

July 15, 2009

Our part of the world gets, on average, 43 inches of rainfall each year. That's too much to worry about the price of rain barrels going up, but not enough that your average gardener can really trust Mother Nature for all watering needs. It seems the popular and cost-effective solution of choice is Drip Irrigation. My introduction to it was nine years ago, in Sacramento, California. My son-in-law hooked up miniature hoses and nozzles, which sputtered, stuttered, and sprayed a fine water mist for three whole minutes twice a day, onto ferns, banana trees, morning glory, oleander, hibiscus, and bird of paradise. His "backyard" was literally a beautiful pool and a cement pool deck with huge terra cotta pots containing mammoth plants. I was astonished that the plants flourished in these conditions. Seriously convinced, once home I visited Lowes in search of all things drip irrigation. I threaded rubber hose no thicker than a pencil through a maze of rhododendron, yew, azaleas, hydrangeas, moon vines, morning glories, black eyed Susan, cardinal vines and impatiens. I attached, at various intervals, micro sprinklers and nozzles, balanced the water output with Y-splitters, and screwed into the nerve center of this hydroponic contraption, one battery operated Gilmour automatic water timer.

But not every gardener has it so easy (so to speak). Parts of California, Nevada and New Mexico, for instance, get between 8 and 16 inches of water per year. There's a saying that farming is just gambling in slow motion – you have to wait nine months to find out if you've won. Recently, *Morning Edition* featured Zach Sheely, a farmer who can't afford to place a bet on (or wait nine months to find out) whether he waters too much or too little. Sheely uses a system designed by PureSense (pictured right) to help him rebalance the moisture levels on his 10,000 acre, California vegetable farm. "Using probes, sensors, weather instruments and meters, PureSense calculates the moisture and nutrients in the soil; it uses the Internet to send the information to servers, and then uses software to analyze whether or not the crops are getting the right amount of water." The data is then transmitted wirelessly to Sheely's iPhone; he can literally make it rain on any section of his crops with the tap of a button.



The principles governing agriculture and investing are much the same. Plant the best seeds at the right time in good soil, then water, fertilize, weed, thin out, protect against threats, harvest, enjoy, repeat as often as necessary. Too much or too little of any of these activities can create undue risk. But, hit the right balance and you stack the odds of reaping a harvest in your favor. In our last commentary, we outlined six "prism tweaks" we've put in motion. We discussed, in detail, the importance of Price, Moat, and Uncertainty; this quarter, we'll cover Dividends, Diversification, and Safety.

Dividends. Sometimes it helps us to think about investing in terms of being a gardener who sells vegetables, whole vegetable plants, and potted flowers at the local farmers' market. On any given Saturday, she can decide to sell her hand picked vegetables (which, in investing, is similar to collecting dividends), or she can sell a whole plant (selling a dividend paying stock), or she can also sell her potted flowers (selling a non-dividend paying stock). The problem the gardener faces with buying and selling too many potted flowers (buying non-dividend paying stocks) is that the only way to make a profit is if her buyers think the flowers are worth more than she paid for them. That's all well and good if her time horizon is long enough or the market for plants is stable. But what if (like many investors today) her time

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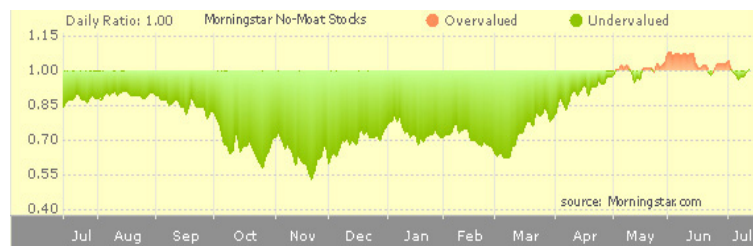
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horizon is shorter and the market for plant buyers isn't especially stable? Or what if the price of soil skyrockets or news reports circulate that recreational gardening is a health risk? People won't want to plant in their gardens and prices of these plants will drop. If our gardener is depending on selling her plants (vegetable or flowering) for her income, she would have to sell them at an inopportune time. As advisors, we aim to set up our clients' gardens (portfolios) in such a way that their vegetables (dividends) provide for the majority of their income needs and they aren't dependent on the price of their plants (stocks) on the day they need income. There's much more to dividends than finding the highest yield (for example, determining a company's ability to keep paying it, management's commitment to upholding it, and what we can expect in terms of its growth) but that's for another commentary.

Diversification. Suppose our gardener needs to choose between planting squash, cucumbers, or both. She figures each will produce approximately the same amount of income for her and will need the same amount of sunlight, water, and care. The only difference: squash are susceptible to squash bugs while cucumbers are vulnerable to cucumber beetles. With an equal chance of either insect showing up hungry and harming a crop; it makes sense to plant both squash *and* cucumbers while still trying to ward off both insects. This is the case not only for *stock* diversification (owning more than just a handful of stocks), but even more so for *asset class* diversification (owning more than just a couple asset classes such as US Stocks, Bonds, Foreign Stocks, Commodities or Real Estate.) While it *does* get more complex meshing multiple asset classes, the outcome is still the same. An investor can take a number of inherently risky assets and combine them in a portfolio that delivers the highest expected return for a given level of volatility (determined by what the investor can stomach both financially and emotionally.)

Safety. Sometimes, what could seem safe (taking shelter in a storm under a tree or taking money out of stocks last March) can actually be the most dangerous option possible (both "lightning" and "missing a 30% rally" can really knock the wind out of someone). As portfolio managers, we want to make sure we're always learning from our mistakes . . . but just not learning *too* much. We're conscious to look at the important data points, not the prevailing perception that might say seeking sustainable dividends, wide moats, and low uncertainty is being too "safe" to provide any meaningful returns. We might *normally* agree, however today is far from normal. We're in a market where companies with the widest moats are selling for the largest discounts (78% of their worth) while the companies without moats, see chart, are trading for no discount (100% of their value).



Author Anne Lamott says "Danger is the safest thing in the world if you go about it right." While investing is and will continue to be "dangerous" in terms of uncertainty and volatility, we're confident that we're "going about it right." As we said last quarter, we're doing that by: concentrating on buying undervalued assets (Price), owning businesses with sustainable competitive advantages (Moat), and investing in areas where we have a narrower range of outcomes (Uncertainty). By adding to those the areas we've covered this quarter, we're able to take calculated risks that line up with our clients' ability and willingness to take those risks.