**2005 Semi-Annual Letter to Clients**
**(for the six months ending June 2005)**

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August 15, 2005

To Our Valued Clients:

Regular readers of our letters know by now that we don't spend much time thinking about interest rates or the near-term economic outlook. In adopting this approach, we agree with Peter Lynch who said that "if you spend 13 minutes per year trying to forecast interest rates and the economy, you have wasted 10 minutes."

At the risk of spending more than our allotted "3 minutes" on macro issues and despite our strong preference for company by company "bottoms up" analysis, we will comment on the current macro environment for investors. First, valuations appear full in most sectors. Few financial assets are clearly out of favor – limiting our current access to fertile territory for our contrarian and value oriented approach. Moreover, most assets including real estate, bonds, and most equities appear fully valued by both absolute and historical standards. While valuations of certain large firms are below historical levels, we remain guarded about investing in most truly large firms since the law of large numbers may make it more difficult for these firms to grow over longer periods of time. Some important sectors, like real estate, may even be unsustainably frothy, and a reversal or pause in valuations could dampen economic activity, balance sheets, and asset valuations at once.

Other near to intermediate term catalysts could also puncture the optimism reflected in securities prices today. These factors include rising interest rates, the possibility of balance sheet weakening related to the significant financial leverage which exists throughout the US economy, increases in inflation, an unexpected drop in consumer optimism and spending caused by factors like all-time high energy prices, or a re-rating of the sustainability of American trade and fiscal deficits. If history is a guide, a wholesale change in outlook could occur, if at all, quite rapidly and be driven by factor(s) that surprise everyone. In contrast, the issues cited above are well known and often discussed in the media. If we are right (and we may not be, especially in the near term), we may again enter a period where values are more prevalent. Based, in part, on these concerns, our current bias (which has been in place for over a year) is to hold some cash in your accounts while we wait for value to emerge.

Of course, as we've pointed out in the past, challenges and opportunities come with the investing territory, so it rarely pays over time to be either too excited or too pessimistic. So we wish to be neither Chicken Little, nor Pollyanna. Instead we'll stay focused on protecting your money as if it were our own, while we wait for opportunities to invest in a handful of good businesses with good managements if they go on sale. Fortunately, because of our focused approach to investing, we won't need to find many names that meet our criteria for it to make a significant contribution to our long term results. Even if we are wrong about the above factors, we should over time find some companies that we think are attractive at then available prices.

In the balance of this letter, we will be reviewing our results to date and since inception, discussing some (hopefully) helpful perspectives on long-term investing and some news and administrative items as well.

**2005 First Half Performance**

The composite of the accounts managed according to the Core approach by The Ridgewood Group fell -2.34%[1] from December 31, 2004 to June 30, 2005. In contrast, the S&P500 fell -1.70% 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 -0.81%. The Ridgewood Core Composite somewhat underperformed the S&P500 during the first half of 2005. Given the short time period involved (short relative to our stated emphasis on three to five year rolling periods of measurement), we do not attribute much meaning to the above delta. As your advisors, however, we want you to have all the facts that we discussed in advance and our own perspectives on those facts so that you have some sound basis to come to your own conclusions.

[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.

Our Core Composite has outperformed the S&P500 by a wide margin since we began the firm and created the composite at year end 2002. Specifically, the Core Composite advanced 56.68% versus 41.53% for the S&P500 including reinvestment of dividends in the two and a half years ending June 30, 2005 representing a compounded annual return of approximately 19.7% per year. Keep in mind that the S&P500 is always fully invested, whereas the Core Composite included a significant cash component over that entire two and a half year time span. In summary, our core composite has substantially outperformed the benchmark since inception, while simultaneously taking less "risk."[2]

According to modern portfolio theory, earning extra return with less risk is a paradox, an inefficiency that should not exist since it would have been arbitraged away by Adam Smith's invisible hand working in the securities market. In our case, this theory suggests that any advantage we have enjoyed to date has been the result of random luck or hidden risk taking, neither of which can be enjoyed indefinitely. For reasons that we discuss below, however, we and many other intelligent investors disagree with the implications of these theories when it comes to our brand of intelligent value-oriented investing. Contrary to this theory, we believe that that long-term patient investors (investors like you who utilize our contrarian value oriented approach) may enjoy certain structural advantages ignored by the general formulation of modern portfolio theory.[3]

