

February 14, 2005

Dear Friends of AAM,

“What we anticipate seldom occurs, what we least expect generally happens.”

-Benjamin Disraeli-

In October 2004, children prepared for Halloween while the ghosts of bear markets past appeared braced to deliver a scare to U.S. equities. Already in negative territory for the year – higher energy prices, a falling dollar, a divided U.S. electorate, concerns about the sustainability of the economic expansion, deficits, and rising commodity prices – provided powerful ingredients for a witch’s potion that would seemingly provoke the bull market into a deep sleep.

But as often happens in the tales of Mr. Market, the prince or princess (we are not sure who kisses a bull) waited quietly just above the fog of Halloween night, prepared to play a surprising trick. As pessimism peaked and valuations troughed, the ghosts and goblins retreated. Common stocks staged a screamer of a double digit rally over the last 10 weeks of 2004 leaving us all looking for the wizard’s wand. When the dust settled, the Dow Jones Industrial Average and the S&P 500 had generated total returns in excess of 5% and 10% respectively.

The double digit upside move in the last weeks of 2004 is consistent with the historical behavior of U.S. equities. Market gains come suddenly, unpredictably, and with great force. If you miss the ten days each year where the equity asset class has its largest gain, you miss the benefits of owning stocks entirely.

Your advisor does not time markets and places the preponderance of its energies into bottom-up analysis of individual companies. To paraphrase George Orwell, “Sometimes the first duty of those striving for the intellectual high ground is to restate the obvious.” We are really aiming high!

The AAM 2004 year-end letter provides a view of where we are finding value in 2005, a review of two recent academic studies on the equity asset class (which aggregate well with our wiring), a check-up of one of our core holdings, insights into happiness and wealth from the Indian classic *The Mahabharata*, and our standard eclectic conclusion. (Who said multiple writers can’t put together a cohesive letter).

THE BIGGER, THE BETTER

“New ideas stir from every corner. They show up disguised innocently as interruptions, contradictions and embarrassing dilemmas. Beware of total strangers and friends alike who shower you with comfortable sameness, and remain open to those who make you uneasy, for they are the true messengers of the future.”

- Robert Lebow-

As bottom-up value investors we take an opportunistic approach toward the market capitalization of businesses that attract our capital. Several years ago, the companies with the

THE BIGGER, THE BETTER - CONTINUED

deepest undervaluation tended to be mid-size businesses. They have been bid up in price in the early stages of the earnings recovery. Accordingly, our gaze has shifted toward some of the largest, most well capitalized businesses in the world. Not only are they relatively and absolutely inexpensive in many cases, but they have historically performed well during periods where: 1) Earnings growth returns to a more normalized level, and 2) the Federal Reserve is tightening interest rates.

Earnings growth in 2003 and 2004 was characterized by strong double digit advances. The quality of the earnings, as measured by cash-flow, was equally impressive. We anticipate that over the next two years corporate earnings growth will moderate to the high single digits (Impressive but not the fireworks of the prior two years). In addition, the Federal Reserve has begun to put the breaks on liquidity in the U.S. economy to temper the risk of future inflation. We believe the combination of these two “macro” factors provide a tailwind to our “micro” bottom-up investment approach.

In our view, equities owned with a margin of safety provide superior after-tax risk adjusted long-term returns vis-à-vis cash, bonds, and real estate. We are particularly concerned with the valuation of the latter as real estate increasingly takes on the tone of the Internet land grab that ended in 2000. Household income as a percentage of average home prices is at an historical low, and the cap rates on commercial investments are at levels we have not seen since the mid 1980's. We don't know when the music will stop – but nothing lasts forever.

THERE IS NOTHING COMMON ABOUT SENSE

There is an old joke that business schools exist to provide a pedagogic way to teach common sense (not only is the joke very old but we've been straining for a place to put the word pedagogic). Levity aside, two studies from academia caught our attention this past year as they affirm the value path your advisor has walked for almost 15 years.

Esteemed Finance Professor, Louis Lowenstein of Columbia University, analyzed a subset of the market from 1999-2003 in a paper that is currently circulating entitled, *“Searching for Rational Investors in a Perfect Storm.”* Lowenstein argues that the speculative excesses of the 1990s threw a harsh light on proponents of efficient market theory (EMT). EMT holds at its very core the ideal that stock prices reflect everything that is known about a company's prospects and about the state of the economy. He observes that “if the NASDAQ Composite Index... was right at 1,200 in April 1997, it surely wasn't right at 5,000 in March 2000, and then right again at 1,100 two years later.”

