

INSIGHTS ON FRONT STREET



BY JOHN W. GUDRITZ, CFA

PROFITING FROM FAITH IN THE INVESTMENT PROCESS

NOVEMBER 2007

Despite the fact that the popular stock market indices are up mid-to-high single digits this year, many stock portfolios are not keeping up. That is because there has been a divergence in the market in recent months where fewer and fewer stocks are taking the market averages to their highs. During challenging times like this when many investors feel out of step with the market there is a desire to change strategies and to get into those stocks that are working. That short-term tactic is usually a BIG mistake. We choose to think long-term and “keep the faith” with the investment process that has been very successful for us over the years.

Anyone who has invested in stocks over as many years as we have knows that there are times when one’s approach to investing does not give the kinds of short-term results that are wanted. The stocks that seem the cheapest and represent the best values are sometimes in sectors of the market that do not attract investors’ interests for one reason or another.

For example, we know plenty of investors who had their portfolios full of large-cap growth stocks like General Electric, Sara Lee, Johnson & Johnson, and Coca-Cola and felt very frustrated by the disappointing returns they were earning from 2003 through 2006. How could the stocks of such great companies provide such mediocre returns?

I can imagine that many large-cap growth managers were busy meeting with unhappy clients and were feeling pressured to “do something” to make the returns better.

The reality is that these managers were hired because their investment process focused on large-cap growth stocks. For them to suddenly become small-cap value managers in pursuit of higher returns would probably have led to greater disappointment for their clients.

Thankfully, our investment universe has never been limited to large-cap stocks and our clients have benefited from that freedom. Our investment style was totally in sync during this time and our efforts were being greatly rewarded.

Our investment process allows us to look at companies of all sizes in any industry that we understand. We tend to gravitate towards financially strong companies whose stock prices have fallen because of fears in the market or specific problems. Obviously, before laying money on the line we need to determine that these problems are only temporary in nature.

This investment process has led us to invest in companies as large and well known as Microsoft and Google to some as small and obscure as a little wholesale food company like Overhill Farms or a small regional airline like Pinnacle Airlines. We have even found some similar opportunities overseas.

What all of these companies and the others in the portfolios had in common at the time we purchased their stock was a substantial decline in their stock price and lowered investor expectations for each company's future. These lowered expectations and low stock prices in relation to the companies' earnings, cash flow, or asset values provided some downside protection but even more upside potential if and when the companies got back on track.

Deciding what price to pay for the stock of a company is only half of our investment process. Deciding when to sell is the other (and often more difficult) part of the process.

We have always believed in having a disciplined approach to realizing profits as the price of the stock rises. Our clients know we are not shy about selling a portion of a stock position after it has hit our near-term price target, especially when it represents a larger holding in the portfolio. While we don't like generating a lot of short-term capital gains, we will take them if we determine the risk of losing those gains is too high.

We also try to be disciplined sellers of stocks that don't live up to our expectations. This is a tough part of the process and is most investors' Achilles' heel. We have learned from experience that it is possible to get blinded by one's analysis of a situation and not clearly see the reality.

The market environment changed this summer with the fallout from the sub-prime mortgage debacle and the concerns of the affects of declining home prices on the U.S. economy. Investors have been running away from all financial stocks and most stocks of companies that have anything to do with consumer discretionary spending like retail. They have been run-

ning to large-cap technology, energy and material stocks of companies that have benefited from the strong global economy.

To give you an idea of the extent of the disparity in market returns, the financial sector of the S&P 500 Index has fallen about 16% year-to-date while consumer discretionary sector is off about 9%. Remember these are average numbers. We have seen many financial and retail stocks that are off over 50% from their recent highs.

On the other hand, the technology, energy, and material sectors are each up over 20% year-to-date as earnings continue to come in strong. The technology returns were somewhat skewed by a few high flying stocks like Google and Apple.

Our disciplined approach to finding the most undervalued opportunities in the current market environment is leading us to those very areas from which most investors are staying away. While we understand the attraction to those sectors of the market that are currently seeing the higher earnings growth (including foreign stocks), we are very concerned that the stock prices in these areas already reflect this good news. Expectations for continued growth in those sectors are very high and that makes us uncomfortable with the downside risk of those stocks.

We know we may be early in our pursuit of some cheap and unloved financial and consumer stocks and we accept the fact that this strategy may hurt our near-term investment returns. We don't invest money with our eye on the near-term. We have the experience to know that when we stay true to our process, it sows the seeds for strong long-term results in the future.



Phone: (231) 947-3775
Front Street Investment Management
400 W. Front Street Suite 206
Traverse City, Michigan 49684