Despite our long-term confidence grounded in reason and a proven approach, you should expect that we will face one or more multi-year periods during which we fail to keep up with broader markets. This relative underperformance, when it comes, may even persist for as long as two or perhaps even three years in a row. We base our caution both on history and mathematics. From history, we have observed that other investors whom we admire have also experienced two to three year periods of sizable underperformance - despite their long track records of outperforming before and/or after such periods. Mathematically speaking, we know that investing is a probabilistic pursuit and probability suggests that we will have both good and some not-so-good years as we pursue our goal of long-term compounding.

We provide the above caution not to scare you needlessly, but because it is important that you set realistic expectations calibrated to cultivate the fortitude you will need to stay patient during such periods. Since we pay little direct attention to tracking or keeping up with the S&P500

[2] As we hope to discuss in a future letter, rigorously defining risk is far trickier than a casual observer might guess. However, there is basis for the above statement whether you view risk as risk of statistical short term price fluctuations (not our preferred definition) or the more difficult to mathematically calculate risk of losing money (account principal) over our three to five year targeted time horizon.

[3] We don't want to minimize the general and impressive efficiency of markets in the aggregate, since most securities are efficiently priced most of the time. However, the exploitable gaps in inefficiency though less common, offer ample opportunity to those who have the patience to wait for them and the fortitude to act and stay the course once they arise.

(though for convenience we report it to you) or any other short-term relative benchmark, understanding the above point has special relevance to our own clients.

If we could, we'd love to tell you in advance when we are going to be entering such a period as well as its likely duration so that you can be prepared. Unfortunately, since we lack perfect foresight, such an advance warning is nearly impossible. Instead, we hope you will anchor your long-term confidence and horizon on a faith in the proven fundamentals of our approach rather than on past relative performance. During good times, of course, human nature is such that despite our best efforts, some of your confidence is likely to be grounded in recent past performance. Despite market fluctuations, we hope you will draw confidence from the knowledge that you own a collection of quality businesses. Since we are contrarians, we generally have the additional advantage of having bought these positions at times when these businesses were (hopefully temporarily) unpopular.[4] Generally these factors allowed us to purchase businesses at good (read attractive) prices. Our low price purchasing strategy controls our downside. For all the above reasons it is reasonable to be confident in a good result as long as you maintain your long-term outlook almost regardless of the near-term outlook or fluctuations of the markets and your investment accounts.

Recall that when we invest on your behalf, we do so assuming a minimum investment horizon of three to five years in mind. Why three to five years? Specifically, we arrived at our three to five year time horizon through a process of elimination. On the one hand, since we focus on fundamentals, we had to select a period during which fundamentals would likely outweigh other factors of little long-term consequence. There is empirical historical evidence to support the notion that fundamental values and security prices sometimes become meaningfully disconnected over periods of even two to three years. Fundamental business value (or the lack thereof) seems to assert itself as the dominant consideration when three year (or greater) intervals are used.[5]

On the longer end of the spectrum, we would have chosen a seven to ten year horizon as ideal. We recognize however, that human nature and human psychology present certain constraints. Anticipating these objections, we decided that five years was a more "realistic" or "attainable" metric when communicating our upfront yardsticks to clients and prospects.

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[4] This lack of popularity will, in most cases, be replaced by enthusiasm but it could take three to five years before the swing occurs (unless, of course, we made a mistake in the first place).

[5] The dot-com boom provides a recent empirical example regarding this observation. As measured by the Nasdaq, the tech and dot common bubble began in the Fall of 1998 and was completely deflated reaching a similar level in the Fall of 2001. The extreme phase lasted less than two years. Of course, there is nothing magical about three years, but it seems a long enough period of time such that unsustainable or speculative factors driving prices over shorter time frames have a good chance of being questioned and corrected by markets.

## Lord John Maynard Keynes – the Investor

John Maynard Keynes (1883 – 1946) is probably the most famous economist of the 20th century and without a doubt the most influential. Keynes' seminal work, The General Theory of Employment, Interest and Money, was initially published in 1936. Since it is a prominent work in economics by a prominent economist, primarily written to persuade other economists, it is surprising that the book contains wisdom on intelligent investing. Keynes, the investor, made some surprisingly advanced and farsighted observations about intelligent investing.

