

## E-Memo

**TO:** INVESTORS/MEMBERS AND FRIENDS  
**FROM:** Jon Bruss and Bob Ollech  
**Date:** June 9, 2005  
**Subject:** Mark Twain on Investing—Styles vs. Sectors

Recently the *Babson Staff Letter* from Babson Capital Management, the well-known investment management and research firm, carried a couple of interesting quotes from Mark Twain and some interesting observations on investment techniques which we'd like to focus on this month (for the entire letter go to Babson's Web site at <http://www.babsoncapital.com/Research/file/89.pdf>). Anthony Maramarco, CFA of Babson is the author. He's co-portfolio manager of Babson's large cap value portfolios and happens to be a literate writer, which Babson has recognized by allowing him to co-edit the *Babson Staff Letter*.

Mark Twain once observed that "human beings are the only animals that blush—or need to." We're sure he was red-faced himself when he declared bankruptcy in 1894 after sinking \$200,000 into a venture capital deal, the Paige Linotype, a high-speed typesetting machine that never sold. In today's dollars, \$200,000 would be about \$40 million according to Maramarco. Arguably he failed to heed one of the aphorisms of David "Pudd'nhead" Wilson, a character Twain created and after which he titled his novel, The Tragedy of Pudd'nhead Wilson which Twain published in 1884, fully ten years before he put all his eggs in one basket. He apparently heeded the advice of Pudd'nhead who said, "Put all your eggs in one basket—AND WATCH THAT BASKET!"

According to the Babson Letter, "the seemingly obvious, commonsense prescription *not* to put all your eggs in one basket" has become a "mathematically sophisticated expression underpinning modern portfolio theory." In other words, *diversification* has become an important success factor in the world of investments. One recommendation for diversification is ownership of a portfolio of a "variety of stocks spread among a number of industries", according to Babson. Babson calls this the most obvious method of diversification. Interestingly, the balance of the *Letter* discusses investment "styles" or the ownership of stocks classified as value, blend and growth mixed with different-size companies, small cap, mid-cap and large-cap—the Morningstar "style box" approach to segregation of investment management styles.

We've included a table below which shows that no investment style stays in favor very long. We highlighted in yellow the years that each style outperformed the others:

**CHART 1**

Year	LCG Barra 500	Growth of 1 Dollar	LCV Barra 500	Growth of 1 Dollar	SCG Russell 2000	Growth of 1 Dollar	SCV Russell 2000	Growth of 1 Dollar
1985	33.31%	\$1.33	29.68%	\$1.30	30.97%	\$1.31	31.01%	\$1.31
1986	14.50%	\$1.48	21.67%	\$1.51	3.58%	\$1.35	7.41%	\$1.38
1987	6.50%	\$1.07	3.68%	\$1.04	-10.48%	\$0.90	-7.11%	\$1.31
1988	11.95%	\$1.18	21.67%	\$1.25	20.37%	\$1.10	29.47%	\$1.61
1989	36.40%	\$1.36	26.13%	\$1.26	20.17%	\$1.20	12.43%	\$1.73
1990	0.20%	\$1.37	-6.85%	\$1.19	-17.41%	\$1.03	-21.77%	\$1.51
1991	38.37%	\$1.38	22.56%	\$1.23	51.19%	\$1.51	41.70%	\$1.93
1992	5.06%	\$1.43	10.52%	\$1.33	7.77%	\$1.59	29.14%	\$2.22
1993	1.68%	\$1.02	18.61%	\$1.19	13.37%	\$1.13	23.77%	\$2.46
1994	3.14%	\$1.05	-0.64%	\$1.18	-2.43%	\$1.11	-1.54%	\$2.45
1995	38.13%	\$1.38	36.99%	\$1.37	31.04%	\$1.31	25.75%	\$2.70
1996	23.97%	\$1.62	22.00%	\$1.59	11.26%	\$1.42	21.37%	\$2.92
1997	36.52%	\$1.37	29.98%	\$1.30	12.95%	\$1.13	31.78%	\$3.23
1998	42.16%	\$1.79	14.69%	\$1.45	1.23%	\$1.14	-6.45%	\$3.17
1999	28.24%	\$1.28	12.73%	\$1.13	43.09%	\$1.43	-1.49%	\$3.15
2000	-22.08%	\$1.06	6.08%	\$1.19	-22.43%	\$1.21	22.83%	\$3.38
2001	-12.73%	\$0.87	-11.71%	\$0.88	-9.23%	\$0.91	14.02%	\$3.52
2002	-23.59%	\$0.64	-20.85%	\$0.67	-30.26%	\$0.61	-11.43%	\$3.41
2003	25.66%	\$1.26	31.79%	\$1.32	48.54%	\$1.49	46.03%	\$3.87
2004	6.13%	\$1.32	15.71%	\$1.48	14.31%	\$1.63	22.25%	\$4.09
<b>Annualized Returns</b>								
<b>10 Year</b>	<b>11.44%</b>		<b>11.87%</b>		<b>7.12%</b>		<b>15.17%</b>	
<b>20 Year</b>	<b>12.84%</b>		<b>13.16%</b>		<b>8.59%</b>		<b>13.95%</b>	

