Client Letter

AUGUST 2006

A Firm Foundation

The joy of establishing a new firm is that we can slowly but surely build it upon a strong foundation of responsive client relationships and value-added fundamental research analysis. The frustration of establishing a new firm is that we cannot reach the levels of excellence to which we aspire, without working through a lot of the early basic decisions that define a business. We are making these decisions right now. If you find any of our actions disquieting, we hope that you will not hesitate to let us know so that we can quickly correct them.

So, with the support of our clients and our friends, we will build a firm foundation that will serve us for many years to come.

Simple Lessons from "America's Best"

How about this for a provocative headline, "America's Best Don't Need Wall Street"? This is heresy for those of us in the investment business. There I was, quietly reading the Saturday edition of *The Financial Times* on May 27th, and suddenly a columnist named Arne Alsin informed me that I was unneeded. Usually this type of headline is followed by a column that is full of invective about greed and avarice in the investment world. However, at least this time, the provocative headline was followed by an essay that was quite enlightening.

The key definition in the column is that America's "best" investors are those individuals who have created the most lasting wealth over their lifetimes. Thus, the best investors aren't necessarily the people who run mutual funds or hedge funds but, instead, they are the people who created their wealth by investing in and growing with the great growth companies of the past thirty years. So the best investors are Microsoft's Gates and Allen, Bershire Hathaway's Buffett, Dell Computer's Michael Dell, and the second generation of Wal-Mart's Walton family. And, yes, these great investors live the "bon mot" of Barnard Baruch (I tried to verify this attribution but couldn't. Let me know if I got it wrong) who said, "Put all your eggs in a single basket, and watch the basket very, very closely."

In his column, Arne Alsin, suggests that we can learn four lessons from these "best investors".

"Hold for the long term."

The best investors of Alsin's definition seemingly never sell. They take advantage of the fact that they have found a great investment by hugging to it tightly and avoiding the temptation to sell their stock just because it has gone up. I admit that many of these super wealthy investors do sell some of their stock from time to time to fund their lifestyles, and, more importantly, to fund their charitable causes. However, through thick and thin, they have maintained their long-term investment in the stock of the company that created their wealth. Thus, they have been able to compound their wealth at very high internal rates of return without the high costs of paying capital gains taxes. Most importantly, they recognize their good fortune in finding and holding that extremely rare species: a great long-term business enterprise.

"Concentrate your capital."

One of the great miscalculations of the current financial dogma is the emphasis on diversification. Yes, more modest investors, like you and me, should own more than the one stock portfolio that made the best investors so wealthy. However, if you own a single mutual fund, you are likely to be diversified across more than one hundred individual stocks. Moreover, many investment advisors use strategies based upon asset allocation models that result in the recommendation of multiple mutual funds which inevitably means that their clients' capital is diversified amongst hundreds of individual stock holdings. Mr. Alsin repeats one of my favorite quotes from Martin Whitman of the Third Avenue Value Fund, "Diversification is a surrogate for ignorance." These mutual fund managers like Mr. Whitman exhibit the courage of their convictions by investing a significant percentage of their capital in each of their individual stock holdings. If you own a fund whose largest holding represents less than three percent of the total portfolio, I suggest you are getting too much diversification. Every investor wants to be safely diversified but the best investors cited by Alsin are so knowledgeable about their one investment that they feel perfectly safe having their wealth concentrated in one great company.

"Don't listen to Wall Street."

This lesson is rather toxic for a newsletter written by someone who, until very recently, worked for a traditional Wall Street firm. There are, in fact, a great many honorable people who work on Wall Street. Nonetheless, it is important to remember that much of Wall Street depends on the daily volume of buying and selling to earn wages. Thus, much of the information disseminated by Wall Street (and the financial press) is designed to stimulate an investor's urge to take action. In this case, turnover is beneficial for my industry. As you appreciate, my business model of charging fees for my advice allows me to better serve you, my client, by urging you to do nothing, and instead to hold on to your best investments. I am not embarrassed to admit that most of the value-added advice that I have delivered to my clients over the past thirty years has been to ignore the short-term advice of Wall Street and hold on to their most successful investments just Alsin's "best investors".

"Buy organic growth."

These investors founded and held on to companies that have enjoyed marvelous long-term growth in the sales of their underlying product or service. There are a myriad of ways to make a living in our economy but there are relatively few companies that can grow on an organic basis for a lengthy period of time. I suggest that the great organic growth companies are those that invent an entirely new industry. In the beginning, it is very hard to understand these great companies because they defy categorization. However, as their sales growth compounds, we begin to awaken to the fact that these companies have created an entirely new industry. With the humility that comes from having missed many of these great growth companies, I take pride in the fact that I have helped my clients find and invest in a few of the winners. One way to identify some great organic growth companies of the future is to search among the relatively small subset of publicly traded stocks where the company's founders still run the business and who have the vast majority of their wealth still invested in their company. It is these people who Mr. Alsin will recognize when he updates this column in ten or twenty years.

So, thanks to Mr. Alsin for writing such a provocative headline that attracted me to read his very thoughtful column. Now, all we have to do is renew our search for a great organic growth company, whose zealous founder continues to run the day-to-day business. Then, we have to have the patience to hold on and do nothing, as we let our initial decision prove itself over the long term.

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