

respected journal that claimed anything past eight holdings for the sake of diversification is redundant. Yet you'll see virtually every equity mutual fund with hundreds, even thousands, of names.

Warren Buffett argued that diversification increases risk.

The total costs of the average fund range between 1 and 1 1/2%. To me that's risk, the acceptance of sub-par performance at a greatly elevated price. It's

sad that most people lack a clear alternative.

You see, the way I've described the architecture that goes into an idea that becomes a holding greatly reduces risk. Risk must always be defined in conjunction with reward. I believe our product achieves a beautiful balance. I think you can achieve stellar returns, not every year, but over time, employing the system I've described. Remember earlier I quoted Warren Buffett from his 1993 Annual Report. He argued that diversification increases risk. He further stated that you should own just a few holdings, the one's you know best, because that approach presents the least risk and offers the greatest potential profit. I couldn't agree more. That is why I started Hedgehog Partners, and that is why our standard portfolios look so totally unlike virtually every other manager. Obviously if I invest in clunkers, there's a risk to both capital and opportunity. But I believe our ideas will turn out pretty much as I envision, as long as we steadfastly hold to the disciplines demanded of GEMS.

Q What direction would you like to see your firm take?

A I hope we're never all that well known to the general public. If I had the choice, we'll never be a candidate for a fund supermarket because if asked I know we'd say no. I hope that doesn't sound arrogant; it's simply a way of saying we don't equate getting big with anything important. Staying small and avoiding complexity are two good ways of taking investing to its highest levels. That's best for our clients and, interestingly, best for us too. That's our primary goal. If we achieve it, we'll all be assured of our secondary goal — having fun.

Q But how can you expect the public to find you if you're barely known?

A I won't attempt to offer any solution to the problem other than great luck. However, nature favors the prepared. In our Partnership, which has only four Limited Partners at present, we have a gentleman who made an investment with us based on our 1996 results which were published in a hedge fund journal and also because he bought into the concept of concentrated holdings. He did some homework and found his way to us. But he's rare. I'm going to do everything I can to make him look smart. The majority of future investors will undoubtedly emerge after several solid years. That's the way it always works. How can you expect otherwise?

Q Thanks, Dan. Any final words?

A Yes, tell your readers our firm's greatest asset is 104 years of collective mistakes.

Michael Mitchell is an independent financial writer specializing in investment management.



Cashman and Associates

1235 Westlakes Drive
Suite 240
Berwyn, Pa 19312

Phone: 610-725-8200
Fax: 610-725-9585
E-Mail: cashmanlp@aol.com

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Money Management



Hedgehog Investing

By Michael Mitchell

INTRODUCTION

In my twenty-plus years of interviewing asset managers, I've heard rationalizations for just about every investment discipline imaginable. Since I limit my interviews to managers who have demonstrated the ability to outperform recognized market indices, there is generally some justification for their fervor. These are knowledgeable, articulate people — missionaries for their investment strategies. But after a while, their strategies, no matter how passionately supported, all start to sound like the same song simply played in different keys. After dissecting hundreds (thousands?) of investment disciplines, it takes more than above-average performance or a zealous presentation to get me excited.

This month, I interviewed an investment manager who revived my enthusiasm. Dan Cashman is founding partner of Cashman and Associates in Valley Forge, PA. Cashman and Associates was established in January, 1996, after Mr. Cashman resigned from a \$2 billion firm he had co-founded. Interestingly, it was the growth of his previous company — staff, facilities and product offerings more so than assets under management — that led to his gutsy decision to leave an enterprise he had spent 16 years building and start anew.

Over the years Cashman has been featured in numerous financial and investment media and was the subject of a flattering article in *Forbes* after the 1987 crash. Cashman has authored several insightful papers, including one written in August, 1987, entitled *The Wheel Turns*, which warned of a major collapse in the equity market. In that dissertation he stated that there had never been a period in this century, including 1929, where there was such little value. Within weeks the great collapse of October, 1987, occurred. Another, entitled *His Majesty Rests*, authored August 16, 1982, the very day the market bottomed at 785, counseled a fully vested position based on Cashman's assessment that the markets possessed the greatest value in this century, save for August of 1932.