LCG (large cap growth), LCV (large cap value), SCG (small cap value), SCV (small cap value). Indexes without dividend reinvestment. Sources: Callen Associates, Bloomberg, LP and Fortress Partners.

The best of the four styles for the 20 years ended December, 2004 was large-cap growth with 9 years in which it outperformed the other three styles while small-cap value outperformed the other three for 7 years. Now if you could fit these all together and were totally omniscient, you could move from one style to the other and win in all twenty years. Knowing when to move your eggs from one basket to the next requires more than just watching one basket.

The core data for the above chart came from the Babson Staff Letter. We added the annualized returns for each style and the column showing the growth in value of \$1. This chart clearly demonstrates that **small cap value stocks**, as represented by the Russell 2000 Value Index, **outperformed the other three indices by a very substantial margin.**

However, a recent article in the June 2005 issue *Financial Planning* entitled "Style War" points out that "some argue that there's more than one way to slice a portfolio." We recognize that by adding this new article ("slice a portfolio") we are mixing metaphors. Perhaps Pudd'n'head Wilson would have seen this as merely arranging the eggs differently in the basket or concluded that all the eggs in one basket, no matter how well watched, would have been too risky and would have concluded that more baskets would have been needed. Mark Twain may have been able to save his fortune.

The *Financial Planning* article cites a 2003 study performed by Ibbotson Associates that concluded that "sector investing is now potentially a better diversifier than grid investing [or style box]." But sector investing is not market timing. Market timing, in our opinion is a dicey alternative at best. We are not alone. Weston Wellington, a vice president at Dimensional Fund Advisors says that "if anyone can reliably predict when to pile into [a sector] and when to dive into [another sector], they should do it; they will have great results. And undoubtedly, you will hear from people claiming to have a terrific record doing just that." However, he points out, "I'm not aware of any market-timers who have met with long term success."

Grid or style investing mavens, Morningstar, set one of their analysts to work at the request of *Financial Planning*. John Rekenhler, a vice president of research at Morningstar, created a hypothetical portfolio. He used each of four dissimilar industry sectors—computer software, healthcare, financial services and energy. Next, he built a portfolio with four style boxes, large- and small-cap value and large- and small-cap growth. In each of the funds, he divided the sectors or the styles into four equal parts of 25% each. He next chose the period of 1998 through 2004. For that seven year stretch, the four **style** boxes "earned a return of 6.6% annually." For the same period, the four **industry** sectors earned a return of 8.1% annually." He hastens to say that this study should not be looked up as anything but preliminary. We would agree. We think that such a hypothesis needs to be projected over a period of 20 to 25 years and tested using different sectors other than those chosen.

We thought that Rekenhler's findings were important in that the financial services sector, a so-called "interest rate sensitive" sector, was included in this hypothetical portfolio. We thought it might be interesting to take the Morningstar study one step further. We added data from our special March 25, 2005 *E-Memo* entitled "Small Banks—A Natural Hedge for Your Portfolio" showing the performance of the NASDAQ Bank Index and we added a column showing the growth in the value of \$1 invested in 1985.

