



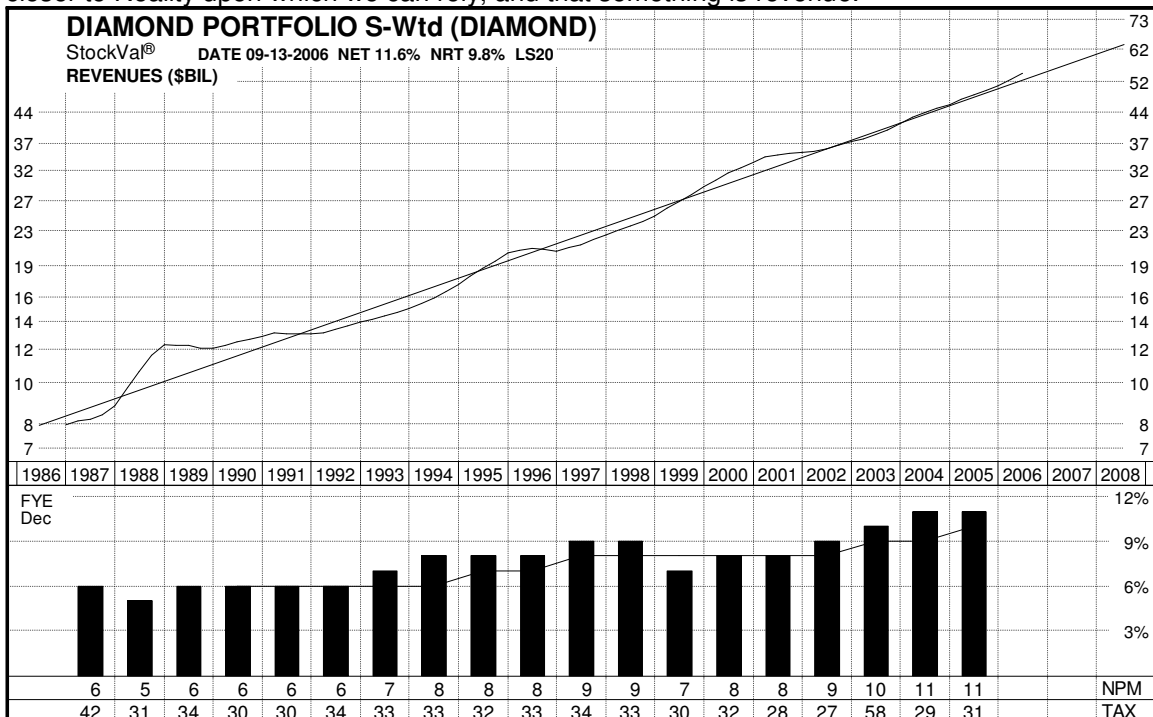
## QUARTERLY UPDATE

9/30/2006

### What is the prime mover?

Since Plato, philosophers have pondered the implications of the proposition that “every effect must have a cause.” Things do not happen spontaneously, or *ex nihilo*. The dilemma that arises, however, is the logical implication of either an infinite series of causes or the existence of an uncaused cause, the so-called “first mover.” Medieval theologians and the mystically inclined leapt upon the latter as “proof” of the existence of God, the so-called Ontological argument. This syllogism violates its own internal logic (never a problem for theologians) that **every** cause has a cause. For help out of the horns of this dilemma, perhaps we should look to an analogous situation in astrophysics, the question of what happened before the Big Bang. Since time and space are just different dimensions of the same thing – Reality – the question regarding the existence of one without the other 3 (or 10 depending upon your views on String theory!) is nonsensical. One cannot pose a question about time apart from space; one cannot ask what happened **before** the Big Bang, or what caused the creation of the universe, for time commenced coincident with space. Conceptually, every cause does have a cause, an infinite series that collapses to nothing as time approaches zero – the calculus of the uncaused cause!