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Cashman espouses what is a rare and refreshingly uncomplicated approach to investing, a *concentration of ideas* as opposed to the much more common diversified portfolio theory. In fact, even the company's logo, the hedgehog, exemplifies Cashman's investment approach. It seems an obscure Greek poet, Archilochus, remarked, "The fox knows many things, but the hedgehog knows one big thing." Cashman's hedgehog represents not one big thing literally, but rather the hedgehog makes the case for simplicity and concentration.

Q Financial planners typically recommend a diversified portfolio on the theory that it lowers risk. Why are you more comfortable with a concentrated portfolio?

A Over the thirty-two years I've been managing money, I have constantly had our analysts present me with dozens of ideas each year. You see, the system that pays them equates productivity with volume. But at the end of each year, I noticed that the few ideas that truly impassioned them were the ones that tended to be the best money makers. These were the ideas that were gin clear to me and possessed a high probability — rather than a possibility — of happening. Year after year I would incorporate this handful of wonderful ideas into a portfolio and then be compelled to surround them with a cluster of lesser lights simply to achieve the "diversification" that the marketplace demanded. But now, working with my best — and only my best — ideas, I am free to concentrate our portfolio and this is our edge.



Dan Cashman
Remembering the future

Investors should never, ever confuse volatility with risk.

Q And that strategy lowers the risk factor?

A Remember, I said any given analyst's impassioned picks were diluted

with other lesser picks for the sake of diversification. Now while that's not necessarily a risk to one's capital, it is a risk to one's *opportunity*. That should concern investors, who should never, ever confuse volatility with risk. Obviously, a concentrated portfolio will be a more volatile entity than a fully diversified one, but who doesn't love volatility on the upside? Who complains when a given stock goes from \$20 to \$70 per share in a given year? Is such a move volatile — yes. Is it risky — not necessarily. I'm dismayed by managers who have hundreds of "best ideas," who shamelessly mimic the market and have the gall to charge anywhere from 4 to 10 times the going rate for a passive product.

But that is not solely my opinion. Warren Buffett, in his 1993 Berkshire Hathaway Annual Report observed:

"We believe that if you are a know-something investor, able to find five to ten sensibly priced firms that possess important long-term competitive advantages, then conventional diversification makes no sense for you. It is apt simply to hurt your results and increase your risk. I cannot understand why an investor of that sort elects to put money into a business that is his twentieth favorite rather than simply adding money to his top choices — the businesses he understands the best, and that present the least risk, along with the greatest profit potential. In the words of the prophet Mae West, 'Too much of a good thing can be wonderful'."

Isn't it interesting Mr. Buffett believes diversification increases risk?

Q But obviously, there is still risk in a concentrated portfolio.

A Of course. You can't escape risk. It's always there whether it be risk to your invested capital or

the risk of opportunity. My job is to ratchet risk down for my clients. I start with the somewhat pithy adage that goes

"The best way to make money is not to lose it." Or as Cus D'Amato, the late, great boxing trainer quipped, "The object of

boxing is not to get hit." When I assemble a portfolio, I'm very mindful of that. But I'm also aware of the fact that rewards are spawned from risk. I am not getting paid to avoid risk. My role demands that I have a sufficiently high level of risk in the portfolios I'm managing.

In a wonderful presentation made several years back to the Endowment Institute, the President of TIFF Investment Program, David Salem, noted that money managers and plan sponsors alike must be willing to take career risks to achieve something worthwhile. What his advice implies is that you must commit to a profession where you're likely to be uncomfortable most of the time. I once read in the I Ching, "Before a brilliant person begins something great, they must look foolish to the crowd." Not many people have the fortitude for this and that's why most money managers do what's currently fashionable or comfortable. For example, paying close to fifty times earnings for Coca Cola, a company that's really only growing around 12%, is lunacy in my estimation. Yet it's one of the most popular and most over-owned stocks in money management circles.

On the other hand, we currently have 42% of our client's money in one small sub-sector of the S&P 500, the oil service industry. That would put most people on the edge of their seats; I know it makes me uncomfortable, along with my Partners, and we clearly understand it is a career risk. But as Hyman Roth observed in *Godfather II*, "this is the profession we have chosen." This is why it's such a joy working with my Partners. They understand they're risking their careers and the abyss they face if they're wrong. But they also understand how to intelligently, and in measured fashion, craft a portfolio that astonishes and delights our clients. This can't be done without taking risks. We're comfortable with risk; we make it work for us and our clients.

