a few of you have taken the effort to actually ask probably means that most of you are wondering but have not yet asked.

No doubt, the question is at least partly motivated by an obvious calculus: we charge you a fee to manage your money based on all your assets under management yet cash currently earns low rates of return. In these circumstances, it would be natural to wonder whether you are justified in paying us to hold a significant portion of cash or its equivalents in your account. Since I cannot answer this question more eloquently than outstanding investor Seth Klarman of the Baupost Group did in his 2003 letter, I'll simply quote him:

> Perhaps some of you will soon be asking why you are paying us a management fee to hold . . . cash. Let us preempt you by saying that you are not. You are paying us to decide when to hold onto cash and when to invest it, to determine when the expected return from a prospective investment justifies the risk involved and when it does not . . . successful investing involve(s) recognizing and correctly choosing among a series of tradeoffs. Cash . . . is a way of safely doing nothing until compelling investment opportunity arises. It offers positive albeit very limited yield, complete safety of principal[2], and full and instant liquidity. A low positive return . . . is not a bad proposition in the absence of better alternatives.
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> Our view is that investors should choose to hold cash in the absence of compelling opportunity, not because they are making a top-down asset allocation into cash, but based on the result of a bottom-up search for bargains. . . Every investment must be compared to the alternative of holding cash. If an investment is sufficiently better than cash -- offering a more than adequate return for the risk involved -- then it should be made. . . Exiting cash for any other reason involves dangerous thinking and greatly heightened risk.
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> Investors' immediate problem is being too short-term oriented. One of the biggest challenges in investing is that the opportunity set available today is not the complete opportunity set that should be considered. . . The opportunity set of tomorrow is a legitimate competitor for today's investment dollars. It is hard, perhaps impossible, to accurately predict the volume and attractiveness of future opportunities; but it would be foolish to ignore them as if they will not exist . . .

[2] Obviously, more so in nominal terms since inflation/currency depreciation can still eat away real purchasing power

> [Unfortunately], believing that better opportunities will arise in the future than exist today does not ensure that they will. Standing apart from the fully invested crowd for significant periods of time can be a grueling, humbling and even demoralizing experience[3]

To summarize the point, holding cash in your account gives us the option to invest it on your behalf in the future in opportunities that, hopefully, will promise better returns with less risk than those that we can find today. This option, like most options, has a value that may seem intangible but is nevertheless real. If we can find opportunities in the short or intermediate term and if, when they do arise, they are available at compelling prices, then the cost of waiting will be outweighed by the prospect of a higher long-term return with a greater margin of safety. Our patience is not without some risk. We risk underperforming the market - especially in the near term and on a relative basis. We may in time even be proven wrong in waiting, but nevertheless, that's the way we will bet.[4]

It should be recognized that very few individuals or money managers successfully implement such a long-term oriented patient approach towards investing. To understand why, it is helpful to remember Blaise Pascal, the brilliant 17th century French mathematician, who said that "Man finds nothing so intolerable as to be in a state of complete rest, without passions, without occupation, without diversion, without effort." He went on to say that "all man's miseries derive from not being able to sit quietly in a room alone." While the latter is probably an overstatement, it helps explain why most investors prefer to speculate on second rate securities rather than patiently wait for higher quality investment opportunities to arise.

There is a tendency, both in modern life and human nature, to associate activity with progress. Even those who understand the philosophical and logical advantages of a patient approach (probably a minority to begin with), find it nearly impossible to resist the psychic imperative to DO something. The imperative to ACT or at least go through the motions of acting constantly manifests itself - from the frantic activity of certain day traders to the practice of face time, whereby conscientious employees without work to do stay at the office coerced by the often wrong perception that being present means being productive. In investing, as in life, we need to be wary of spurious and superficial correlations that can lead us down the path to mediocrity or disaster.

The reality is that, at least in investing, quantity of activity does not automatically lead to quality of results. In fact, there are a number of good reasons to believe that the inverse (i.e. less activity or long periods of inactivity) and investment success may be much more correlated.[5] Intelligent investing is like combat in the sense of the wag who observed that it consists of long periods of boredom and discomfort interrupted by flashes of intense activity (he actually said unspeakable terror, but this is where, hopefully, the analogy will deviate from our experience of investing).