There is another sense of the term “prime mover,” and that is the *primary motive force*, as in the engine in an automobile. In the world of finance, growth investors are fond of saying that “earnings drive stock prices,” therefore all one has to do is own the stocks of companies with the fastest growing earnings and your portfolio will be certain to outperform all others, regardless of what you pay for those stocks. Besides the possibility of excessive valuation, there are two problems with relying completely upon this approach. First, other factors, such as interest rates and investor psychology, clearly impact stock prices as much as or more than earnings, at least in the short to intermediate term. If not, why do stock prices fluctuate so wildly? Certainly our views on earnings do not change as rapidly as stock prices. Second, earnings are an intellectual construct, subject to numerous accounting assumptions and adjustments. As a derived concept, earnings seem not completely reliable as an indicator of value. There must be something a step closer to Reality upon which we can rely, and that something is revenue.



## Quarterly Update Third Quarter 2006

As we witnessed during many of the recent scandals, senior management were often able to create earnings through the use of aggressive accounting assumptions. It is much more difficult to “create” a dollar of revenue than a dollar of earnings; sales tend to happen in a quarter or they do not. Sales are what happen outside a company in the real world, whereas earnings are the end product of what happens inside a company, and thus more subject to potential manipulation. Sales are perhaps a better indicator of how a company is faring in the real world. The chart above illustrates the revenue growth of the companies in the Diamond Portfolio over the past 20 years. There are two notable features in this graph. First, revenue growth is extremely steady, displaying very little evidence of economic cyclicality. This is one reason why we are agnostic about the economy; it really matters little to our portfolio. Second, the earnings growth in the portfolio (**Normalized Earnings Trend = 11.6%**) is extremely well supported by the revenue growth (**Normalized Revenue Trend = 9.8%**). The companies in the Diamond Portfolio can grow their earnings so consistently and reliably because they have the revenue growth to support it – there is no need to resort to accounting chicanery. Another point to note is that the revenue growth of the Diamond Portfolio is nearly triple that of the S&P 500’s 3.6% revenue growth.

*Greatness matters<sup>SM</sup>*. Great companies grow their revenue faster and more reliably than their peers. Great companies grow their earnings faster and more reliably than their peers. And as the accompanying Portfolio Update illustrates, the stocks of Great companies consistently outperform their peers.



There is an old saying that goes, “fool me once, shame on you; fool me twice, shame on me!” Well, shame on me – I was fooled twice. During the past quarter, we sold **Vodafone** for the second time. We had originally purchased Vodafone several years ago, when under CEO Chris Gent the company appeared to be a unique way to participate in the rapid global growth of wireless telecommunications. Through a string of blitzkrieg acquisitions, Gent built a global wireless footprint and the largest wireless company by subscribers and market capitalization. He even pulled off what seemed like a very clever merger of Airfone with Verizon Wireless after wresting control away in a takeover battle. But the growth proved to be an illusion. Vodafone slowed its acquisition pace, struggled with some operations (most notably in Japan where it was forced to retreat), and even the joint venture with Verizon appears to have bogged down. Our hopes for continued rapid growth dash, we moved on.

About a year ago, attracted by what appeared to be a very attractive valuation and signs of life for 3G wireless services, we were enticed back into a position in Vodafone. But the value proved to be an illusion. The company was forced to take a massive write-off and the new CEO, Arun Sarin, formerly the CEO of Airfone, came under attack. So with the very same stock, we fell into both a Growth trap and a Value trap at different times. We decided to take advantage of the turmoil occurring at another wireless company to establish a position. Previously, we had been owners of Nextel, selling the position when its takeover by Sprint was announced. The announcement drove the stock to our then Target Price and we had concerns about how the two companies would meld their technologies and cultures. We waited for about a year and a half for the dust to settle from the merger (and for the stock price to drop precipitously!). We deployed the funds liberated by the Vodafone sale to purchase **Sprint Nextel** in the belief that all of their challenges are reflected in the current stock price and that their recent decision to leap ahead of their competition by deploying a 4G WiMax-based network will prove to be visionary.

During the quarter we also sold our position in **Sysco** and purchased **Coach**. The sale of Sysco was a difficult one, as it is a wonderful company and we have made a great deal of money on the stock for our clients in the past. But as a food distribution company, Sysco faces the prospect both of continued relatively high food prices and a downturn in the restaurant dining. Coach, on the other hand, has continued to perform very well with their line of “affordable luxury” leather goods, so we decided to take advantage of a recent price decline to establish a position for the Diamond Portfolio. The market will always offer opportunities to participate in Greatness.

Thomas M. Weary, CFA  
Chief Investment Officer