The Art of Intelligent Investing℠

Third Annual Letter to Clients
(for the year ending December 2005)

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To Our Valued Clients:

This is our sixth semi-annual letter to clients and we've just passed the three year anniversary of starting The Ridgewood Group. Assets under management again grew nicely in 2005 – made possible by the many clients around the country who have trusted us to supervise their hard-earned money. We want you to know how much we appreciate your trust. We will continue to diligently work to reward the opportunity you have given us to serve you.

Entrepreneurs generally start with a vision and passion. Ours started with the dream of taking our passion for value investing and using it as the foundation upon which to build a special firm, one that would do good while also doing well for its stakeholders. We planned on utilizing a patient and disciplined framework that requires us to educate our investor clients based largely on the successful frameworks, philosophies and techniques of investors whom we admire and whose approaches we strive to implement with independence of thought, rigor, and patience.

We are pleased to have crossed a number of significant milestones in the last three years. We also look forward to building upon this base. Our main goal, over time, is to delight our clients with a world class combination of service and performance. As a small firm today, we mostly focus on getting all the basics right. In the years to come we will try to implement many more initiatives designed to enhance your client experience and occasionally surprise (in a good way) and/or delight you as well.

We began writing these letters three years ago to share our views with clients and potential clients so that they would have a detailed window into how we think about investing on their behalf.

With this letter, we have six letters and other supplemental materials available to current and prospective clients on our website at www.ridgewoodgrp.com. We have tried to create content based more on the enduring fundamentals of investing – so we hope that these letters will stay relevant even as time passes. Given the current longer format of these letters, we have, so far, disseminated them only twice per year. In addition, due to the circulation of these letters we focus our discussion on general principles rather than specific companies.

Some of our clients have expressed an interest in receiving shorter but more frequent updates so we have decided to experiment with an alternate format that we plan to use to keep in touch with our current clients. Using the new format, and for the first time, our managed account clients will receive a bit more insight into some of the businesses that we own. By selectively reviewing the business characteristics of some of our owned businesses, we hope to help our existing managed account clients think like business owners who are better armed to ride out the fluctuations that might occur.

Fortunately, our decision to start a weblog (or blog for short) turned out to be a fruitful one and should allow us to continue to maintain an active dialogue with non-clients as well. In 2005, we used several opportunities to add content to our blog at www.ridgewoodgrp.com/blog and will continue this practice. Instead of writing letters, we will continue to publish interesting and thought provoking content on our blog for general circulation. For example, several months ago we published an article on the blog discussing the Wit and Wisdom of Peter Lynch which was the most recent in our ongoing series of, hopefully, informative articles on the philosophies and techniques of other super-investors/value investors. We plan to continue this tradition and hope that non-clients will continue to visit and enjoy our site.

Performance Since Inception

In most of our past discussions, we have emphasized that a three to five year horizon (ideally five years) is the minimum reasonable yardstick of excellence in investing – so we are pleased to have crossed the three year mark in regards to monitoring our own efforts on your behalf.

The composite of the accounts managed according to the Core approach by The Ridgewood Group rose 2.80%[1] from December 31, 2004 to December 31, 2005. In contrast, the S&P500 index rose

[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.

3.00% during that same period of time. Including reinvestment of dividends the performance of the S&P was 4.91%. At the mid-point of 2005, we reported that The Ridgewood Core Composite somewhat underperformed the S&P500 during the first half of 2005 after outperforming it in each of the prior two years. Given our emphasis on absolute returns over three to five year rolling periods, we are not overly disappointed with our relative and absolute results in 2005 for the Core Composite.

The Core Composite outperformed the S&P500 by a decent margin in the three years from inception to December 31, 2005. Specifically, the Core Composite advanced 64.92% gross and 59.74% net of all fees versus 49.7% for the S&P500 index including reinvestment of dividends in the three years ending December 31, 2005. Gross of fees, our performance represents a compounded annual return of approximately 18.1% per year (and above our stated goal to compound the Core Composite at 12 to 15% over the long-term).