Ironically, while Lord Keynes was a very good investor who dabbled in investing, both on his own account as well as for the endowment for Kings College, Cambridge, he considered investing to be beneath anyone of real talent or ability[6]. Despite this disdain, his track record was impressive. Based on his, perhaps, casual efforts, Lord Keynes is said to have accumulated a personal fortune of several million pounds (an astronomical sum in those days). In addition, he managed the endowment for Kings College, Cambridge, and it is said that from 1928 to 1945, despite taking a huge hit in the crash of 1929, Keynes' fund produced a rough increase of about 13.2%. While impressive on its own, this performance is even more striking since the UK market declined by an average of just under 1% per year during that same interval.

As most of you know, our own approach has been informed by careful study of other great investment thinkers like Warren Buffett, Benjamin Graham, and Philip Fisher (among others). Lord Keynes' observations and approach were formulated without the benefit of Ben Graham's writings. Because he was a man of some significant substance and ability, however, the methods that he adopted independently include most of the same philosophies that we implement on your behalf.

Some of these key elements of his investment approach include his careful selection and focus on a relatively few number of investments, being cognizant of maintaining some balanced investment positions among this minority of investments by taking a variety of possibly opposing risks, and the key elements that we'd like to discuss in this letter: his emphasis on long-term investing by "holding fairly large units through thick and thin, for a period of multiple years, until they fulfilled their promise or demonstrated that they were mistakes" that required corrective action.

## Keynes on Cultivating a Long Term Horizon

Chapter 12 (The State of Long-term expectation) of The General Theory discusses the nature of markets and the character and psychology of most market participants. In this chapter, Keynes recognizes that we attach greater weight to near-term information and trends when forming our long-term expectations, because the near-term forces are matters about which we generally have greater confidence. Focusing on long-term factors usually involves working through an

[6] To quote Keynes: "The game of professional investment is intolerably boring and over-exacting to anyone who is entirely exempt from the gambling instinct; whilst he who has it must pay to this propensity the appropriate toll."

uncomfortable degree of uncertainty. Ironically, our impetus to emphasize facts or knowledge in which we have the most confidence is strong, even when those facts have little relevance to the situation under analysis and there are other factors of obviously greater bearing but about which our knowledge is less tangible. According to Keynes, who foreshadowed the behavioral economists at least in some of his observations, we suffer from cognitive dissonance when setting our long-term expectations due to our tendency to linearly extrapolate from known short-term factors.

At The Ridgewood Group, we are aware of this dissonance, and strive on your behalf and ours to implement a process focused on attaining results over a true long-term horizon. This approach distinguishes us from the majority of other investors because our long-term process should allow us to capture a sort of persistent time-based arbitrage between our ability to look at the five year outcome, and other short-term investors who have only a six to twelve month outlook.

In another irony, the public securities markets provide us rapidly fluctuating price quotes and ample liquidity, but by creating liquidity, markets also create a nearly irresistible incentive to become overactive. In illustrating this important point, Keynes, like Graham makes a distinction between investing or enterprise on one hand and speculation on the other:

> As the [organization] of investment markets improves, the risk of the predominance of speculation. . .increase(s)[7]. . . These tendencies are a scarcely avoidable outcome of our having successfully [organized] "liquid" investment markets. It is usually agreed that casinos should, in the public interest, be inaccessible and expensive. And perhaps the same is true of Stock Exchanges. . . The spectacle of modern investment markets has sometimes moved me towards the conclusion that to make the purchase of an investment permanent and indissoluble, like marriage, except by reason of death or other grave cause, might be a useful remedy for our contemporary evils. For this would force the investor to direct his mind [only] to the long-term prospects . . .
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> In former times, when enterprises were mainly owned by those who undertook them or by their friends and associates . . . Decisions to invest in private business of the old-fashioned type were . . . decisions largely irrevocable . . .With the separation between ownership and management

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[7] Though written in the 1930s, these words are remarkably applicable to our own times. There is ample evidence for the notion that most investors have short-term horizons. For example, studies indicate that average holding periods have declined while turnover has significantly increased over the last fifty years. The average mutual fund, the average institution and the average investor don't hold securities for very long. It is not surprising that so many of these investors, facing the prospect of temporarily "renting" securities for short-term price appreciation tend to place more emphasis on expectations of price action than on a search for fundamental value. Quoting Keynes again, these overactive investors quickly engage in a third order game theoretic exercise where they "devote their intelligences to anticipating what average opinion expects average option to be" – a strategy quite disconnected from fundamental analysis and also one that is far more difficult to successfully execute over time.

