



Broadleaf Partners, LLC

The Land of Free Lunches September 1, 2011

In recent Economic Updates, we've spent some time discussing our investment philosophy and how we believe the three cycles – Economic, Innovation and Credit – influence investment value over time. We've recently concluded that the innovation cycle will become paramount to wealth creation in an environment of slow growth “for as far as the eyes can see” and when credit is relatively scarce.

At the same time, the economy and financial markets are fluid and dynamic. The situation can and does change. While scarce today, banks will eventually start lending again, changing the dynamics of a muted economic cycle. And while innovation is always an investable theme, in an environment where growth is scarce, such scarcity can also lead to situations where select groups of stocks become wildly overvalued as was the case for the Nifty Fifty in the 1970's and technology stocks years ago.

In a word, the world does change and at times, what may seem like a small, industry specific issue - like the housing bubble - may actually be something far more sinister, capable of bringing an entire world economy to its knees and permanently altering the retirement trajectories of an entire generation. One of the most difficult questions from a portfolio management perspective is trying to discern when changes are warranted based on new information that can't simply be dismissed as noise. Change made at the wrong time can be just as damaging to a portfolio as no change at all.

While our three-cycle investment philosophy helps guide us in **creating** an initial portfolio, the reality of a changing environment dictates the need for two additional steps in our investment process. The second step involves a strategy for **managing** the portfolio on an ongoing basis and the third lies in **critiquing** our results and the changes we've made. This last step, we believe, is highly unusual in our industry, but one which we believe fosters a firm wide culture that values an ongoing commitment to investment excellence. Mistakes are a given in investing, but not learning from systemic mistakes would be a failure.

History has taught us three general truths about the world that might be useful from a portfolio strategy perspective. One, over very long periods of time and across generations, free men and women tend to improve their lot in life. While this position may appear dubious to a first generation American settler that lost his family to Indian raids, I think we can all agree today that the decision to migrate was worthwhile.

A second truth may be that as free men and women, we remain deeply flawed. While technical advances, elitist academic theories, and the constant flow of new-fangled investment products sell us on the ill-conceived notion – perhaps at a subliminal level - that we've arrived in the Land of Free Lunches, bad stuff still happens. Heaven is not a place on earth. Rather than accept setbacks as the norm, we are repeatedly shocked and appalled when obstacles arrive at our doorstep, all too eager to blame it on something,

someone, or some political party, and then wait in hopeful expectation for some form of recompense, financially or legally.

The third related truth for investors is that you must enter the fray knowing that you will make mistakes and that they will at times be painful.

While we won't go into detail on the process we use for **managing** the portfolio on an ongoing basis – we'll cover that in another Portfolio Strategy update – we will repeat what we have said before. Managing a portfolio is a lot like caring for a garden; to ensure its long term health and vitality, one shouldn't be afraid to prune back strong growers, weed out the disappointments, and transplant new names as economic seasons change.

In recent weeks, our turnover has increased a bit, and with greater portfolio turnover the little voice in the back of our heads – and perhaps yours – may be asking whether or not we're confusing motion with progress. While our long term performance results have exceeded those of the S&P 500 over the last six years, we also want to know if the changes we've made have added value for our clients. In other words, would we have been better off doing nothing?

To that end, I'd like to briefly address what we mean when we say we actively **critique** our portfolio decisions as a third step in our investment management process. To keep it as simple as possible, any time we sell a name, we categorize that sale as a prune, a weed or a transplant and then track the performance of that sold name as well as the name we've bought both on an absolute basis and a relative basis, assuming any proceeds could instead be invested in the S&P 500.

For our clients, this means that we track on an ongoing basis the success or failure of each element of our buy and sell discipline, hoping to gain wisdom on the factors under our control and the courage to take action when matters might be improved. To date, the evidence suggests that each element of our buy and sell decisions is working to a varying degree, with the greatest absolute and relative gains coming when we add new names to the portfolio and when we sell or transplant names based on company specific fundamental concerns.

A great baseball player strikes out far more often than he gets on base. But a great baseball player also practices his hitting over and over again, often enlisting the aid of a hitting coach and analyzing film, particularly when faced with a slump.

As in baseball, strikeouts are unavoidable in the game of investing. At Broadleaf, while we embrace the notion that we will never be perfect and that there is always room for improvement, the tools we use to critique our decisions on a regular basis suggest that our process has added value and benefitted clients.

Kindest Regards,

Doug
Doug MacKay
CEO & CIO
dmackay@broadleafpartners.com

Mike
Mike Czekaj
Research Analyst
mczekaj@broadleafpartners.com