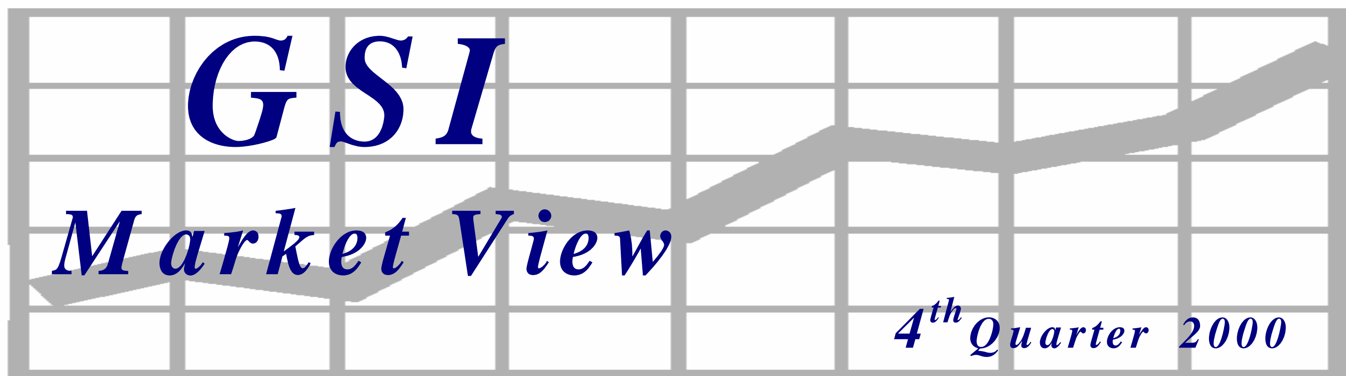


A recent interaction with one of our customers went something like this. *"Why did you sell part of my Cisco and Microsoft? They have been a couple of my best stocks. I think that these are great companies. They will go up dramatically over time. I just don't understand why you would sell them when they are doing so well."*

As an investment manager, Glenn and I wear many "hats." This is to say that we perform many functions relating to the investment management process. *One of these functions is to serve as an educator*. As and educator, we attempt to enlighten people in terms of why we do what we do and how it will benefit them in the long run. This is not always easy and is often met with a divergence in perspective from that of our customer. *Yet, it is our belief that we, as investment managers, must adopt a set of disciplines that we are committed to throughout the entire process*.

The theme of this educational session, outside the obvious "rich valuation" argument, *highlights the importance of diversification*. Diversification, as we view it, pertains to the allocation between stocks and bonds, the appropriate number of securities to be owned in each account and the overall "weight" or percentage any security should have relative to the portfolio as a whole.

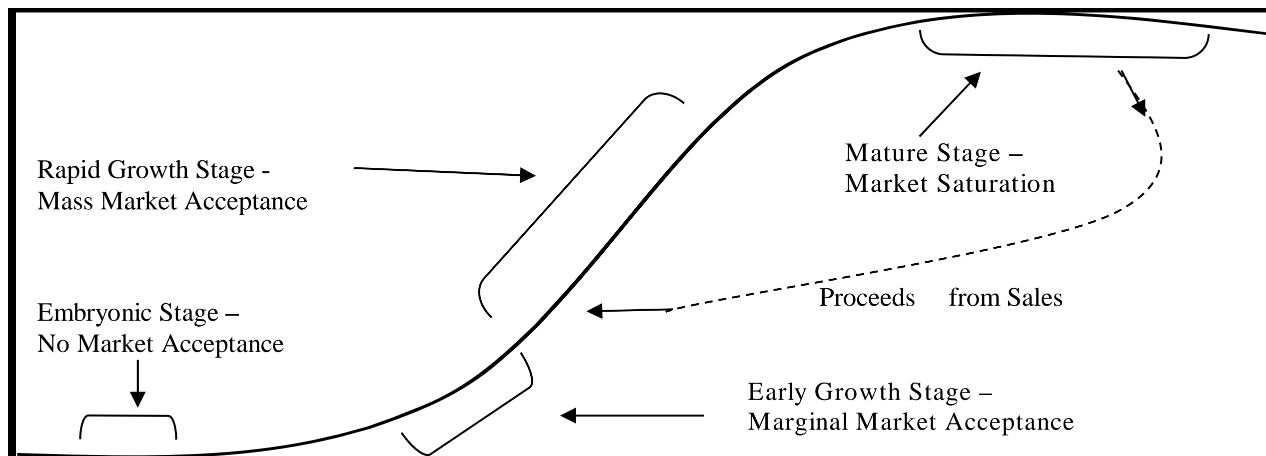
Back to our customer. I explained that although these companies have and may continue to do well, they had become too large relative to the rest of the portfolio. I went on to explain that when any individual stock represents more than 6% of the entire portfolio, it should be pared, in accordance with our discipline. These two companies, I explained, had exceeded that limit and needed to be cut back. In addition, I cited the fact these companies were extremely rich in valuation and that there was no cash flow in the account (it was an IRA Rollover Account) to use for additional security purchases.

