Midwest Investment Management

PERSPECTIVE™

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Proof in the numbers: Too much diversification causes portfolio pain

By Elmer L. (Al) Meszaros, CFA, Partner

As the markets continue their slow but steady recovery from the bear market of 2001-2002, many financial journalists are suggesting that investors "diversify" their investment portfolios in order to enhance the opportunity for growth, while reducing investment risk. Their "recommendations" include creating a portfolio comprised of growth, technology, and international stocks, various bonds, and real estate investment trusts (REIT's).

Diversification is healthy and necessary. But, we also know that over-diversification (or the "eggs in a thousand baskets" approach) is *actually detrimental to performance* and doesn't really protect against downside risk.

No protection

Over-diversification did not protect investors from 2001-2002 when nearly all stock categories declined. Only bonds and cash registered positive returns. International stocks, which are often suggested for diversification, were down 25.3% during that period alone.

Market risk, or what the academics call "systemic risk" cannot be diversified away by buying even more stocks.

A few years ago, we met someone who owned 140 different mutual funds. It was the worst case of over-diversification we had ever seen!

Settling for mediocrity?

The mathematics of large numbers of stocks drives toward mediocre performance. For example, studies indicate that a portfolio with only 15 stocks has a 1-in-4 chance of outperforming its benchmark, while a portfolio of 250 stocks has only a 1-in-50 chance of outperforming its benchmark.

Studies have also shown that a portfolio of 30 stocks can achieve 95% of needed diversification. The volatility may be greater with a focused portfolio, but so are the rewards.

Two types of risk

The purpose of diversification is to reduce two types of risk: *volatility* and *permanent loss of capital.* The antidote to volatility is the virtue of patience, or a longer time horizon. If we buy Pepsico stock for our client portfolios today and know that we have to sell it next week, that's a very risky transaction. However, a 10-year time horizon makes it virtually a very low risk transaction.

Reducing risk

At Midwest Investment Management, we address volatility through our "Strategic Value"

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Annual composite performance audit completed

By Meg E. Halloran, Director of Portfolio Management

In March 2004, an independent Cleveland-based certified public accounting firm completed its annual composite performance audit of our firm, in order to assess the accuracy of portfolio transactions, composite investment performance, and records for clients who have managed portfolios.

This audit has significance for current and prospective clients of Midwest Investment Management because it requires our solid commitment to specified ethical practices and code of conduct that promote full disclosure and fair representation of investment mangers' results.

"This audit…requires …full disclosure and fair representation of investment managers' results."

Voluntary standards

The audit procedure is based on the Performance Presentations Standards (PPS) of the Association for Investment Management and Research (AIMR), an internationally recognized body established to help maintain the highest standards of professional conduct within the financial community.

These standards are voluntary and have become increasingly recognized by both private industry and government regulatory agencies as the benchmark for performance presentation.

Our commitment

It should be reassuring to know that the audit process commits Midwest Investment Management to a higher standard of conduct.

Although many investment management firms ***do not*** make the financial, business, and intellectual commitments for the audit, we

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1st Quarter Economic Review

Low interest rates, corporate investment buoy stocks in see-saw market; outlook remains good

By Joseph A. Harrison, CFA, Partner

The new year began with a continuation of the positive investment returns we enjoyed in 2003. Late in January the press release following a meeting of the Federal Open Market Committee presented a slight change in language describing its attitude toward a future rate change. The word "patience" was substituted for "a considerable period." Investors retreated to Webster and Roget for clues to any prospective change in interest rates.

Federal Reserve Board Chairman Alan Greenspan offered public reassurance that a change in interest rates was unlikely. Current thinking is that August is the earliest likely time for a change.

The economy continued to post impressive readings:

- A continuing recovery appeared to be transforming into an expansion;
- Housing and automobile sales remained strong as consumers were encouraged by continued low interest rates, rising disposable income, and the start of the tax refund season.
- Consumer prices remained stable. Low interest rates made the assumption of more debt an affordable luxury.

Corporate profits

Corporations also benefited from these same stimulants. Profits and cash flow, the mirror of personal disposable income, are very strong. Loans for capital and inventory investment

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"The most immediate issue is employment growth…"

Proof in the numbers…

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style of investment management. Countless studies have demonstrated that the "Value" style is less volatile and more rewarding than other categories. For example, over the past 21 years the Russell Large Value Index grew an average annual rate of 14.2%—the best of all the major categories, with less volatility. It was down only 4 years in 21, the fewest declines among stock categories. In its worse year, 2002, the Large Value index declined 15.5%, far less than the worst year for the S&P 500, which was down 22%, and the Large Growth Index, which was down 28%.