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[3] Liberally quoted from Seth Klarman's 2003 Letter to the limited partners of The Baupost Group

[4] A reference to a quote paraphrasing Damon Runyon, American writer and humorist, who said that "The race is not always to the swiftest, nor the battle to the strongest, but that's the way to bet."

[5] See for example, Robert Kirby's notion of the "Coffee Can Portfolio", Warren Buffett's long-term successful ownership of quality businesses, and the inverse correlation between portfolio turnover and total returns which partly explains why many index funds outperform many active managers and individual investors.

As we said in our previous letter, taking the long view[6], though boring at times, can significantly tilt the ultimate odds of a good result in our favor. What makes this patience difficult in practice is that it requires us to do nothing and when you are in the middle of a period of underperformance, "being 'long-term oriented' can for a time look a lot like 'being wrong.'"[7] The only fortification against the temptation to deviate from a dependable, but temporarily out of favor approach, is education (especially regarding the history of investing and its second cousin speculation). As George Santayana the Spanish American philosopher once said, "when experience is not retained, infancy is perpetual . . . (t)hose who cannot remember the past are condemned to repeat it."

Unfortunately for their clients, most managers continue to measure themselves and be measured and compensated by others using short-term yardsticks of past relative performance. In part, these yardsticks arise because many clients and/or their consultants and advisors either lack the knowledge or experience to use any other (superior) measures of ability or have incentives that mitigate against such alternatives. The fault lies not in the investors, however, who cannot generally be expected to know any better. The managers, consultants, and the institutions that employ them, however, could accept more responsibility since most fail to EDUCATE their prospects on how they ought to best seek out, utilize, measure, and thereby benefit from long-term value-oriented professional money management alternatives.

There is no doubt that educating others is challenging, especially if potential clients either don't know they need it, know they aren't interested in it, or are busy and have other priorities. Doubly so if economic incentives quickly reward firms for selling and marketing what prospects think or can be convinced they want and seem to punish (at least by short-term yardsticks) those few that invest in educating clients to think for themselves about what works and what tends to fail in investing.

At The Ridgewood Group, we take the latter path since we only want to work with clients who share our values and desire long-term success. While this approach may constrain our growth, it is the only path we ever considered. Fortunately, the prevailing notion of a conflict between the success of our clients and our firm is an illusion grounded in short-term thinking. In the long-term, our firm and our clients should both be far better off as a by-product of this commitment.

Our Philosophy and Principles

At the risk of repetition, we want to use the balance of this letter to remind you that we follow a philosophy of investing that is based on a number of principles that we learned by studying other outstanding investors (especially Warren Buffett and Charlie Munger as informed by Benjamin Graham and Philip Fisher), reading extensively to derive useful mental models from other branches of knowledge, and through our own experience with and reflections on intelligent

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[6] When taking the long view, it helps to do so based upon a framework of buying quality businesses bought at sensible prices. This approach relies on the correlation in the long run between stock prices and metrics like owner earnings and book values. Mindless long-termism without this foundation is a different matter, however, akin to the story of the erstwhile entrepreneur who, though losing money because he was selling dollar bills for fifty cents, nevertheless persisted after deciding that he would make up for it "in the long-run" on volume.

[7] Seth Klarman's 2003 letter to the clients of The Baupost Group

investing. Since many of you may have missed or forgotten these principles (which are also featured on our website at www.ridgewoodgrp.com), I discuss them again herein.

We hope you will carefully review the six principles below to make sure that you both understand the main points and agree with the underlying thought processes. We invite anyone reading this letter to contact us if you have questions regarding either the principles themselves or how and why we go about applying them on your behalf.

1. Whatever the legal or formal structure of our relationship, our attitude is that of a partnership.

We like to work with people who we like, trust and admire and who feel the same way about us. We would like to attract clients/partners who share our long-term goals and values. Like good partners, we try to be fair and equitable to everyone with whom we have a relationship and create win-win relationships.