As we expected, the NASDAQ Bank Index (CBNK) **outperformed the other four indices based on its 10 year and 20 year annualized returns.** Moreover, when compared to the other indices it outperformed the other four indices 7 times beating the Large Cap Growth and Small Cap Value which each outperformed the other four only 5 times. **Imagine what would have happened had we removed all the financial service companies from the style indexes.**

CHART 2

Year	LCG Barra 500	Growth of 1 Dollar	LCV Barra 500	Growth of 1 Dollar	SCG Russell 2000	Growth of 1 Dollar	SCV Russell 2000	Growth of 1 Dollar	CBNK	Growth of 1 Dollar
1985	33.31%	\$1.33	29.68%	\$1.30	30.97%	\$1.31	31.01%	\$1.31	52.05%	\$1.52
1986	14.50%	\$1.48	21.67%	\$1.51	3.58%	\$1.35	7.41%	\$1.38	18.08%	\$1.70
1987	6.50%	\$1.07	3.68%	\$1.04	-10.48%	\$0.90	-7.11%	\$1.31	-5.33%	\$1.65
1988	11.95%	\$1.18	21.67%	\$1.25	20.37%	\$1.10	29.47%	\$1.61	11.62%	\$1.76
1989	36.40%	\$1.36	26.13%	\$1.26	20.17%	\$1.20	12.43%	\$1.73	-9.98%	\$1.66
1990	0.20%	\$1.37	-6.85%	\$1.19	-17.41%	\$1.03	-21.77%	\$1.51	-34.81%	\$1.32
1991	38.37%	\$1.38	22.56%	\$1.23	51.19%	\$1.51	41.70%	\$1.93	37.52%	\$1.69
1992	5.06%	\$1.43	10.52%	\$1.33	7.77%	\$1.59	29.14%	\$2.22	52.02%	\$2.21
1993	1.68%	\$1.02	18.61%	\$1.19	13.37%	\$1.13	23.77%	\$2.46	29.37%	\$2.51
1994	3.14%	\$1.05	-0.64%	\$1.18	-2.43%	\$1.11	-1.54%	\$2.45	1.11%	\$2.52
1995	38.13%	\$1.38	36.99%	\$1.37	31.04%	\$1.31	25.75%	\$2.70	44.81%	\$2.96
1996	23.97%	\$1.62	22.00%	\$1.59	11.26%	\$1.42	21.37%	\$2.92	26.16%	\$3.23
1997	36.52%	\$1.37	29.98%	\$1.30	12.95%	\$1.13	31.78%	\$3.23	63.59%	\$3.86
1998	42.16%	\$1.79	14.69%	\$1.45	1.23%	\$1.14	-6.45%	\$3.17	-11.77%	\$3.74
1999	28.24%	\$1.28	12.73%	\$1.13	43.09%	\$1.43	-1.49%	\$3.15	-7.98%	\$3.66
2000	-22.08%	\$1.06	6.08%	\$1.19	-22.43%	\$1.21	22.83%	\$3.38	14.67%	\$3.81
2001	-12.73%	\$0.87	-11.71%	\$0.88	-9.23%	\$0.91	14.02%	\$3.52	10.08%	\$3.91
2002	-23.59%	\$0.64	-20.85%	\$0.67	-30.26%	\$0.61	-11.43%	\$3.41	4.52%	\$3.96
2003	25.66%	\$1.26	31.79%	\$1.32	48.54%	\$1.49	46.03%	\$3.87	29.93%	\$4.26
2004	6.13%	\$1.32	15.71%	\$1.48	14.31%	\$1.63	22.25%	\$4.09	10.99%	\$4.37
<b>Annualized Returns</b>										
10 Year	11.44%		11.87%		7.12%		15.17%		16.53%	
20 Year	12.84%		13.16%		8.59%		13.95%		14.13%	

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We'd like to think the foregoing evidence would cause Puddn'head Wilson to advise his creator, Mark Twain, to invest in a diverse basket of small banks. Think about what his fortune would be today had he done so. Think about what yours would be like if you had done the same 20 years ago. Had you invested \$10,000 in such a basket of banks as that represented by the NASDAQ Bank Index (investing in that index is not possible currently), your portfolio would have been valued at \$43,700 (excluding dividends), a superior value to any of the touted style approaches suggested by Babson and Morningstar.

If you want to learn more about Fortress Partners approach to investing in banks go to our Web site, [www.fortresspartners.com](http://www.fortresspartners.com) or contact us for more data.

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