



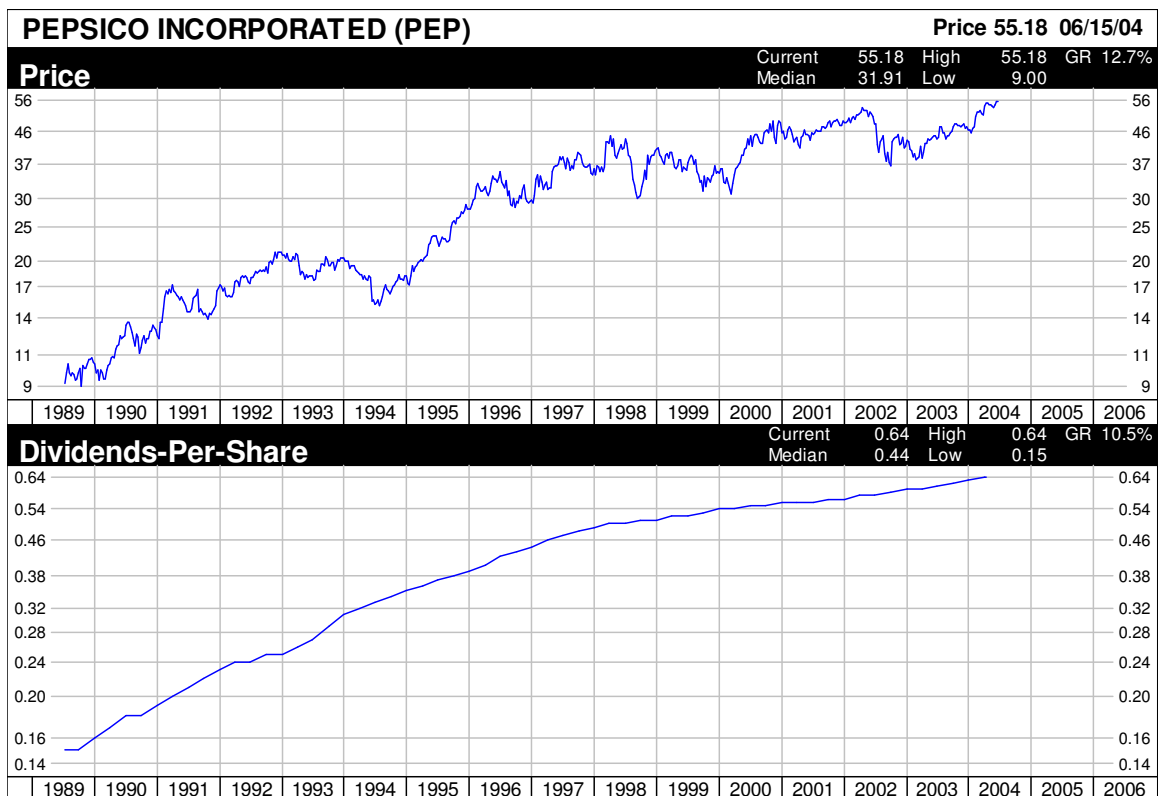
# QUARTERLY UPDATE

6/30/2004

## What do we notice?

It is sometimes said that perception is reality, but what is it that we perceive? Do we really take in all that is going on around us at all times, or do we filter out “noise” to prevent being overwhelmed by sensory data? Do we perhaps even “fill in” impressions based upon past experience, fooling ourselves into thinking we have experienced something when we really have not. Time is a key factor in perception, especially in the investment world, for the truly significant themes unfold too slowly for human perception while they are occurring, yet many investors behave as short-term traders where the end of the day (much less the next quarter) is the dominant time horizon. The slow-motion car crash that is the management succession at the Coca-Cola Company is today making the “news”, and yet it has been evident for years. The Diamond Portfolio has instead held PepsiCo, and has been amply rewarded through a combination of a rising share price and dividends, as the graphs below illustrate.

