

## Doing Our Own 'Big Dig' - For Investment Insights

We (Tim, Cecil, Kevin and Julius) recently made another due diligence trip to the northeast to visit portfolio managers at three money management firms we respect. We landed in Providence, RI just before lunchtime, then headed north on I-95 towards Boston. Our short 45-mile commute turned long because of heavy traffic from “The Big Dig”, Boston’s underground central artery roadway project. After we checked in at the hotel, we grabbed a quick bite in Quincy Market and set out on foot for our first meeting at Boston Harbor.

There, we met with **Jeremy Grantham**, **Ben Inker** and **Rob Soucy** of Grantham, Mayo, Van Oterloo, a value-oriented institutional money manager with \$26 billion in assets and a very impressive performance record. The oft-quoted Grantham, who was recently the subject of an extensive *Barron's* interview, is GMO’s chairman and oversees the firm’s investment strategies. Inker is the Chief Investment Officer and is responsible for asset allocation, and Soucy is the Director of US Equity Management.

GMO’s quantitative bent quickly became apparent as Grantham reviewed his firm’s much publicized seven-year asset class forecast. GMO leans heavily on history and is a big believer in the cyclical nature of investor behavior. The underlying assumption in all of GMO’s work is the idea of *mean reversion* – that is, a tendency for the broad market to return to historical norms. When pointing to the 17-year up cycle for stocks which ended early in 2000, Grantham recently explained, “Stock prices tend to return to average. What’s driving stock prices down is that they went up [at an above-trend rate].”

For many years now we have managed our clients’ portfolios with considerable exposure to the international stock markets, and we will continue to do so. That will benefit our clients if GMO’s projections are accurate. Grantham said, “My guess is that we spend the next seven years in favor of international.” In the US, he currently prefers the stocks of small companies to large ones, an attraction we also see with our increased positioning in small company mutual funds.

Speaking of small companies, we met the following morning with **Jim Kaplan** and **Paul Weisman**, who manage nearly \$3 billion including the Undiscovered Managers Small Cap Value fund in which we are investors. Kaplan emphasized his intellectual and emotional commitment to value investing and proclaimed, “Either you read [Warren] Buffett’s essays and [Ben] Graham’s books and buy [their approach to investing] – in its entirety – or you don’t.” Kaplan earned his Ph.D. in applied mathematics and revealed in our conversation that he put himself through graduate school by counting cards, a skill he learned from reading the book, “Beat the Dealer” by math professor Edward Thorp.

Kaplan described in detail the makeup of his firm and the process that their nine investment professionals use to pick stocks. Unlike Grantham, they rely on qualitative criteria in addition to quantitative factors. Kaplan stated, “Five company managements come into our offices each week, and our analysts go to meetings every day. It’s like dating.”

Our final meeting was with **Hakan Castegren**, **Jim LaTorre** and **Ted Wendell** of the \$4 billion Harbor International fund. (We are investors.) Castegren has managed the fund since its inception in 1987 and has assembled an impressive long-term record that has landed the fund consistently in the foreign stock category’s upper ranks. Interestingly, in our meeting at GMO the previous day, Jeremy Grantham revealed that he himself was an investor in Harbor International and called it “the most tax-efficient foreign fund.” Castegren was educated in Stockholm, Sweden and now occupies an office by himself in Bermuda. He explained, “I have lots of time to think.”

During the meeting, Castegren took several minutes to describe his feelings about opportunities in various markets around the world. At this point, he seems most interested in China (growing into a very productive economy), Singapore, Australia, South Africa, Europe (conservatism is the rule in accounting) and Russia. The areas he is staying away from are Japan (characterized by slow reforms and the potential for accounting scandals), Malaysia, the Philippines, Pakistan, Turkey and Egypt.

## Expectations for Stocks

After the difficult markets that we have experienced over the last couple of years, one question on everyone’s mind is, “What can we expect from stocks in the future?” We posed that question in each of our meetings. Over the next seven years, Jeremy Grantham looks for US stocks in the aggregate to earn annualized returns between 3% and 6% and international stocks to earn between 8% and 11%. (He anticipates his results will be better.) Jim Kaplan, who is currently finding plenty of good buying opportunities, expects “high single digit returns over the long-term”. Hakan Castegren indicated that he is seeing a lot of good

values right now and agrees with Grantham that investors will do better in international markets. He quipped, “If you were to ask me to list very cheap companies, I could do it on the back of an envelope.” His expectations for foreign stocks? “12% – with a lot of caveats.”

## **We are Expanding Our Services and are Very Excited About It!**

Effective immediately, Medley & Brown will be offering investment management in a concentrated portfolio of individual stocks. Initially, these accounts will be available as a complement to a more broadly diversified portfolio of mutual funds. While some clients have expressed interest in such a program, the primary motive for this undertaking is that we believe we can enhance total returns, without adding undue risk.

The approach to stock selection we will use has been in place with one pilot account over a period of seven years. Julius Ridgway, who joined us this summer, will be responsible for managing these portfolios. He is an experienced stock analyst and portfolio manager, and comes to us with a thorough understanding of our process and investment philosophy.

Over the years we have developed an expertise at identifying the best no-load fund managers. Since 1986, we have also followed the activities of Berkshire Hathaway, run by the world’s most successful investor, Warren Buffett, and his partner, Charlie Munger. During that time we have come to have a good understanding of what sorts of businesses attract these great investment minds. While each of our favorite managers has a slightly different approach to investing, they all have some common characteristics. Without getting too technical, they are all value investors that subscribe to the Benjamin Graham school of value investing, seeking to buy a dollar’s worth of value for fifty cents. In addition, they are trying to identify attractive businesses with superior management. The best investment candidates will have all three – a good business model with a good management team at the right price.

**By following the activities of these great investors, we believe we have developed a level of competency in identifying and valuing attractive businesses. That said, we don’t have the research capabilities or access to management that our top fund managers do, so we have added a fourth criterion that acts as a safety net – attractive ownership. In our process of trying to identify attractive businesses at attractive valuations, we will also be looking at the ownership. We want to see that like-minded, intelligent investors, such as our favorite fund managers, hold meaningful positions in our portfolio candidates before we take a position. Their ownership increases our confidence that our proprietary analysis is on target.**

We expect these portfolios to hold 12 – 20 stocks at any one time. As such, they may be more volatile than a typical broadly diversified portfolio. However, we are very enthusiastic about the potential for superior returns.

We should note that investing in common stocks involves risk. Stock markets are characterized by periods of rising and falling stock prices. Consequently, investments in stocks are subject to wide fluctuations in market value. Since investors could lose money over short or even extended periods, investing in common stocks may not be appropriate for all investors.

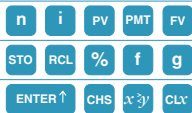
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**Call us today for more information:** Kevin Anthony, Cecil Brown, CPA / PFS, Tim Medley, CFP, or Julius M. Ridgway, Jr.  
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