The comparison reflects even more favorably on our efforts over the last three years than the above numbers suggest. The S&P500 is always fully invested, whereas the Core Composite included a significant cash component over its three year life. In addition, we owned no energy or commodity stocks in our Core Composite in 2005. Commodity businesses usually fail to meet our "good business" criteria. Most commodity firms are "price takers" with high capital expenditure requirements and low and volatile average returns on their capital invested. In 2005, moreover, most companies in these sectors were popular and therefore weren't particularly cheap based on an assessment of their average earnings power over time and under a variety of scenarios. Given our patient, low-turnover, contrarian and value-based approach, we are willing to sometimes be out of sync in order to maintain our disciplined process, avoid risk and hopefully profit over the long-term from our patient opportunism. Unfortunately, we will occasionally go through periods during which our results are penalized by our discipline – at least on a relative basis. In 2005, we gave back a little bit of the gap that we held against the S&P500 as compared to the end of 2004.

At least 2005 was a positive year (it won't always be the case) in which our client account values advanced, albeit slowly. As we have said in the past, investing is fundamentally a probabilistic pursuit so we can and should expect some great, some bad and some flat years in an impossible to predict sequence. Our results in 2005 fell mostly into the third category. Over the next three to five years we will continue to invest in a way that should (hopefully) deliver solid performance while still maintaining our focus on preserving your capital over time. This approach has worked for our clients over the last three years. Of course, if you started with us in the last year or eighteen months, your aggregate performance is likely to be positive, but perhaps not excitingly so. Please try to remain patient - over the next five plus years, our focus on investment quality ***and*** investment value offer a good chance of producing at least reasonably pleasing results for you and our other clients net of the fees you pay to us.

Fooled by Randomness

Fooled by Randomness: The Hidden Role of Chance in Life and in the Markets is a 2004 book by Nassim Nicholas Taleb in which Mr. Taleb, a trader and academic, explores the role of randomness and luck in life, business and investing. Using a variety of examples and anecdotes, Mr. Taleb presents evidence that individuals and institutions often mistake luck for skill. Though Mr. Taleb comes from a trading background many of his observation are just as valid when applied to other probabilistic fields – including long-term investing. In the book, Mr. Taleb particularly focuses on three major sources of our cognitive tendency to be "fooled by randomness" namely our tendency to use induction to extrapolate short-term success into the future, our blindness to even obvious data biases and particularly survivorship based biases[2], and our genetic wiring which makes us poorly suited to govern or even recognize these failings.

When fooled by randomness, most people take unintelligent risks. The unlucky ones suffer immediate losses[3] - the lucky survive and even thrive until they too (in time) self-destruct. This process is continuously at work in the markets, especially in zero sum[4] games. Fortunately (or unfortunately), there is always a fresh supply of confident victims and agents ready and qualified to replace the fallen.

In markets, one of the commonest examples of being fooled by randomness is provided by those investors who chase short-term past performance. While such a strategy can work, sometimes even over the intermediate term, most investors will fail with this approach over an extended horizon. As Warren Buffett has observed, "The dumbest reason to buy [an investment] is because it is going up." Reflexively, selling something merely because the price is falling is also

[2] Survivorship bias is the tendency to measure historical performance based on data sets that don't include those that did not survive to the end of the measurement period. This common practice is partly motivated by practical considerations – it is difficult to even identify let alone collect comprehensive data for bankrupt firms or failed managers. Unfortunately, this bias skews the data. In many cases the correct data imply very different conclusions than those based on biased data.

[3] In many instances, those who lose quickly are the lucky ones because their losses usually represent a small part of their total capital. During the Internet bubble, those who invested and immediately lost turned out to be the lucky ones, learning a valuable lesson quickly and relatively cheaply. In contrast, those who enjoyed random initial success became confident of illusory capabilities and/or abandoned their discipline - they consequently suffered dearly when the bubble deflated. Paraphrasing physicist Stephen Hawking's observation about knowledge, the enemy of investment success is not the lack of investing ability, but the illusion of it. "Whom the gods would destroy, they first make mad." (Euripides)

[4] Zero sum is a phrase use to describe situations in which one participant's gain is entirely offset by and must come at the expense of another's equal but opposite loss. Zero sum games are a limited subset of the larger class of constant sum games. By way of example, most derivative contracts, like options and futures are zero sum contracts with a winner and a loser. A closed market system (such as the stock market) is a constant sum game in a given period in the sense that there is one pie (determined by the overall earnings of all the companies in the market) which must be sliced among its participants. Fortunately, the constant sum in the stock market grows over time as a country becomes more productive and the sum of all earnings compound at a positive rate.

unintelligent. Nevertheless, this is exactly what most people tend to do – even most of those who should know better.