Q How do you make risk work for your clients?

A I have noticed over the years that four elements are always present in an idea if you hope to contain risk. Three of four are germane to the company as opposed to the underlying equity. The fourth has to do with the stock. Not necessarily in any order of importance — the first element you look for is growth, and I mean growth in the top line, revenues, and growth in the bottom line, earnings. I'm not defining what is commonly con-

Let's go back and recreate our thinking when we bought Nabors at 18 7/8 per share. It had reported \$0.75 per share for 1996, or 24x reported earnings. We are wildly enthusiastic about the prospects for the oil service sector of our economy, and Nabors is the largest and the highest quality land-based driller in the world. We think we're in a ten year cycle for these companies with about 3/4 of that time left to go. We also believe Nabors can at least grow its earnings at a 25% clip during our 1997-2000 period. From a base of reported earnings of \$0.75 we derive an EPS figure of \$1.83 at year end 2000. The next step is assigning a multiple. The oil service industry, of which Nabors is a part, traditionally sold at a 40% premium to the S&P 500. The S&P was selling at 18 times 1996 earnings. We like to tone things down a bit and not push the envelope, so at the time of purchase we awarded Nabors a 25% premium or a P/E multiple of 22.5 times. Now 22.5x \$1.83 implies a price of 41 1/2 sometime during 1999. From our purchase price of 18 7/8, we were looking at a gain of 118%. We had tremendous confidence in management delivering, and IRIS projected in excess of our targeted 26% annual return.

Q What about the other three?

A I won't go into all the detail I just did with Nabors, but using the same methodology for Mirage we came up with a target price of 44 or a gain of 103%. Globalstar promised a gain of 144%. With this one we have the greatest chance of being so far off, it's laughable. This company has the most potential of anything I've worked with in my entire career in the financial markets. Alternative Living Services should easily double in the same time span. It's a leader in a wonderful but embryonic industry.

Q Amazing. Can you elaborate on Globalstar?

A Nope, but I will to anyone who buys a ticket.

Q You're closing in on your second full year. How have your accounts fared?

A It has been most gratifying. In our first year, the Partnership, net of all charges, returned to the Partners a 50.8% positive return. This year, the Partnership is up in excess of last year's return. And that's net of fees; the absolute number is in excess of 60%, but I prefer to use figures my partners can spend at the grocery store.

Last year, our standard accounts were up a disappointing 18.9% versus the S&P 500's 22.9%, but as I delight in pointing out, we beat the S&P 495. Without Intel, Microsoft, Coca Cola, IBM and General

Electric, the market would have been only up 17.2%. This year, thanks to our commitment to energy, the accounts are presently running at a rate of 46%. Nabors is the big winner, up 104% since our purchase. Mirage is up 29.5%. And ironically, Globalstar is the runt of the litter up 20.6%. In fact Nabors is closing in on its 1999 target price of 41 1/2. Good things happen when you work with GEMS.

Q That's great, but isn't it tempting to assume there has to be substantial risk on the downside following results of that magnitude?

A I don't believe so. First off, returns like that happen all the time in a bull market. They just don't happen for too many people. However, somebody's always in the right place at the right time. The real test of an investment manager's mettle is producing superior returns on a consistent basis, and I truly believe you can do so without undue risk. Lee Trevino once defined pressure as a \$20 bet on an eight foot putt with only \$5 in your pocket. Substitute the word risk for pressure and I think an important distinction is made. A lot of stellar returns are made on borrowed funds or leverage if you will. I will never use leverage — ever. I don't need that type of octane. I will never use options or derivatives. I remember reading in *The Wall Street Journal* a couple of years back about a hedge fund that lost \$600 million of its clients' money over one weekend. The explanation, to this day, still sticks in my mind. It went something like, "The fund could not meet margin calls on a basket of assets consisting of thinly traded derivatives." Is that madness or what?

Now that's risk, but it's just one form of risk — the risk of losing capital. There's also the risk of opportunity. For instance, I can name several pundits who have sat out the last 4,000 - 5,000 points. The other risk is over-diversification. Like high blood pressure, it's subtle, but it's a killer. It kills opportunity. I once saw a study in a

Nabors is the big winner, up 104% since our purchase.

I am not getting paid to avoid risk.