Lowenstein asks whether any investors acted rationally during the five-year market starting in 1999, and if so, whether they had enough similarity to suggest that their success was not random.

His conclusion is that the market does not always efficiently price businesses, and that investors who have capitalized on these inefficiencies over time share some amazing similarities. Beginning on the next page, we highlight several key themes in Professor Lowenstein's work and comment on their likenesses to AAM's investment approach.

THERE IS NOTHING COMMON ABOUT SENSE - CONTINUED

1. Buying Businesses with a Margin of Safety: Lowenstein observes that a similar quality among successful investors is that they are “looking to buy pieces, i.e., shares, of companies at a substantial discount from the value an intelligent investor would pay for the business as a whole.” This discount provides a ‘margin-of-safety’ that allows for the inherent risk in estimating future cash flows and the proper discount rate to be mitigated.

This bottom-up, company-by-company evaluation often leads to concentrated portfolios since many of these investors believe that safety lies in careful selection, not random diversification or closet indexing. The average domestic value-oriented fund that Lowenstein observed held under 35 stocks compared to the average domestic equity fund which holds about 160 securities.

In AAM’s mid-year 1998 client letter, we observed that despite the growing popularity of momentum investing, we remained focused on allocating capital based on traditional security analysis:

*AAM believes that the tenets of fundamental security valuation are as valid in 1998 as they were in 1968. Accordingly, we continue to allocate client capital employing margin-of-safety principles. AAM views holdings as genuine ownership positions in underlying businesses and maintains an ongoing review of the **management, business strategies, products, and long-term competitive position** of each enterprise. We analyze companies to assess their intrinsic value, the price a rational businessperson would pay for the entire company under normal conditions — discounting all anticipated future cash flows to the present. AAM only buys businesses that we are capable of understanding, with distinct qualitative and quantitative characteristics, available at a minimum of a 35% discount to intrinsic value.*

Similarly, we sell a company when it exceeds its intrinsic value or experiences a change in its business model that impairs the valuation process. AAM has purchased many outstanding businesses over time and we expect that most will continue to appreciate after they are sold. They do so with our blessing. If we ever sell for the highest price we have either gotten lucky or cut it too close.

2. Minimal Portfolio Turnover: Several of the holdings your advisor has selected as core positions have been held over more than one Presidential Administration. Lowenstein’s research finds that investors who have outperformed over time do so with minimal portfolio turnover. According to *Morningstar*, the average domestic equity fund holds its stocks for an average of ten months – equivalent to a turnover ratio of 121%. The result is unstated trading costs and commissions that diminish returns.

In contrast, top investors exhibit turnover of only 20% or an average holding period of five years. Lowenstein states that “the difference between taking momentary fliers and selecting long-term buys is the difference, truly, between speculation and investing... Implicit in the longer holding periods is the fact that value funds define

THERE IS NOTHING COMMON ABOUT SENSE - CONTINUED

risk as business risk – profit margins might shrink, the flow of new products might dry up – not the market fluctuation risk which still consumes so much scholarly attention.”

In an investment era where information is readily available, there is no advantage to having massive research teams and analysts. If anything, the mind-numbing flow of daily statistics can lead managers to over trade due to short-term noise. Martin Whitman of the Third Avenue Value Fund observes that his “fund doesn’t have superior information; the trick is to use the publicly available information in a superior manner.” Indeed, Lowenstein’s research finds that most outperforming managers have relatively small staffs that have the ability to selectively filter out information that is relevant.

3. Eating Your Own Cooking: Lowenstein’s final observation is that top managers ‘eat their own cooking’ so that their personal interests are aligned with those of their investors. Your advisor has long felt that it is very important to have our family’s money invested alongside our client’s money.

TRUMPED

From New York City, the familiar funk strumming of The O’Jays “*For the Love of Money*” greeted eager TV viewers as they watched Donald Trump sift through a group of eager contestants to identify a suitable *Apprentice*.

Psychologists have observed in different forums that the shocking popularity of Trump’s show hinges on the fact that people have an endless curiosity about the lives of the rich and famous with the conscious hope that they will find the short-cut to great wealth.

Within the past ten years, many have witnessed the tremendous wealth created by technology innovators like Bill Gates of Microsoft, Jerry Yang and David Filo of Yahoo!, Sergey Brin and Larry Page of Google, Jeff Bezos of Amazon.com, and Pierre Omidyar of eBay. These high profile success stories attract interest and explain why there is never a shortage of speculators eager to buy shares of new and groundbreaking businesses that appear to have the greatest growth potential. These low probability, high severity “opportunities” are the greatest dangers to wealth creation and preservation for the average investors.

