



AndersonGriggs

“Common Sense Investing for Intelligent Investors”

Monthly Letter to Our Clients and Friends A 4-Star Manager’s Confession

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On March 31, 2010 our Focused Growth Separate Account celebrated its 10th birthday. The composite results for this ten year period were given a 4-Star Rating for separate accounts by Morningstar, in addition to earning a place in the top-quartile of the Large Growth Separate Account universe. The Morningstar Rating is a quantitative assessment of past performance, of both return and risk, with more emphasis on downward variation of monthly returns.

A 4-Star Confession

Beginning in the late 19th century and continuing into the early 20th, mounting economic pressures and overpopulation resulted in a mass migration from the Scandinavian countries of Sweden, Norway, Denmark and Finland to the upper Midwest states of Minnesota, Wisconsin, North and South Dakota, and my own home state, Iowa. You can still hear the influence of these Scandinavians in the accents of the citizens of these states. If you have ever watched the film “*Fargo*” and listened to Marge Gunderson (Frances McDormand) and Jerry Lundegaard (William H. Macy), you know the language of my youth, as I grew up in the little town of Webster City, Iowa, a short sixty miles from the southern border of Minnesota.

The Scandinavians also brought with them the Lutheran denomination, whose churches quickly rivaled those of the Catholics and the Methodists, the oldest and most prominent churches in Webster City. As it was, my Dad came from Scandinavian stock and was a Lutheran at heart, but not in practice. Dad met my Mom during his traveling days. Mom was a French Canadian with a little German thrown in for good measure. Her French Canadian Catholicism won the battle of religion in our home and the Anderson children grew up under that faith. It took more than simply attending Church once a week. Each of us were also required to attend St. Thomas Aquinas Catholic School, where, besides the 3 R’s (reading, writing and arithmetic), our education included a strong dose of religion with daily mass and weekly confession.

Confession, the act of recognizing your sins and asking for forgiveness, is an important part of many religions. The sacrament of confession is treated in a very personal way in the Catholic Church. The confessee sits alone with his Priest in a little dark box and openly states his sins, asking for absolution. This act can be intimidating, embarrassing, and I believe to most Catholics, greatly relieving. For me as a young boy, the act of confession created a great deal of anxiety, fearfulness, and yes, when it was said and done, a sense of relief.

Relief, however, did not come without a price. Depending on the severity of one's sins, the confessor would dole out a sentence to cancel out the debt one had created. This penance normally consisted of saying a few prayers. At St. Thomas, our confessor was one of the parish priests, Monsignor Hallback or Father Bassinias. Of the two, you always hoped for Father Bassinias, as his demeanor and penances were less difficult. Monsignor Hallback was another story. He was well known for assigning the duty of saying the rosary. While it has been a long time since I've sat down with the beads and completed a rosary, as my own family adopted my wife's Lutheran heritage, I do remember that it is a *lot* of praying. Monsignor Hallback handed out this penance to any of us boys who needed an extra dose of healing, and I earned my fair share.

On March 31, 2010, our Focused Growth Separate Account celebrated its 10th birthday. Being the person responsible for the daily decisions of managing the portfolio, I take pride in knowing that the results have earned a number of high ratings, including 4-Stars from Morningstar, Inc. However, being responsible for the results means I also carry the intimate knowledge of how those results came about. If I fail to share some of that knowledge with you, I believe Monsignor Hallback may just descend from above and dish out more than one rosary as my penance.

Everything is Relative

The majority of investment professionals are in the business of selling or analyzing the performance of individual managers. One of these well known organizations is DiMeo Schneider & Associates, LLC of Chicago, Illinois. Two of their associates, Matthew Rice, CFA and Geoffrey Stotman, CFA, authored a study titled *The Next Chapter in the Active versus Passive Debate*, where they "evaluated the persistency of top quartile mutual funds in 17 different categories." The original study was completed in 2007 and updated in 2010 to include the decade's second market crash and subsequent recovery. Their findings give some meaning to our results when compared with others:

Rice and Stotman: "...large cap growth managers showed an ability to outperform when the index is up big and down big. This non-linear (or parabolic) relationship may be attributable to the different sub-styles in large cap growth where conservative growth (or G.A.R.P) managers did well in downturns and high beta (momentum) growth managers did well in up-trending markets."

