

---

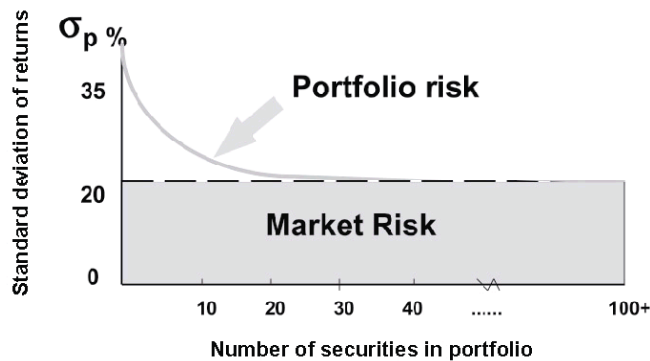
## The Long-Term Performance Advantage of a Focused Portfolio

Investment managers who have the skill to analyze a small number of businesses in detail and have the ability to identify low-priced, outstanding businesses should be able to outperform the market dramatically over the long run. Numerous studies have illustrated this advantage.

Many managers are afraid they might underperform the market, thus they choose to become “closet” indexers. The price they pay for this is the difficulty they face in trying to outperform the market. The issue is relatively insignificant when the market is up 15% or so, but when the market is down 37%, as it was in 2008, it becomes critical for a manager to have the tools and the investment strategy to outperform. KING has managed a focused portfolio since 1981—throughout a variety of economic and market cycles—and has been able to outperform the market handily over the long run.

Many portfolios are too diversified, exhibiting no governing tenet. In contrast, the stocks held in focused portfolios are comprehensively researched because they represent such a high percentage of the overall holdings. An overly diversified portfolio may convey a false sense of security on the premise that if the investment in one company does not work out positively, the overall consequences will not be significant. When that sort of rationale is extrapolated across many companies, however, and if several stocks underperform, the consequences can be much worse than when only one position in a focused portfolio does not perform well.

Numerous studies have demonstrated that most of the benefits from diversification occur with the first 12 to 15 stocks purchased, the incremental benefit then decreases significantly. The benefit of holding 20 stocks rather than 10 is not doubled, and certainly the return received by holding 100 stocks is not 10 ten times greater. In that context, it is difficult to see why a manager would concentrate the research, analysis, and effort required to find another 60 or so stocks when the diversification benefits per stock are so small for each one added.



Many successful investors have been long-time proponents of focused portfolios, Warren Buffet being among the most notable. Buffet believes that a portfolio should not own more than 10 to 12 stocks, and stated, “We believe that a policy of portfolio concentration may well decrease risk if it raises, as it should, both the intensity with which an investor thinks about a business and the comfort-level he must feel with its economic characteristics before buying into it.” He also has famously stated, “I cannot understand why an investor elects to put money into a business that is his 20<sup>th</sup> favorite rather than simply adding that money to his top choices—the businesses he understands best and present the least risk, along with the greatest profit potential.”

*(Continued on back)*

John Maynard Keynes, the celebrated economist, echoed these sentiments when he observed:

As time goes on, I get more and more convinced that the right method of investment is to put fairly large sums into enterprises which one thinks one knows something about and in the management of which one thoroughly believes. It is a mistake to think one limits one's risk by spreading too much between enterprises about which one knows little and has no reason for special confidence.

The problem with many investors, including Mr. Buffet, is that they have become too large in terms of assets to follow their own ideology. A firm such as KING can adeptly manage money using these principles.

A focused manager does not have to mirror an index. By having the same sector weights as the S&P 500, a manager is often increasing an investors' risk by purchasing assets that are expensive and/or stocks which are near their highs (i.e., financials were 28% of the S&P 500 at the end of 2007 and technology was 35% of the S&P 500 in 2000). Thus, while one might inherently believe that risks are reduced by mirroring an index, the actual result may be overweighting stocks with high valuations and underweighting those with more attractive, lower valuations.

Many professionals in the industry define risk as "tracking error" (i.e., a measure of how closely a portfolio follows the index to which it is benchmarked). Tracking error is not a good measure of risk on a stand-alone basis. As an active manager, our expertise involves prudently and successfully deviating from the benchmark (i.e., to outperform over the long run). This does not necessarily indicate that we are taking more risk. Managers with minimal tracking error are essentially passive managers attempting to mirror an index, and thus will not outperform the market over time.

While the market is fairly efficient over the long term, opportunities are created over the short term. A manager who is research-oriented can identify those opportunities and exploit their inefficiencies, leading to greater long-term returns for investors. If only 25 to 35 stocks are held, a savvy manager is able to take larger positions when those unique opportunities are afforded in the markets, thus rewarding clients with superior performance over the long term.