A lengthy discussion ensued in which I again explained to our client the diversification argument and why we were merely sticking to our discipline. As we hung up, I felt that although my client understood me, *he might not have completely accepted our methodology*.

After further reflection on this incident, I thought it might be helpful to approach this from a different angle. *I thought that it might be useful to provide a "visual" approach regarding the types of companies that we buy, when we buy them, and when we might reduce our exposure in each security*. Although this might seem to be outside the scope of diversification, it might help to highlight the importance of it.

Despite the fact that Glenn and I are "balanced" managers (stocks and bonds are used in most accounts), we tend to spend most of our time on stock analysis and selection. Primarily, we are large-cap (big company), *growth stock managers. This means we tend to buy large companies that concentrate heavily on their "top line" (revenues*). Often we are asked, why do you buy what you buy? How do you know when to buy? How do you know when to sell? Answers to these questions can perhaps, be best explained by the chart on the back page.

Business Cycle



In this representation of the business cycle, we have identified four basic stages in the lives of a corporation. The first stage or **Embryonic Stage** is characterized by a technology or idea that is in its infancy. This means that although the technology or idea may have tremendous potential, much work is needed to bring it to a level of general market acceptance. *Most of the time, Glenn and I, although interested, don't buy companies at this stage of the business cycle as the risk often times outweighs the potential reward.*

The second stage of the cycle is *the* **Early Growth Stage** where there is only marginal market acceptance. It is here that these original ideas or technologies have survived the early tests of validity and are beginning to show promise regarding their potential prosperity and application in the marketplace. Again, Glenn and I don't tend to buy at the beginning of this stage. *We do however, try to identify companies here, putting them on a "watch list." This is done to gauge their progress as they attempt to secure initial market share.*

The end of the second stage and the beginning of the third stage or **Rapid Growth Stage** is critical. *It is here that leaders separate themselves from the pack and here that better than average performance results are generated.*

Eventually every company progresses to the **Mature Stage** of the business cycle where their products or services have saturated the market. At this point companies can either focus their attention on the on the expense side of the equation, expand product or service lines or attempt to remake themselves. *Although Glenn and I own some of companies in the Mature Stage, it is not our primary area of focus.*

So why do we buy what we buy and when do we buy them*? We are constantly attempting to identify those companies in the Rapid Growth Stage of the business cycle that will drive the account over time*. Companies like Cisco, Microsoft, Intel and Sun Microsystems have been the drivers of many of our accounts since our inception. And, although we continue to like these companies, we are always looking for the next technology or idea, after gaining market acceptance, that will drive our accounts over the next 5-10 years. Simply put, this is part of what we are paid to do.

Finally, why do we sell certain companies and how do we know when to sell them? *It is said that the beauty of the investment business is that it is not an exact science, except in hindsight. It is truly a form of art. By this we mean that there is no "perfect" time sell a stock. More often than not, Glenn and I try to identify those companies in the Mature Stage of the business cycle, making sure that they are not an overwhelmingly large part of the entire portfolio and using them, on occasion, to fund the purchase of companies in the Early Growth/Rapid Growth Stages*. Does this mean that we look to purge the Ciscos, Intels, Microsofts and Suns of this world when we feel that they might be entering the Mature Stage of the business cycle? Not at all. It is to say, however, that we pay careful attention to our diversification parameters at all times. One of our goals is to prohibit a single company from endangering an entire portfolio. *If we can effectively communicate this as a part of our overall investment approach to our customer base, we feel that another hat has been successfully worn*. Happy Holidays!

John & Glenn

GS Investments, Inc.
920 Second Avenue South, Suite 600
Minneapolis, MN 55402
(612) 371-0590
www.gsinvestments.com