



QUARTERLY UPDATE

3/31/2005

Can we choose not to choose?

One of the great debates throughout history has been free will versus determinism. In philosophy, religion, psychology and even law, we often examine how much of what we do is shaped by forces beyond our individual control, be they genetic, cultural, supernatural or context-dependent? This question is of vital importance, especially in legal matters, as it is at the heart of the issue of accountability. We can be held accountable only for matters over which we have control. Juries wrestle with this issue every day, whether in examining the culpability of an underage murder suspect or the role of a CEO in a massive accounting scandal.

As in many difficult issues in life, the truth most likely lies somewhere between the extremes. We probably are not as free in our choices as we would like to think that we are nor do we live in an entirely mechanistic universe where all of our actions are foreordained or entirely predictable. Humans are conceptual beings who mentally engage the universe around them, not just reacting instinctually to stimuli as other organisms do. Cognition is an act of volition. We constantly make choices as we convert perceptual data into conceptual information and then act (or not) upon that information. The one choice we cannot make is not to choose, as is logically self-evident. Therefore, at the very core of what it means to be human is the notion of accountability; we are responsible for the choices we make. This is why Courage appears at the base of the Leadership Diamond[®], supporting the entire structure. Without autonomy, independence, free will and accountability, all aspects of Courage, there would be no possibility of Vision, Reality or Ethics.

As an aside, Stoic philosophers often get a bad rap as being cold, aloof and emotionally distant, which I feel is a fundamental misunderstanding of the nature of Stoic ethics and the idea of "philosophical detachment." Stoic philosophy holds that it is our free will that imbues us with human dignity and that nothing is more important than the choices we make. However, we must carefully differentiate between that in our lives over which we have control and that over which we have no control. Philosophical detachment means recognizing that ultimately it is pointless to worry about things over which you have no control, and in reality there is very little in life – your reputation, the stock market, your wealth, your health or even your lifespan – over which you have total control. You may be able to influence some of these matters, yet true control is beyond your powers. However, you do have control over the choices you make. You are responsible for your own choices, and therefore the choices you make are immensely important. In fact, they are the only things that are truly important from an existential point of view.

As the manager of the Diamond Portfolio, I am accountable for its composition and performance. At Diamond Portfolio Advisors, we take very seriously the responsibility placed upon us by our clients having placed their trust and assets with us. The choices that we make on their behalf are immensely important. Therefore, I would like to review the recent changes we have made in the portfolio and the thinking behind those changes.

In December, we sold our position in **Nextel Communications** and bought **Ambac Financial Group** shortly after Sprint announced their intention to acquire Nextel. We view the merger as a combination of incompatible corporate cultures and technologies, perhaps driven more by desperation in a rapidly consolidating industry than by long term strategic advantage. With a takeover price of \$30 and our Target Price having been \$33, we were being deprived of the potential to realize that last 10%, so we decided to move on. Ambac is primarily in the business of providing financial guarantees to public sector clients; their guarantee allows a lower-rated entity to issue those AAA-rated municipal bonds conservative investors so love. Given the finances of most state and local governments and their need to attract funding, this is likely to remain a growth business for the foreseeable future.

Quarterly Update First Quarter 2005

In January, we made a number of changes to the portfolio. First, we were beginning to become concerned about our position in **Electronic Arts** from several dimensions. From a fundamental perspective, the lack of any new gaming platforms on the horizons will likely hold back the demand for new videogames after a period of rapid growth. From a Leadership Diamond® perspective, we were worried by news of employee lawsuits being filed related to working conditions, which may be only a symptom of larger problems to follow. From a valuation perspective, the stock had done quite well since we added it to the portfolio and was sporting a rather aggressive P/E ratio. Seeking to lower risk in the portfolio, we sold Electronic Arts, initially replacing it with **Anheuser-Busch**, a very steadily (if somewhat slowly) growing company whose price had been fairly stagnant for years and thus had (for it) a relatively low P/E ratio. Unfortunately, the stock continued to weaken, and rather than obstinately watch a poor idea deteriorate further, we decided recently to admit to the problem and remove it from the portfolio before the damage got worse. Remaining at the bar, we replaced it with **Constellation Brands**, the leading seller of wine in America (having recently acquired the Robert Mondavi label) and the sole importer of Corona beer in the Western United States, with a significant distilled beverages business as well, thus diversifying our exposure across a broader spectrum of the alcoholic beverages market.

We also faced up to the reality that **H&R Block** would likely remain a disappointment. Although an inexpensive stock, the company was facing challenges on many fronts. The mortgage division, which had been a source of positive surprises during the refinancing boom, was now surprising to the downside as refinancing ebbed. The financial adviser division was witnessing a never-ending stream of lawsuits and regulatory action. And the core tax preparation business has been experiencing serious erosion in its customer base. These are not the kind of fundamentals we like to see in our holdings. We replaced it with **Omnicom**, the world's largest holding company of advertising agencies. Always a steady performer, we believe Omnicom should thrive in a time when its corporate customers are flush with cash yet desperate for growth and gains in market share.

Fifth Third Bancorp provided us the opportunity to add them to our portfolio at an attractive valuation. Always highly regarded, and usually highly priced, a series of missteps and a temporary regulatory halt to further acquisitions precipitated a drop in the stock price. We decided to take advantage of the situation to buy Fifth Third Bancorp, replacing our position in **J.P. Morgan Chase**, which is likely to tread water for the time being as they digest their recent acquisition of Banc One and incoming CEO Jamie Dimon cleans up for the beginning of his reign.

Finally, we recently swapped **Fedex** for our long-held position in **Southwest Airlines**. Southwest is a wonderful company that has remained profitable throughout the airline industry debacle. However, it is very difficult to arrive at a reliable valuation for the company on visible earnings, and its competitors are so desperate that it may be unlikely that conditions improve anytime soon. We decided that Fedex gives us a much greater degree of confidence that its earnings trajectory will be maintained.

As the above indicates, recently we have been a bit more active in the portfolio than usual. Changing circumstances often require action, and change is the only constant as Heraclitus noted. Courage is the source of action, and we hope to have the courage to admit mistakes when they become evident and the courage to back new ideas in an uncertain world. We also seek sufficient Courage in the companies we hold, because Courage provides the energy for innovation. As Ayn Rand wrote "The great creators – the thinkers, the artists, the scientists, the inventors – stood alone against the men of their time." Going against the crowd in the investing world can mean avoiding Internet stocks in 1999 or commodity stocks today, both of which may seem odd in the moment yet wise upon reflection. Going against the crowd may also mean getting off the well-trod path of traditional participants to pursue the course of an innovative trailblazer. Greatness MattersSM.

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