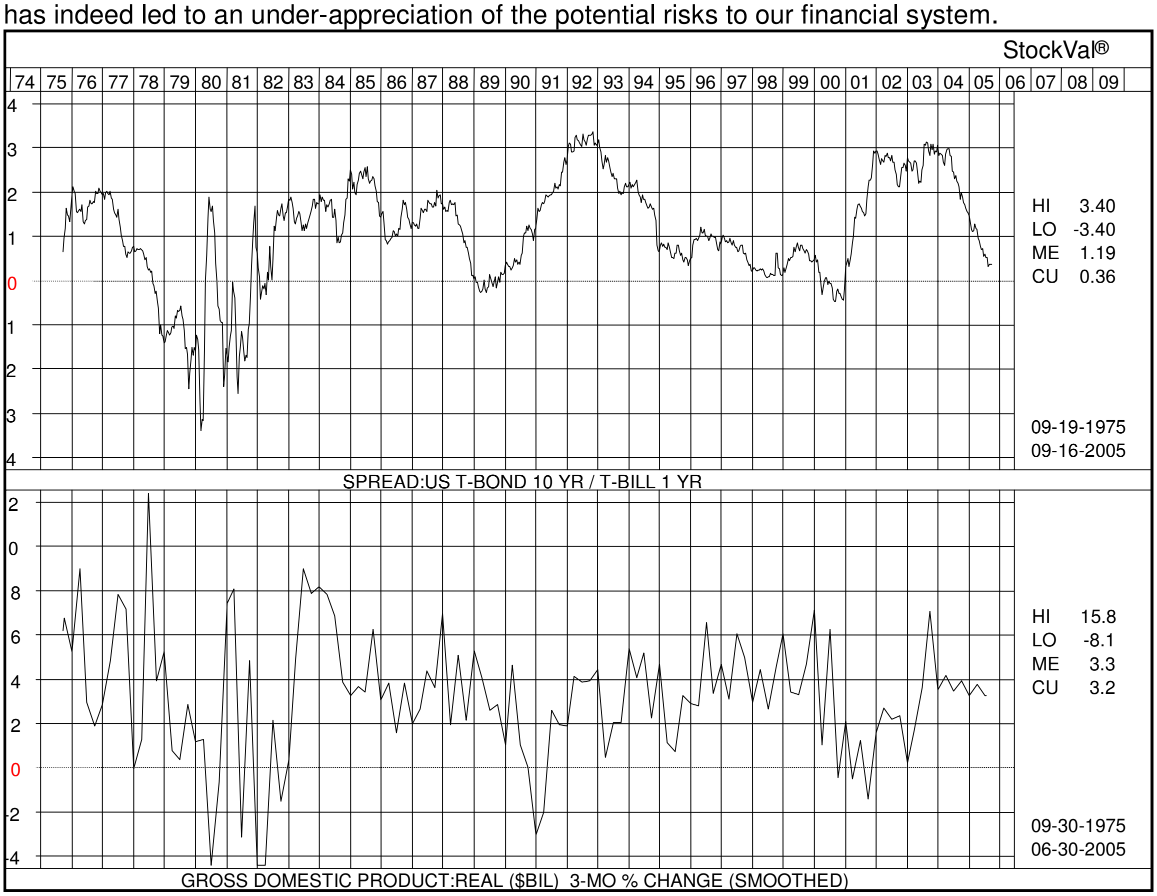
Diamond Portfolio Advisors, LLC

QUARTERLY UPDATE

9/30/2005

Whither risk?

Every August the Federal Reserve Bank of Kansas City hosts a symposium (which literally means “drinking party” in Greek) in Jackson Hole, Wyoming, a gathering which has become a major event for central bankers, economists and other financial types. Given that Alan Greenspan is retiring January 31 after 18 years at the helm of the Fed, attendees decided to use his final appearance as Chairman to lionize his many accomplishments in what became a virtual canonization of St. Alan, conveniently overlooking the many landmines in which the Fed had a hand that occurred during his tenure– the Crash of ’87, the banking crisis of the early ‘90s, the stock market bubble, and the grandest of all, the real estate bubble. Modesty, and perhaps a sense of history, led Chairman Greenspan to reflect upon his legacy rather than on his track record, and a worrisome legacy it is. "In perhaps what must be the greatest irony of economic policy making, success at stabilization carries its own risks." By this Greenspan means that the very perception that he can successfully stabilize the economy no matter what has encouraged investors to take on imprudent levels of risk. A less flattering interpretation of history is that his track record of bailing out investors by flooding the monetary system with cheap money after every crisis has made investors complacent. The term for this is “moral hazard.” If traders perceive that they are in an environment with little or no downside, because the Fed will bail them out to avoid a systemic failure, then they are emboldened to take as much risk as they can in search of elusive gains, especially in a generally lower return environment. Greenspan is lauded for overseeing an era with only two relatively mild recessions interspersed with one very long and durable economic expansion. But the complacency engendered by the combination of this benign economic backdrop and Greenspan’s tendency to open the monetary taps during a crisis has indeed led to an under-appreciation of the potential risks to our financial system.