> which prevails to-day and with the development of [organized] investment markets, a new factor of great importance has entered in, which sometimes facilitates investment but sometimes adds greatly to the instability of the system. In the absence of security markets, there is no object in frequently attempting to revalue an investment to which we are committed. . . but the Stock Exchange revalues many investments every day and the revaluations give a frequent opportunity to the individual (though not to the community as a whole) to revise his commitments. It is as though a farmer, having tapped his barometer after breakfast, could decide to remove his capital from the farming business between 10 and 11 in the morning and reconsider whether he should return to it later in the week.

We hope the above perspectives are helpful as you think about your own commitment to long-term investing. While Keynes' radical and rhetorical suggestion that perhaps liquidity should be banned is clearly inappropriate, we need to remain vigilant in our commitment to long-term fundamentals. This commitment to fundamentals and a business-like approach is the missing link that turns the disadvantage of "excessive" liquidity driving overactive investing by others into an enormous advantage for the minority of investors who can patiently pick their spots and wait for outstanding opportunities created by overboard selling when the news is temporarily unfavorable.

**A Tangible Illustration of the Power of Patience and Long-Term Investing**

Though we generally do not discuss specific investments in our letters, we would like to use a past investment case study to illustrate some of the nuances of long-term investing in practice. The illustration involves AutoZone, a national after-market retailer of auto parts and accessories, that I purchased in my personal account back in 1997[8] after a detailed analysis of its business and at a price in the low to mid 20s per share. Interestingly, Auto Zone was purchased at around the same time (but in much larger size) by Edward Lampert the hedge fund manager of recent Kmart/Sears fame though at the time I had never heard of him and did not specifically note his involvement.

At the time I purchased it, AutoZone (a former stock market darling with an impressive long-term track record) had stumbled for failing to continue its consistent revenue and earnings growth. AutoZone met most if not all of our criteria at the time of purchase (virtually the same criteria that we still use today) including a good long-term track record of value creation, a high quality business with predictable economics, a good balance sheet, etc. Moreover, we paid what we believed was an attractive price to initiate our holding. Over the next three years, AutoZone's stock price fluctuated within a range of plus or minus 25% from our cost basis. Looking back three years later, the price had hardly moved in comparison to our cost and less

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[8] Well before we formed The Ridgewood Group

patient investors might have long since moved on to other holdings within the first year or perhaps two at most.

From our perspective, however, the holding continued to be promising since management continued to work on the fundamentals in the business, the company continued to be profitable, and long-term prospects remained solid. In the fourth year of our ownership, however, the market perception and valuation changed dramatically. During about ten months in 2001, the price more than tripled from our purchase price creating an outstanding level of compounding on that commitment made approximately four years prior and more than compensating us for our patience.

**Our Investment Partnership[9]**

Since this is a joint update letter, we also wanted to touch on the performance of our investment partnership which has delivered solid performance since inception. The Ridgewood Investment Fund LP is our value oriented investment partnership, now also managed by The Ridgewood Group. The Ridgewood Investment Fund advanced 31.28% (gross of fees and allocations to the general partner and manager) in the 17 months from inception in February 2004 to July 31, 2005. This compares to a return of 10.48% for the S&P500 including dividends reinvested over that same interval. Year to date through July, the partnership generated a gross return of 6.13% versus 2.88% for the S&P500 including the reinvestment of dividends.

Our partnership is grounded in the same principles of investing that underlie all of our activities. The Ridgewood Investment Fund, however, unlike the Ridgewood Core Composite accounts, is both more focused and more opportunistic since it has a broader mandate. The partnerships are illiquid investments that are free to utilize leverage, options, hold even more concentrated positions, and make short sales.

