

December 31, 2004

Dear clients,

Of course a very Happy New Year to all!! Last quarter I briefly mentioned the merits of investing a relatively small percentage of your portfolios in commodities. Now I would like to explain to you why this type of investment is prudent, how we can do it, and how much we should do.

First, let's take a look at what commodities are. Unlike financial securities such as stocks and bonds, which represent ownership in, or debt obligations of, companies and governments, commodities are real assets such as gas, oil, cattle, hogs, wheat, corn, sugar, cotton, coffee, gold, silver, etc.. Because my office here in White Plains is not large enough to hold 1000 hogs or 100 tons of wheat, we invest in commodities through futures contracts. These contracts can be efficiently and cost-effectively owned through mutual funds that operate just like the ones we presently use for stock and bond investing.

Next, let's consider the "why" of commodities investing. As you know we are huge proponents of keeping portfolios broadly diversified at all times. I've said countless times that diversification is one of the last "free lunches" available in that when properly diversified you definitely reduce risk and don't necessarily give up reward. A prudent allocation of diversified commodities, added to an already diversified mix of stocks and bonds, further reduces risk and may even increase return. The key reason for this is that although a broad mix of commodities held over the long-term has produced risk and return characteristics roughly similar to that of stocks, the year-to-year timing of these returns vis-à-vis stocks has historically been much different.

The performance of stock (and bond) markets is not at all strongly correlated to the performance of commodity markets. In plain English, this means that frequently when one market zigs the other zags. Often when stocks markets are on the decline, commodity markets are strongly on the rise. Of course the opposite can also be true but that's the nature of true diversification. Getting back to the idea of correlation, if long-term return and risk characteristics are roughly comparable, but the investments don't move in lock step, this means that our portfolios can enjoy not only a smoother ride from point A to point B, but also an easier one!

"Why an easier ride?" you may ask. Here is an example to illustrate:

Suppose one portfolio alternately gains 20% one year and loses 10% the next year for 10 years. The simple average return is 5% but the internal rate of return is 3.92% meaning that at the end of the 10'th year the initial \$100 investment is worth \$147. Now suppose our second (more diversified) portfolio gains exactly 5% per year for 10 years. It is worth \$163 after the 10'th year producing an annualized return higher by almost 1.1%.

So by having investments working within a portfolio, with returns that are not closely correlated, we can likely reduce the portfolio's year-to-year volatility and increase return even if the newly introduced investment's average rate of return is the same as the investment's it is replacing. This is why we want to add commodities to our mix.

There are a few mutual fund vehicles through which we may add commodities to our portfolios and I am still researching and contemplating which I feel will be most appropriate for us. I will likely recommend that we commit somewhere between five and ten percent of our total portfolios to commodities but this will be discussed with each of you one-on-one prior to making any investments.

That's it for now. My very best wishes to all for a safe, healthy, and prosperous 2005!!

Andrew