Reducing permanent loss

We address the risk of permanent loss of capital (a more serious risk than volatility) through two simple rules of sound investing:

1. *Buy a stock only when the price drops 20% to 30% below its intrinsic or fair value.*
2. *Buy only quality companies that can increase profits 8% to 12% each year. This means a company must occupy a strong enough franchise-like position to generate above-average profitability, and thus free cash flow to pay rising dividends and re-invest for growth.*

I am pleased to note that half of the companies we have purchased for our clients' portfolios increased dividends in *each* of the past 10 years—a rare achievement.

History of over-diversification

What brought about over-diversification? The stage was set by modern portfolio theory, whose authors claim that if markets are efficient, (i.e., if current prices reflect all relevant information), then new information rules the future—which is unpredictable. Thus, the markets are a "random walk," and investors should buy indexes in all asset classes to reduce risk.

"Market risk… cannot be diversified away by buying more stocks."

Annual Growth Rate
Major Indexes—1983 to 2003

Index	Rate
Russell Large Value	**14.2%**
Russell Small Value	14.0%
S&P 500	13.4%
Russell Large Growth	11.8%
International	11.6%
Lehman Bond Index	9.3%
Russell Small Growth	7.5%
3-Month T-Bills	5.5%

Detailed Indexes On-Line
Year-by-year data for the performance indexes in this Annual Growth Rate table can be viewed at *www.mimllc.com/tables*

The indexes above are unmanaged and investors cannot actually make investments in those indexes.

At Midwest Investment Management, we see two flaws with the "efficient market" hypothesis. First, just because stock prices are *sometimes* efficient doesn't mean they are *always efficient*—that's a big difference! For example: were stock prices "efficient" on the *morning* of October 19, 1987 (the day the market crashed) or *six hours later* when the market declined 23%?

Secondly, there are a group of investors who have beat the indexes consistently. Warren Buffet calls them the "super investors of Graham & Doddsville." They follow a simple directive, which is to "buy below intrinsic value"—a key strategy we employ on behalf of our clients.

For decades, Al Meszaros' skilled stock-selection process has produced outstanding returns for his clients. To learn more about the advantages a managed portfolio offers, you are invited to contact him at (216) 830-1133 or elm@mimllc.com

How our on-site research benefits our clients

Part II

Editor's note: *In the previous issue of PERSPECTIVE, Midwest Investment Management Partner Al Meszaros explained why on-site research is vital to the prudent assessment of stocks held in client portfolios. In this interview, Partner Norman F. Klopp, Jr. discusses the diligence that is required when meeting with corporate managements.*

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Editor: *Norm, during the fourth quarter of 2003, you traveled the country to meet with senior managements of several companies whose stocks are held in client portfolios. Why are these meetings important?*

Klopp: Personal visits are the most important form of investment research. Our clients' money is invested in those companies, so our visits are of critical importance. Our visits take many forms. The challenge is to understand how to manage each form in order to gain maximum benefit.

Editor: *Please describe one of your recent meetings.*

Klopp: I attended an analysts' meeting at a New York City hotel for a company that had installed a whole new management team in the previous 18 months—all of them from inside the company. I had previous exposure to them, and arrived about 45 minutes early so I could have informal discussions before the meeting with the CEO and CFO about three strategic topics I had identified in preparation for this meeting.

While listening to the questions and answers during the meeting and talking with some of the major institutional analysts during the breaks, it became apparent that many analysts didn't believe the financial projections of this new management team.

However, this was a "positive." The analysts were convinced the new managers were being very conservative in their 2004 estimates, and that the estimates would most likely be revised upward as 2004 progressed. This is not unusual for a "new" management team that wants to build credibility with the financial community. I also know it usually creates an environment for positive stock performance.

When I returned to Cleveland, my Partners and I agreed to retain this stock in client portfolios, based on the growing positive perception of this management team and improving prospects for the company. As this article went to press, the stock was up about 23% since that meeting—more than triple the markets gain since that date, and up 62% in the last twelve months. Although we recently reduced the position size in each of our clients' portfolios, we remain invested in the stock.

Editor: *You've said "coffee breaks" at analysts' meetings can be valuable, also.*

Klopp: Those gatherings provide an opportunity to talk one-on-one with various executives. I am able to conduct brief but "pointed" conversations with a specific "mission." During a morning break at a recent large company-sponsored meeting, I asked the CEO about his succession plan—an important topic because he is only a few years from retirement. During the afternoon break I talked with one of the top executives who is a possible choice as the next CEO. My presence there, and the subsequent discussions, resulted in our firm's decision to add to the existing position. So, even at large meetings I can obtain unique knowledge, if I have a plan for gathering information.

"Our clients' money is invested in those companies, so our visits are of critical importance," says Norm Klopp.