2. We try to invest in outstanding businesses when we find them. We spend most of our time reading about businesses and looking for the outstanding ones.

There are a number of characteristics that outstanding businesses share. We have a disciplined approach that seeks to find these businesses and invest in them if the price is right. However, outstanding businesses are rare. It takes time and effort to find and qualify these businesses and good ideas are valuable and scarce. However, on one point we are clear, we would rather do nothing than make an investment that does not meet our criteria.

3. We are value investors and believe that price matters. However, this orientation is not to be confused with an approach that avoids investing in growth companies, which are sometimes outstanding long-term investments.

We believe that it is critical to assess the quality of the businesses and franchises that we own. As value investors, we also believe that the price we pay is often just as important in determining the ultimate outcome of a particular investment as the quality. Consequently, we consider ourselves value investors, i.e. we seek to purchase assets when the price is favorable and represents a discount to the value of what we are getting in a way that provides us with a significant margin of safety. This does not mean, however, that we avoid investing in outstanding growth companies that are likely to deliver excellent compounding over time with an acceptable risk profile. In fact we love to own quality business with outstanding growth prospects - as long as we do not have to overpay (and ideally when we can get a bargain) at the same time.

4. We have a contrarian orientation and have found that the best investments are often in places that others may be avoiding. We tend to invest in businesses when it goes against the crowd and conventional Wall Street "wisdom."

In this regard, we heed Warren Buffett's advice to "Be fearful when the world is greedy and greedy when the world is fearful." A good number of our best investments arise when short-term disappointments create an attractive buying opportunity in a business which has long-term merit. However, the values created by these short-term company, industry, or market issues do not necessarily disappear quickly. Our contrarian approach requires that we and our clients take a patient long-term view towards investment success. Companies that we find attractive could even continue to decline in the short-term if the conventional assessment of the near-term outlook remains gloomy or becomes even more pessimistic than when we invested.

Counter intuitively, this also means that for those investors who are net savers in the intermediate term, a period of market declines or market pessimism may be a wonderful opportunity to increase their long-term wealth. This will be so even though market declines will also negatively impact existing portfolio quotations, because we will get to buy attractive bargains with excess cash. 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 if bargains become hard to find as cash is available to invest. This difference will not usually be apparent immediately, but the wealth effect will be powerful and obvious in the long-term.

5. Our goal is to optimize the long-term results from our investments. As we think about it, long-term means rolling three to five years periods, on average. In practice, longer or shorter periods will also arise with respect to individual investment commitments.

Our goal for ourselves and our investors is to compound our capital consistently and with low risk. We have no ability to predict the short-term market fluctuations of securities prices in a 12 or even 24 month period since short term prices are driven by a number of difficult to predict factors including investor psychology and supply and demand. However, we know that in the long-term the prices of our investments will converge towards and be driven by underlying business performance as reflected in metrics like owner earnings and book values. Consequently, our energy is focused on confirming those factors that we can assess, i.e. the quality of the businesses that we buy, the long-term outlook for these businesses, and the price that we pay. In short, we try to buy partial interests in businesses when the price we can pay gives us confidence of a good result 3 to 5 years out with a good margin of safety.

The margin of safety is important in that it gives us a chance to preserve our capital over that same time frame in case we make inadvertent mistakes about the outlook. This focus on margin of safety is a conscious effort to reduce the risks associated with our investments. By risk, we mean permanent loss of capital as contrasted with temporary stock market price fluctuations. For example, we are happy to see an increase in intrinsic value accompanied by a short term price drop (which we can take advantage of) in one of our investments. The opposite, however, while it can sometimes lead to an acceptable outcome in the short-term, would generally be a sign that we have made a mistake. No matter what we do, you can be assured that we spend significant time and effort paying attention to and avoiding potential losses (the permanent kind). As the philosopher said, "Don't lose money!"