Unfortunately, few are insulated from the possibility that skill can be mistakenly attributed to results which were really grounded in chance. Though we have a solid three year track record, investors cannot rely on this track record as conclusive evidence of our investing acumen or skill. What we *can* say, is that the longer the measurement period the less uncertain the attribution of skill – though chance can never be completely discounted. If we do well over the next five, ten and fifteen years, your confidence that our performance is due more to skill than to chance should increase. Shorter periods of time – say a given quarter, year, or even several years – are unreliable signals that are probably best ignored when trying to assess "true" skill.

The prevalence of randomness raises a very practical dilemma for investors seeking to evaluate their alternatives – whether their own skills or those of their chosen advisors. Fortunately, there is at least one reasonable path out of this wilderness of randomness.

Process versus Outcome

Most investors who are fooled by randomness focus too much on outcome (i.e. historical experience grounded in statistics) and too little on process. By focusing on outcome over process, you tend to become overactive, undisciplined and a follower – looking and finding short-term patterns to which you attribute often false significance. You constantly attempt to move to greener pastures but rarely arrive at your destination or stay to enjoy your surroundings. In investing as in life, most people overestimate what can be accomplished in one year and vastly underestimate what can be accomplished in ten years.

Process focus is a fundamental of intelligent investing. All good investors, including Warren Buffett, either automatically or deliberately focus more on process than on outcome. Of course, they all recognize that their focus on process, if the process is sound and soundly implemented, is also more likely to produce the desired outcome(s) than other approaches (especially approaches that focus excessively on outcomes to the exclusion of process). A process based approach is superior because it frees you to plan and implement your plan over a longer time horizon. A process focus also rescues you from many of the cognitive short comings likely to sabotage your efforts. The process becomes your touchstone - a more objective standard by which to channel and evaluate your efforts and make the necessary adjustments. Rome wasn't built in a day and it probably wasn't built with that outcome in mind from the beginning.

As you know, we focus on a process that should work over the long-term. We can say this with some confidence because similar processes have worked for many others when these processes were implemented with discipline. Summarizing many of the themes we have discussed in the past, our process focuses on:

- Identifying higher quality businesses
- With better than average, hopefully exceptional, management teams
- Buying them at a price that is attractive in both relative and absolute terms
- Probably arising from fears related to factors that we deem to be either temporary or overblown and
- Being willing to hold these businesses for long-term capital preservation and compounding

The short-hand we use to describe our devotion to the above process is that we are value investors. By paying attention to value and by going against the crowd, our process gives us an edge over other investors who chase outcomes. We expect that this process will continue to produce at least reasonably attractive results over the long-term.

Our Investment Partnership[5] and the Mad Mad Mad Mad World of Hedge Funds

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 34.5% gross and 26.14% net of fees to the general partner from inception in February 2004 through December 31, 2005. This compares to a return of 12.66% for the S&P500 index including dividends reinvested over that same interval.

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 has a broader mandate that allows the fund to be even more opportunistic. The partnership is an illiquid investment that is free to utilize leverage, options, short sales, and hold concentrated positions.

Hedge fund is an umbrella term that is now loosely used to describe almost all investment partnerships with performance based fees. Hedge funds today are being sold and bought as the answer to many needs. Despite (perhaps because of) their popularity – we see an extraordinary relaxation of discipline being applied in many parts of the hedge fund universe. We predict that this sector will encounter some turbulence as a result of the misguided expectations and processes being implemented by hedge fund investors and managers alike.