Editor: *You also visited a long-term contact.*

Klopp: That's right. I met for three hours with a top executive at a large diversified industrial company whose stock we've held in client portfolios for several years. I have been calling on him for more than twenty years. He feels comfortable knowing that I won't push hard to try to get a specific answer to a question the company will just not answer. That executive described an important strategic plan the company is implementing across all of its operating divisions. If successful, and indications are it will be, the cyclicality of each of the businesses will be reduced, increasing profit margins for each division, and slightly increasing the long-term growth rate. This is truly a formula for investment success.

Editor: *Did you ask him how much the margins or growth rate would increase?*

Klopp: No, because I knew he wouldn't answer that question. It's my job to estimate based upon what I've seen happen at two other industrial companies I follow when similar strategies were executed. The conclusion of our firm is that, even though the stock is up 80% in the last twelve months, we should not sell the stock, but continue to hold it in client portfolios. And, we now have a clearer idea of how to monitor the success the company is having with its strategy.

Editor: *How would you summarize your many years' experience meeting with corporate leaders?*

Klopp: If done right, the insight gained can be unique. If done consistently, the value can be substantial. We continue to believe that field research provides important value-added insight to our investment decisions. It is truly one of the exciting and rewarding parts of our investment management process.

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Norm Klopp's knowledge, discipline, and diligence has produced attractive long-term results. If your portfolio is not currently benefiting from Norm's stock-selection process, you're invited to contact him at (216) 830-1135 or nfk@mimllc.com

"If done consistently, the value can be substantial."

"We continue to believe that field research provides important value-added insight…"

How To Reach Us.

You may contact the partners or staff members at Midwest Investment Management by phone or e-mail. Here is a complete listing for your convenience.

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Economic Review *(Continued from page 2)*

remained very inexpensive, and more-attractive depreciation schedules enhanced cash flow. Furthermore, strong research and development expenditures—as well as the growing number of patent applications—suggest a positive longer-term outlook for the economy.

Other measures of economic health, such as initial claims for unemployment, regional and national reports from the Institute for Supply Management (ISM), store sales, and housing starts, all point to a broad economic expansion that is gaining momentum.

Lethargic job growth

Longer-term issues are subject to much debate. The most immediate issue is employment growth that has only recently shown modest improvement. Technology-based productivity improvements require fewer new jobs.

We are in the midst of a significant change: today our population is much better educated than prior generations and much better equipped to adapt to a new environment. For example, the level of persons over 25 with a high school education is 84%, twice the 41% in 1960. Those with college degrees at 27% are triple the 8% level of 1960. Further, with 70 million youngsters under the age of 15, advanced educational opportunities speak to a highly skilled work force in years to come.

Some concerns

A second long-term issue is the specter of higher rates of inflation and the prospects for much higher interest rates in response. Consumer inflation rates, whether measured by the familiar Consumer Price Index or the Price Index of Personal Consumption Expenditures, remains quite low. But commodity prices which directly affect the consumer are a concern. Energy and agricultural commodities are subject to natural global demand and the additional demand occasioned by a lower dollar. Thus, everything from grain to paper products, building materials, metals, and chemicals are all increasing in price. Eventually these prices will find their way to the consumer. How federal policy makers and the economy respond is not known, and that suggests caution.

Another cautionary issue is that of the domestic federal deficit. While the dollars are high, the amount relative to the size of the economy is not a concern. However, the trend of the deficit cannot be ignored. At the moment, cyclical factors are working to reduce the deficit. Corporate tax receipts and individual tax withholding are increasing as unemployment benefits decline. The pace of overall government spending, magnified by election year budget appropriations, remains a concern.

Looking ahead

On balance the current economic climate is favorable. Low interest rates, growing incomes and expanding corporate investment are all favorable to us both as citizens and investors. With the past year's improvement in equity prices, valuations are not as favorable, but do remain attractive given the broad momentum in the economy.

Joe Harrison's keen understanding of economic trends has helped him generate outstanding returns for client portfolios. To learn more about the benefits a managed account relationship offers, you are invited to contact him at (216) 830-1131 or e-mail: jah@mimllc.com

Audit process... *(Continued from page 1)*

believe the process provides our clients with the extra peace-of-mind they have come to expect from Midwest Investment Management. It also demonstrates our commitment to operating with total and absolute integrity.

Midwest Investment Management claims compliance with the AIMR Performance Presentation Standards (AIMR-PPS®), the U.S. and Canadian version of GIPS.® AIMR has not been involved with or reviewed Midwest Investment Management's claim of compliance.

Clients may request a copy of the verification report for 2003 or a complete list and description of Midwest Investment Management's composites and/or a presentation that adheres to the AIMR-PPS® standards by writing to Norman F. Klopp, Jr., CFA, Midwest Investment Management, 1301 East Ninth St., Suite 1110, Cleveland, Ohio 44114

The CFA® Program is overseen and administered by the Association for Investment management and Research.®

We hope you enjoy reading our quarterly newsletter, which contains news about our firm, its investment philosophy, the economy and market trends. We suggest you retain these newsletters for future reference.

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