Recent research by Professor Jeremy Siegel of The Wharton School, shows that new firms and industries deliver returns that are often inferior to those of older companies in mature industries. His work can be read in his new book, “*The Future for Investors: Why the Tried and True Triumph Over the Bold and the New.*” Why do older companies outperform? Investors often pay too high a price for high growth companies and are then doomed to suffer poor returns. Siegel observes that the financial benefits associated with innovations flow to the creators, the founders, the venture capitalists who fund the projects, the investment bankers who sell the shares, and ultimately to the consumer who buys better products at lower prices. The individual investor, who seeks to grab a share of the growth, inevitably loses out.

TRUMPED - CONTINUED

Siegel examined the 20 surviving firms of the original S&P 500 index with the best returns. Three primary lessons from his research echo sentiments that have been expressed by your advisor over the years.

1. **Tech and Telecom:** No technology or telecommunications firm made the list of best-performing stocks. Investors expect technology firms to have very strong earnings growth, so even when these firms do prosper, their optimistic projections have already been built into share prices.

The risk of obsolescence in tech and telecom is high because there are always disruptive technologies that will eventually upend the incumbents. Accordingly, tech and telecom stocks have never been large core holdings for client portfolios because we feel that their future cash flows and franchise values are too difficult to handicap.

2. **Branded Goods and Services Triumph:** The overwhelming number of the top performing businesses had developed high-quality branded goods and services that have been marketed successfully not only in the U.S. but around the world. Trust in product quality is of paramount importance to their success, allowing the firms to charge a higher price than the competition and attain higher profit margins.
3. **Valuation Matters:** Portfolios invested in the lowest valuation stocks as measured by P/E far outperformed those with higher valuations and expectations. In fact, none of the top performing companies had an average P/E ratio above 27. There is no such thing as “buy at any price.” Buying stocks with proven long-run growth potential at moderate valuations is the key to a winning strategy. This observation is material to your own advisor’s view of the world.

THIS BOULDER ROLLS UPHILL

A practical application of the academic research we have highlighted can be found in a core position, The Boulder Total Return Fund (BTF). BTF is a closed-end fund that has been in AAM’s portfolios for several years. When we began acquiring shares, BTF was trading at a discount of almost 20% to net asset value (NAV). We were paying 80 cents on the dollar for businesses whose independent stock market value was available for calculation. In addition, we believed many of the holdings in the portfolio were selling with a significant margin of safety in their own right.

BTF’s portfolio of value-oriented securities is anchored by Berkshire Hathaway and assets with income producing characteristics. Furthermore, the manager of the fund, Stewart Horesji, personally owns over 40% of the fund through a series of family trusts (so we know that he is on a steady diet of home cooking). Finally, the fund has significant tax loss carry forwards, which is the only remnant from the prior manager of the fund that was worth anything to anybody.

THIS BOULDER ROLLS UPHILL - CONTINUED

Even after five years of consistent out performance by the fund's manager, BTF still trades at a discount to its net asset value.

A lot of research has been conducted to explain why highly visible and liquid assets like closed-end funds trade at less than fair value. In a well-known 1977 analysis of discounts, Princeton University economist Burton Malkiel argued that investors in a closed end fund with unrealized capital gains will not pay the stated NAV because when the gains are realized and distributed the investors will suffer a tax charge. Investors in BTF do not have this issue as your advisor has highlighted. Other research has pointed to control issues and the presence of noise trading. There is still no single satisfactory explanation for the existence of discounts in closed-end funds.

What is known, however, is that discounts can be narrowed. Two ways to achieve this include converting closed-end funds to open-end funds, and paying managed distributions which allow managers to repurchase shares. Shareholder activism to narrow persistent discounts in closed-end funds was set in motion in 1996 when the Securities and Exchange Commission (SEC) wrote to the fund industry's trade group, the Investment Company Institute, to say that it expected better disclosure on NAV discount policy from fund firms that handled closed-ended funds. A wave of shareholder proposals urging managers to narrow their fund discounts to NAV followed. Some institutions like Harvard University, Lazard Freres, and Fidelity joined the chorus and began actively forcing closed-end funds to close their NAV gap.