Confession: On March 31, 2000, the S&P 500 index closed at 1498.58. On March 31, 2010, the same S&P 500 closed at 1169.43, a negative return of 21.96% for the decade. This negative performance earned the dubious record as one of the single worst decades for the S&P 500 since records began. The category of Large Growth, the premier objective in the year 2000, full of itself with the recent performance of Technology stocks (The Nasdaq 100 dropped 55.47% during the same 10 year period), performed even worse. **This declining market favored our approach to owning large quality holdings.**

Rice and Stotman: “...85 percent of ten-year top quartile mutual funds were unable to avoid at least one three-year stretch in the bottom half of their peer groups. This is down modestly from 89 percent in our 2007 study”. “...62 percent of ten-year top quartile mutual funds were unable to avoid the bottom half during a five-year period. This is up significantly from 51 percent in our 2007 study.”

Confession: I have been in the top quartile, the bottom quartile, and have received 5-Star Ratings, 4-Star Ratings, 3-Star Ratings and 2-Star Ratings for various time periods. As time progresses, the trailing ten years covers a different period of time and these different time periods will produce different results. **These results could quickly take us from the accolades of 4-Stars up to 5-Stars, or down to 1-Star.**

Rice and Stotman: “*Falling prey to natural human behavioral tendencies during the manager selection and termination process generally leads to failure. Investors need to make better efforts to understand their managers’ investment processes, sub-styles and investment philosophies before investing to develop the confidence and patience required for long-term success. Otherwise, they should invest passively.*”

Confession: We have probably not explained our love of quality investments enough. This belief in quality along with our belief that markets will recognize growth of capital over time has been sidetracked by recent market volatility. **This failure has lead many of you to believe that the government and its impact on the economy is far more important in the long-term success of your portfolio than the results of the businesses we own as shareholders.**

The Greatest Confession of All

If there is one confession that trumps all others for us as a company, it is this: We only want to own very important high quality companies. This may not seem to be a dramatic confession, but in the dog-eat-dog world of asset gathering you need to produce a product that fits nicely into one or more categories so that your relative performance can be measured. In addition, in order to produce relative returns in the short term you must include in the portfolio companies that are the current market darlings independent of any other criteria. By limiting our portfolio holdings to a sub-set of important high quality companies, we also limit our ability to

produce relative performance in the short term when the market is being lead by companies not meeting our definition.

We were punished for this during two periods of the last decade. As a business, 1999 was our single worst year ever. You would think that 1999, the year the Nasdaq appreciated from 1836.01 to 3707.83, or a 100%+ return, would have been a year of joy. Yet it was the year that we lost more business than any other in our history. At that time, technology was the only game in town. If you refused to jump on the wagon, you suffered. Last year, although business did not suffer, our relative performance did. We were able to keep up with the market, but our peer group jumped on the junk band wagon and left us in the dust.

An example of an important high quality company – 3M Company

Quality is a belief, an attribute, not something that can be measured or defined easily. Each of us has our own definition of quality, and importance is equally hard to define. The easiest way for us to give you our description of an important, high quality company is by sharing an example. We have chosen 3M Company, formerly known as Minnesota Mining & Manufacturing, a company we have owned for many years.

For us, the importance of a company is directly related to the number of people whose lives are intertwined with the company itself. We can measure the importance of 3M, using actual data and adding a little insight with the numbers.

Total Enterprise value is calculated by adding the current market value of the company's debt and equity. In 3M's case, it is approximately \$68 Billion. This \$68 Billion represents the current market value of company's equity owned by its shareholders, plus the amount of funds that have been loaned to it. This \$68 Billion, although easily calculated, also represents the savings of these shareholders and bondholders. Savings are important.

3M employs over 75,000 people world-wide. There is no doubt that 3M is important to these people. Their lives are tied directly to the efforts and the future of this company, and their families also rely on the salaries and benefits they earn at 3M.

The company had revenues last year of close to \$53 Billion. These revenues came from the sale of products to thousands of individuals in over 200 countries world-wide. Each of these sales elevates the importance of 3M.

3M is a manufacturing company who produces thousands of different products. Each of those products requires input from sources outside their direct ownership. These suppliers take the cash earned from 3M sales and uses it for their own operations. Multiply this by the thousands of other suppliers, their employees and their families, and you start to understand that 3M is intertwined with hundreds of thousands, if not millions of lives world-wide. That is importance!