This approach to investing for the long-term requires patience and discipline. It also means that our portfolio performance over the long-term will tend to benefit from low turnover of securities, low trading costs, and reasonable tax-efficiency. In order to succeed, our approach requires that we work with clients and partners who take a similar long-term view towards investment success and who have the patience and discipline necessary to stay the course through the inevitable periods when our approach is temporarily out of favor, prices decline after we invest, or other approaches seem momentarily more exciting or rewarding. In our experience, this patience is the price that investors must be willing to pay to reap the benefits of investing. However, your reward is likely to be the ability to compound your capital at a good rate over the long-term through partial ownership of good businesses bought at good prices. This performance, in turn, can eventually enable you to pursue those things that give your life meaning, unencumbered by money worries.

6. We cannot promise results, but we can promise that our results will closely mirror yours over any given period of time to the extent of our investments that are also managed by The Ridgewood Group.

As investors, we are imperfect beings attempting to take calculated risks based on imperfect information. Mistakes are inevitable - though we do try to minimize them (or at least their impact on our capital) through superior execution of a disciplined and proven approach.

Despite our best efforts, we cannot guarantee results, especially over the short-term. However, we can guarantee you that we will remain focused on those factors within our control that are likely to lead to a good result and that we will continue to take both the easy and difficult actions that should help us reach our long-term objectives. This is important to us not only because we want our clients to succeed, but also because our owners have invested substantially their entire net worth in many of the same securities and investments that we buy for external clients. Or as Warren Buffett has more eloquently stated, "we eat our own cooking."

Moreover, we are motivated by our long-term goal that our firm's mission is to make a meaningful contribution to thousands of clients by managing their money more intelligently. Our dream for each of our clients is that they increase their capital as a means to achieve and maintain financial freedom with the hope that they might use this freedom to live lives of joy, purpose, achievement and meaning.

Annual Meeting and Conclusion

We continued to attract a number of new clients to the firm in 2004. Our clients live around the U.S. and a few even reside outside it. So far, word of mouth referrals from existing clients have been the most important source of new client relationships. We therefore want to give special thanks to those of you who have referred your friends and colleagues to The Ridgewood Group. These introductions are both helpful and appreciated. We hope that with your help and guidance over the next few years, many more individuals and institutions may become aware of firms like ours that offer a viable alternative to the mediocrity that so often characterizes the status quo in our field.

In most cases, those you refer will also truly benefit from the peace of mind and freedom that can result from having their wealth managed (often for the first time) by capable and experienced professionals who eat their own cooking and use a long-term value-oriented approach to intelligent investing

As we mentioned last year, we are planning to organize an annual meeting for our current clients in the latter half of 2005 (most likely in the fall). The event will take place at a venue in or around Short Hills, NJ. We will send each of our current clients a reminder email to save the date as we get closer to the event and you will also receive a formal invitation. We hope that many of you will come out to our annual meeting where we plan to give a short presentation, allow time for Q&A, and then host an elegant (or at least tasty) dinner for our clients.

As always, we invite you to visit and tell others about our website (at www.ridgewoodgrp.com). I recently had the privilege to hear outstanding investor Peter Lynch at a recent conference and am planning to transcribe and send out his humorous and insightful comments in the near future. In addition, the site already contains a detailed transcript that I created based on a panel of prominent value investors including Marty Whitman and Mario Gabelli. We received a number of compliments on this transcript and if you have not seen it yet simply click on the "Articles and Speeches" link at the bottom of our home page.

Finally, I would like to remind you that we continue to welcome your questions, comments and suggestions. If there is any way that we can help you – especially if you have any ideas or suggestions that could allow us to deliver more value to you from our relationship and efforts, please let us know. We look forward to seeing you and working with you and yours during the balance of 2005 and beyond!

Warm Regards,

Kaushal B. Majmudar
President and Managing Partner
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P.S. By now, clients should have received a separate email with your summary performance through December 31, 2004 for each of your accounts[8] The file will be password protected and current clients should call us to get the appropriate password.

P.P.S. We also run several investment partnerships managed by our sister company Ridgewood Investments. Our partnerships have a separate password protected website at www.ridgewoodlp.com. If you require access to this information about our private investment vehicles for accredited investors please call us at 973-544-6970 or email us at the address above to get your password.

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.

[8] We send out annual statements for each account that has been open at least 6 months and that has a value over $20,000