A high profile example occurred between 2000 and 2003 when Harvard University accumulated shares of the Asia Tigers Fund which trades under the apropos ticker GRR. In January 2000, Harvard filed with the SEC saying it had bought 11% of the Fund's shares. At the time, GRR was trading at a 25% discount to NAV. By December 23, 2002, Harvard owned almost 23% of the fund's voting stock and was able to pressure the fund to offer managed distributions. By November 2003, the discount had narrowed to 7% and Harvard was closing its position.

As of December 31, 2004, AAM owned 9.4% of BTF. In 2004, the Board of Directors of the fund approved a managed distribution that is scheduled to begin in 2005. Although BTF still trades at a 13% discount to NAV, it is our hope that a managed distribution, which is a largely a return of capital, will gain SEC approval (we can't speculate about such things) and further close the gap to provide incremental return to shareholders.

TIMELESS WISDOM

It is always in the face of tragedy that we are jolted from our day-to-day routines and sensibilities. The horrific tsunami that struck Southeast Asia the day after Christmas 2004 is well documented. Amidst the devastation, it is only natural for us to seek perspective as we are reminded of our own temporal existence. We came across a passage from the Indian epic *The Mahabharata* that resonated with your advisor. In this abridged exchange, the departed father of Yudhishtira – leader of the Pandavas family – has returned to test his son.

TIMELESS WISDOM - CONTINUED

“What is the most valuable possession?”

“Knowledge.”

“What is not thought of until it departs?”

“Health.”

“What is the best happiness?”

“Contentment.”

“What makes one wealthy if it is cast away?”

“Greed.”

“And what is greed?”

“It is poison.”

“Who is in Hell, though he lives on Earth?”

“The wealthy man who neither enjoys himself nor gives to others.”

“What is it that men call good fortune?”

“This is the result of what they have done honestly.”

“Who is truly happy?”

“The man without any debts.”

“What is the rarest thing?”

“To know when to stop.”

“What is true wealth?”

“Love and kindness are better than gold; honor is more valuable than rooms full of jewels.”

At the end of this exchange, Yudhishtira’s father praises his son for his insight and proudly proclaims, “I came to test your merit, and I have found it true.”

CONCLUSION

We are happy to welcome Michael Mancino to AAM as a research fellow. He is an engineer by training, and joins us after many years working at U.S. Steel. (To paraphrase Sinatra, “If you can make it there, you’ll make it anywhere.”) Mike has rapidly become an important presence in developing internal investment research for the firm. He has all of the qualities we look for in a member of the AAM family.

We are currently beginning the process of giving a fresh look to alterasset.com and it should be completed by mid-year. As always we welcome your input which has been so helpful in the past.

The use of technology to create a more paperless environment for AAM, its friends, and clients, continues to be a significant initiative. Accordingly, beginning with the mid-year 2005 letter AAM will deliver your reports electronically using data encryption to protect the confidentiality of the information. If you do not wish to receive the report electronically or are not a comfortable user of email – drop us a line. You’ll have your report faster, you’ll always know where to find it, and you can print out the number of copies that are necessary for your family. We will also email tax information to your accountant which they will have in their possession by February.

CONCLUSION - CONTINUED

Speaking of taxes, there are changes in the IRS code to bring to your attention.

- IRA contribution limits have increased to \$4,000 for 2005. Catch up provisions allow those over 50 years of age to put away \$4,500.
- Deferral limits for 401k and 403b accounts have been increased to \$14,000 with a total catch up amount of \$18,000. The total contribution limit for these plans has been increased to \$42,000.
- Any big ticket purchases in 2004 or 2005? The IRS is allowing a sales tax deduction that is new for this year so save those receipts. Taxpayers will be able to deduct state and local general sales taxes instead of state and local income taxes as an itemized deduction. Please give us a call if you need assistance or clarifications with any tax questions.

Stephen has become a dad since we last wrote to you, and Grant Shueh has created quite a stir at world headquarters where he is a regular guest. If you have drool on your report, you know with whom to speak.

Charles Schwab has continued to effectively reduce trading costs for our clients over the years. Merrill Lynch has remained stagnate with their costs and we have not seen an increased level of service. We want to speak with you again this year about your custodial choices and make sure you understand the divergent cost differential between Schwab and Merrill.

In addition to AAM's privacy policy, a copy of Form ADV II is included for your review. Most importantly, review your investment policy statement and speak to us immediately if there are material changes in your financial life. We look forward to seeing and speaking with you all throughout the year.

Best wishes for 2005.



Howard Alter



Stephen Shueh



George Andresen