Pepsi-Cola dates back to 1898, but its modern history begins with the formation of PepsiCo in 1965 upon its merger with Frito-Lay. Founder Don Kendall, Pepsi-Cola’s President, targeted the youth market, “The Pepsi Generation”, and purchased Mountain Dew in 1964. The battle with Coca-Cola took on mythic proportions as each company jockeyed for prominence in their flagship products, while diversifying into other ventures. Coca-Cola ventured as far a field as the motion picture industry, as the one-time owner of Columbia Pictures. PepsiCo purchased Pizza Hut, Taco Bell and Kentucky Fried Chicken. At the height of the “Cola Wars”, Coca Cola stumbled badly by introducing New Coke in 1985, alienating their consumers, and promptly bringing back the newly styled Coca-Cola Classic. Through much of the 1990s Coca-Cola was a stock market darling and PepsiCo was viewed as an also-ran. While true that PepsiCo did struggle in the mid-1990s, to fixate on the second-place ranking of one product, Pepsi to Coke, in terms of sales is to miss entirely the true PepsiCo story.



## Quarterly Update Second Quarter 2004

PepsiCo's remarkable turnaround began in 1996. After 10 years as CEO, Wayne Calloway retired for health reasons and was replaced by the charismatic Roger Enrico. Although Enrico had been the head of each of PepsiCo's divisions at one time or another, and had greatly enjoyed tweaking Coca-Cola for the New Coke debacle in his book "The Other Guy Blinked", he was a reluctant CEO, perhaps due to the quadruple bypass he had undergone. His first step was to bring back Karl von der Heyden, PepsiCo alum and former CEO of RJR Nabisco, as CFO to help right the ship. He then implemented a strategy to both focus and expand PepsiCo's lines of business, a process that would completely remake the company.

In order to focus the company, Enrico spun off those businesses which were requiring lots of capital but yielding lower returns. The restaurant division was spun out in 1997 as Tricon Global, and a majority interest in Pepsi Bottling Group was sold in a 1999 IPO. In order to broaden the business beyond carbonated beverages and salty snacks, PepsiCo purchased Tropicana in 1998, launched Aquafina (water), purchased New Age South Beach Beverage Company in 2001, and most recently acquired Quaker Oats (Gatorade). And during all of this change, PepsiCo continued to deliver consistent profit growth, while it's main rival Coca-Cola has stumbled badly. Having accomplished what he set out to achieve, Enrico handed over the reins to a powerfully balanced management duo.

Steven Reinemund, previously the President and COO, was named CEO. This former Marine is known for his discipline, bottom line focus, intensity, detail orientation, skills at execution, and "spit and polish" demeanor. Indra Nooyi, previously the CFO, was named President and COO. Ms. Nooyi is a free spirit excelling at strategy and innovation, who is also a tough negotiator (and who played lead guitar in an all-girl rock band in India). Each brings a history of success. Reinemund was CEO of Frito-Lay as it grew to dominate the snack food industry. At one point, rival Anheuser-Busch simply closed down their Eagle Snacks division when they could neither compete with Frito-Lay nor find a buyer for the business. Nooyi was the architect of the Tropicana acquisition, a transforming event for PepsiCo. The two share a desire to connect their work and family lives, Reinemund stating that while he has not achieved a 'balance', it is more like "the pendulum of a clock", constantly correcting. And the two complement one another so well that Reinemund told Nooyi when offered the CEO slot, "I can't do it unless I have you with me," moving her to tears. This team seems to embody a number of polarities: Vision/Reality, Strategy/Operations, Innovation/Continuity, Formality/Openness, East/West, Male/Female.

From a Leadership Diamond<sup>®</sup> perspective, PepsiCo's strongest orientation is Courage. Perhaps due to years of gladiatorial combat with Coca-Cola, the company has a strong identity, willingness to manage through turmoil and ability to bear responsibility for its own actions. The next strongest orientation is Reality, with the CEO intensely focused on operations and EPS. The company has a strong survival instinct, battling back from the brink in 1994, and their increasing emphasis on diversity demonstrates an appreciation for multiple valid perceptions of reality. PepsiCo is committed to performing in the market and the marketplace. They will deliver, for they remember the price for failing to do so. We view PepsiCo as having not only a robust and well-balanced Leadership Diamond<sup>®</sup>, but also a management team that embodies an almost unique capacity to appreciate and hold key polarities.



During the quarter we made no changes to the Diamond Portfolio, other than to trim our position in **Symantec** as the stock neared 50 and redeploy the proceeds to **Nokia**, which had been hit severely for a temporary slight drop in its overwhelming market share position.

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