One of the well-established fundamentals of investing is that fees matter – they have a 100% success rate for reducing performance. For reasons that are likely to be grounded in cognitive dissonance – quite a few investors and institutions have decided to ignore the obvious connection between fees and performance when evaluating their private hedge fund investments. Today,

[5] 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.

anything called a hedge fund is somehow, magically, exempt from this most fundamental axiom of financial physics. Using the current (we think warped) standards, higher fees are considered in some quarters as a positive signal of quality. In our investment partnership, we adopted a fee structure that is now considered below the norm and subsequently received feedback that while our credentials and performance looked good, people might question why our fees were lower than the "standard." The implication: those who charge more must be better – why else would they be charging so much?

In most of their daily purchases, people seek lower prices and bargains. Quality on sale should be more attractive than items that have been marked up. With the exception of certain prestige or vanity items (LV purses come to mind), higher prices aren't welcomed with enthusiasm nor do they increases sales volumes.[6]

Thinking that fees/prices don't matter has historically been a fairly reliable path to the investment doghouse. If past is prologue, many in the institutional hedge fund world are bound to be disappointed by the divergence between their hopes and expectations and the actual results that they ultimately enjoy. The current dissonance won't continue forever. When more investors wake up, a variety of funds will suffer from withdrawals. Unfortunately, as Warren Buffett has quipped, "When the brothel burns down, even the pretty girls have to run out onto the street."

If and when the above scenario comes to pass, our partnership is likely to survive (hopefully even thrive). We are focusing on a process designed to provide solid long-term results based on serving only a carefully screened group of long-term and intelligent partners. Following the golden rule, we have tried to charge fees that we would consider reasonable if our positions were reversed. These philosophies may mean that our assets under management grow more slowly. We will nevertheless maintain this approach as long as we continue to believe it is the right foundation for long-term success.

Other Recent Developments

On the first Saturday in March, Berkshire Hathaway releases Mr. Buffett's annual letter to the shareholders. If you haven't read his writings go to www.berkshirehathaway.com where Mr. Buffett's letters to shareholders from 1977 to 2005 are currently available. While we realize that we may be atypical, reading the 28 available letters in chronological order is our idea of a great day (pick up a highlighter for even more fun). If that prospect is unappealing of if you have other pressing concerns, select a few at random and just read those. Even a limited exposure to the clarity of thought and reasoning evident on all of Mr. Buffett's original writings will delight and

[6] Besides certain prestige/exclusive items, another more common example where higher prices actually increase volumes involves products and services where the price increase is used to provide for fatter commissions to sales agents (think timeshares, loaded annuities, some insurance contracts, etc.). Lots of people pay dearly for the privilege of being sold things they wouldn't otherwise buy.

reward you with numerous insights on both investing and life, delivered with his trademark down to earth humor to boot.

Each year, the release of Berkshire's annual letter predates a pilgrimage to the annual meeting which occurs in Omaha at the beginning of May. Deemed the annual "Woodstock for Capitalists," the 2006 annual meeting is scheduled to take place on Saturday May 6th. The format for the meeting is a movie and question and answer session that goes from approximately 8:30am to 3:00pm with a break for lunch. If you haven't attended in the past, it is quite an experience.

Last year, we announced the availability of The Ridgewood Group Investing University. Many of you requested this series (our clients and prospective clients receive this series of short lessons and articles on investing and wealth management automatically). We have gotten some appreciative feedback on this content. If you or someone you know is a prospective client who wants to receive this series, send us your details by visiting our website and clicking on the link to The Ridgewood Group Investing University.

On an administrative note, we want to inform our clients that last year The Ridgewood Group changed its form of legal organization from a New York corporation to a New Jersey LLC. This change was driven purely by considerations of tax efficiency and convenience. There has been no practical change in control or management of the firm and there should be no material impact on our relationship with you. Given our growth in assets under management, we are also in the process of transitioning from state to SEC investment advisor registration.

As always, we continue to welcome your support, questions, comments and suggestions. Please continue to visit and tell your friends about our website (at www.ridgewoodgrp.com) and our blog at www.ridgewoodgrp.com/blog. We look forward to working with you during the balance of 2006 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.