Many of you may have been reading about the growth of hedge funds and you should know that The Ridgewood Investment Fund is also a hedge fund. While hedge funds are all the rage and seem to be attracting significant amounts of capital from institutions and others, we are skeptical that these funds will, in the aggregate continue to add much value (if indeed they ever did). However, in every trend that graduates to mania status there is usually some underlying merit (usually a good thing that was eventually taken too far). Among the current crop of managers, there will undoubtedly be some stars. The trouble for most is being able to identify and then get access to them before they grow too large to continue outperforming.

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[9] Open to accredited and qualified investors (individuals with joint income over $300,000 and/or net worth of over $1.5 million including a primary residence). These partnerships may involve additional risks. If you have questions about the above partnerships or how they relate to our activities as manager of your funds in the form of separate accounts, please let us know.

There are a number of concerns (from an investor point of view) that we could share about the hedge fund business in its current incarnation, but we will save this discussion for a future letter. Instead, we will simply point out that our fund is built-to-last based on a business-like approach and attention to the fundamentals of intelligent investing. In managing this fund, we pay more attention to risk and capital preservation than to returns, but of course we want to achieve both. Since we agree with the sentiment that, in many cases, hedge funds are simply a fee structure masquerading as an asset class, we have been careful to structure our fund to be fair to investors. For existing clients, a long-term investment in the partnership could add a higher return opportunity as well as provide the advantage of a performance based fee structure that helps align our interests even further.

**Other Recent Developments**

As many of you are aware, Ahalya Nava my partner joined the Ridgewood Group full time earlier this year. Ahalya has an MBA from the Harvard Business School and was a successful management consultant at Booz Allen Hamilton in New York. I expect that her involvement will be a major asset to our firm and its clients over the next few decades. While she has already been interacting with many of you, please feel free to contact her directly on any matters or questions that you may have at any time.

We'd also like to remind you that on Sunday, September 18th, 2005 we will be hosting our first annual meeting in Livingston, New Jersey. By now, you should have received an invitation that includes additional details on the time and venue. This event is open to our clients and their life partners (or qualified guests – please call us to discuss and RSVP if you wish to invite a guest) and we invite you to come participate in, learn from, and enjoy this event. The format of the meeting will be a presentation, followed by time for your questions and answers, as well as a client appreciation luncheon. We hope you can make it.

On another note, we are in the process of developing some powerful content under the heading of The Ridgewood Group Investing University. This content was created as an effort to provide ongoing education and value to both existing clients and anyone else who may be interested in learning more about intelligent investing as a means to achieving and maintaining financial freedom. The format for this series will be e-topics that will be emailed to our clients and other subscribers roughly once every two to three weeks. The series has been created as an efficient and high leverage resource for busy professionals and business people who want meaty and bottom-line information on how they can become more informed and make better decisions across a host of subjects including investing topics like:

- When to sell
- Hidden costs in mutual funds
- Doing primary research
- Controlling risk in investments
- Adopting a value oriented approach to investing

- Modeling success: learning from Warren Buffett
- The power of enhanced indexing and how you can benefit from it
- A discussion of hedge funds and private partnerships

As well as financial topics like:

- What to do about your stock options
- I just received a bunch of money, now what do I do
- How to think about and utilize insurance
- Why paying off your mortgage may or may not make sense
- Why leverage and freedom are the two most important words for any investment plan

We created this series because we saw and continue to see a significant gap in this critical body of knowledge even among relatively sophisticated and wealthy individuals. We look forward to sharing this series with you in the weeks or months to come. If you are reading this and are interested yourself or know others that might want to receive our series that includes the above e-topics, feel free to drop us an email at info@ridgewoodgrp.com. Alternatively, you can make this request by visiting our website and clicking on the link to The Ridgewood Group Investing University.

As always, we continue to welcome your support, questions, comments and suggestions. Also, please visit and tell your friends about our website (at www.ridgewoodgrp.com) and our new blog at www.ridgewoodgrp.com/blog. We look forward to seeing many of you at our annual meeting next month and working with you during the balance of 2005 and beyond!

Warm Regards,

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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.

 