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How do we know that investors are under-pricing risk? The signs are all around us. The top half of the chart illustrates the difference, or "spread", between 10-year Treasury bonds and 1-year Treasury notes. The current spread is only 36 basis points, meaning that investors are accepting a great deal of risk, 9 years of unknown inflation, for very little extra compensation. Another measure of investors' willingness to take risk is the current narrow spread between corporate bonds and risk-free Treasury bonds. As the chart illustrates, periods when the yield curve flattened are usually followed by contractions in the economy, not a time when you want to underprice corporate credit risk. The VIX index, a measure of stock market volatility, is also at historic lows, implying investor complacency. Closer to home, **Ambac Financial**, one of our holdings in the Diamond Portfolio, has been suffering due to investors' appetite for risk. Ambac is in the business of insuring municipal bonds and other debt instruments. During a conference call, the CEO stated that investors are so interested in yield and so indifferent to risk, that 85% of all CMO (Collateralized Mortgage Obligation) deals were going to market without the guarantee of a bond insurer, which was obviously hurting their business. Investors betting that mortgages cannot default in this environment are more foolish than brave.

We also see evidence of this phenomenon in the performance of the Diamond Portfolio, which uncharacteristically has been lagging as of late. In an attempt to understand what is going on with the portfolio, I examined the performance of each 4-quarter time period since inception. There are 24 (obviously overlapping) such 4-quarter periods in the portfolio's 6¾-year history, with the Diamond Portfolio outperforming its benchmark on average by 6.4%. The Diamond Portfolio has outperformed the Russell 1000 Growth index in 19 (79%) of the time periods. In the 5 periods of underperformance, the portfolio lagged by a small amount in 3 of them. In only two time periods has the portfolio significantly lagged its benchmark – the current period and the 4 quarters ending June 30, 2000. As the chart shows, both were periods when the yield curve was flattening dramatically. Both were periods when investors cavalierly ignored risk. After mid-2000, what followed for investors in general was not pleasant. What followed for the Diamond Portfolio was an extended period of outperformance, by 13.3% and 15.9% in each of the following two quarters alone, as investors reassessed the virtues of Quality.

We have not been sitting on our hands in this environment, but rather have been searching for areas where the portfolio might be subject to risk. In May we sold our position in **First Data** and replaced it with **Cisco Systems**. First Data is the largest processor of debit and credit card transactions, but a large percentage of their profits derive from the wire transfer business through their Western Union division. Congress is considering legislation that would allow credit unions to enter this arena, which will pressure First Data's profitability. Recently, **Bank of America**, another of our holdings and a growing presence in the money transfer field, announced a program to allow funds transfer to Mexico without a fee in a bid to capture a larger share of the Hispanic banking market.

More recently, we sold **Johnson Controls** and **Fifth Third Bancorp**, replacing them with **3M Company** and **Vodafone**, respectively. Johnson Controls is a large player in the automotive interiors market, and we fear that they will increasingly be made to share the pain of their Detroit clients. 3M, on the other hand, seems to be experiencing a renaissance of sorts after the brief but revitalizing stint of CEO Jim McNerney, late of GE, now of Boeing. Long considered a great company, if a bit sleepy before McNerney's arrival, a recent pullback allowed us to enter 3M at what we consider to be an attractive price. The flattening yield curve has been pressuring the net interest margin of banks, and we decided to reduce our exposure to banking by focusing on Bank of America, which seems to be handling the situation more adeptly than Fifth Third. We returned to Vodafone now that consumers in Europe finally seem to be attracted to their 3G offering in significant numbers, justifying the huge investment made in that technology in years past.

Although the future is unknowable, we doubt that now is the time to drop our guard, and thus we shall continue to seek ways to lower the risk profile of the Diamond Portfolio. Stay tuned.

Thomas M. Weary, CFA
Chief Investment Officer