Quality for many financial professionals is directly related to the balance sheet: the relationship between the total of the debt a company has relative to the amount of equity or the amount of free cash flow a company generates. I will agree that these are included in our own definition of quality. However, there is another element to quality that is much harder to measure. This quality is internal to the history of the company and is a result of the current employees acting as stewards of this history.

3M has over 100 years worth of history. They have paid a dividend every quarter for the past 93 years. Their Board of Directors consists of current and former CEOs of some of the largest and most admired businesses in our country. This leadership, as well as 3M's 75,000 employees, understand 3M's reputation and accept the responsibility to uphold and maintain that reputation. **These intangibles have a place in our definition of quality.**

This concentration on quality and importance has its rewards, as we will see when we go over the returns 3M has earned for its owners over the past decade. However, I wanted to share with you a few points from another study before sharing those results.

“The Case for Quality – The Danger of Junk”

One of my favorite financial professionals, who makes a point of sharing his views with his clients and others, is Jeremy Grantham of GMO. Mr. Grantham's quarterly letter is on my must read list. He emphasizes that Large Quality has its place, and as the co-founder of GMO he also has an eye for quality people. **Three of these quality people are Chuck Joyce, Donna Murphy and Ed Choi, who together produced a two page white paper in 2004 titled *The Case for Quality – The Danger of Junk*, subtitled *You can't make a silk purse out of a sow's ear*.** I would have liked to simply reproduce this two page paper in its entirety for you, but alas, a phone call to GMO with the request was met quickly with a resounding “no”. However, they were kind enough to give me permission to reference a few points as long as I also let you know that you may read the paper in its entirety at the GMO website: www.GMO.com.

I find the subtitle of the paper wonderful, and the conclusion offers this observation: **“High quality companies are excellent investments today, but surprisingly are not being discussed much in the financial or academic press. This is probably due in large part to the ingrained focus in the investment management business: value and growth strategies are prolific, as are large and small cap funds. But high quality funds are uncommon.”**

High quality is not on anyone's list of favorite approaches to investment management. Yet I would say that for you, me, and the vast majority of individual investors, it is the most important strategy one can utilize to produce returns. Boring it may be, but boring in the world of investing is a wonderful way to accumulate wealth.

To help emphasize this point I am returning to our example, 3M, a boring company who just keeps on giving to its owners year after year through dividends and increased shareholder equity:

3M Company Dividends and Net Worth 2000 to 2010

Year	Dividend Paid	Net Worth (Shareholder Equity in Millions)	Average Stock Price (Avg. of High & Low Price)
2000	\$1.16	6531.0	\$50.31
2001	\$1.20	6086.0	\$53.20
2002	\$1.24	5993.0	\$57.90
2003	\$1.32	7885.0	\$72.55
2004	\$1.44	10378.0	\$81.80
2005	\$1.68	10100.0	\$78.55
2006	\$1.84	9959.9	\$77.75
2007	\$1.92	11747	\$84.95
2008	\$2.00	9879.0	\$67.40
2009	\$2.04	12764.0	\$62.60
2010	\$2.10 (annual)	?	\$88.67 (4-30-10)

Final Confession: Given the negative returns for the S&P 500 and the NASDAQ 100 over the past decade, most of us would have been a lot better off just buying, holding and collecting the dividends from 3M. For those owners of 3M who did, you received over \$16 in dividends and an appreciation of over \$38.00 for every share. Boring has its rewards!

Some Final Notes

Many of you have made it a point to visit our web site and read our weekly commentaries. These commentaries are posted on Tuesdays. The last three are easily accessible from our home page and titled *FINRA and Thursday's Fiasco*, *Confidence and Confidence*, and *Help – I'm Retiring!* If you haven't visited our site lately and you have a moment, please turn on your computer and visit www.andersongriggs.com.

While you are there, you may want to link to WRHI radio's site to listen to a replay of *Intelligent Investing*. Of course you can always tune in your radio to AM 1340 or FM 94.3 or access the simulcast at www.wrhi.com to listen first hand. The broadcast lasts about three minutes and the first program airs at approximately 7:25 AM on Tuesdays. It is then replayed at various times throughout the day.

As always we want to thank each of you for your continued confidence in our services. We are indebted to those of you who have recommended us to your friends and associates. As we are able to add a few new clients, we would welcome the opportunity to share our story of quality with others. If an opportunity comes up, please remember to mention us.

Until next time,

Kendall J. Anderson, CFA

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