

J. L. BAINBRIDGE

& C O M P A N Y, I N C.

October 2, 2006

Dear Mr. & Mrs. Client

Last month's letter discussed rearview mirror investing as a major cause of poor long-term results. This month's letter addresses the other major cause; fear of incurring losses. As cited by Dunbar Inc.'s "Quantitative Analysis of Investor Behavior" the average independent individual investor achieved an annual return of only 3.9% over the twenty year period 1986 through 2005 due mainly to these two factors. Fear of losing ones hard earned money is understandable given the media's constant hype of imaginary pending disasters and their coverage of high profile bankruptcies such as Enron. However, to achieve meaningful investment results, one must realize this fear causes just the opposite result and therefore one must set emotion driven actions aside and focus on owning quality companies with long histories of consistent double digit earnings growth, an exceptionally strong financial position and a dominant market position.

Fear of losing money can provoke panic selling an individual stock that is declining, as well as, liquidating an entire portfolio when the market is declining rapidly. In both instances short-term losses are converted to a permanent loss of capital. For example, in 2004 Cardinal Health's stock declined due to concern of an internal examination of accounting procedures and a related SEC inquiry. Our analysis of Cardinal's cash flow indicated fraud was not an issue and strongly recommended clients hold Cardinal's stock. Ironically on the day before the results of this examination were announced, a client called very upset because an analyst on television stated Cardinal is a junk company and should be sold. Based on our advice this client decided not to sell, and the next day when the results of their accounting review amounted to insignificant changes, Cardinal's stock appreciated 21% in a single day. Today the stock is over \$67 versus the low of \$36 two years ago. Unfortunately, a few clients did sell and incurred a permanent loss.

Liquidating a major portion of or a total portfolio is caused by media invoked fear that the "world is coming to an end." Seriously, the media hype has reached the point where fear is created when a relatively minor market decline occurs. In July of this year the market declined to a level 7% below the April high but only 1% below the level at the beginning of this year. This minor decline was magnified by the media into a bear market, that due to high fuel prices, rising inflation and a declining real-estate market would become catastrophic. The anxiety caused by media's constantly pounding drums of gloom is commonplace, but must be set aside in order to achieve good investment returns. Our 12.9% annually compounded return achieved over the past twelve years and nine months, which included the overall market decline of the past six and one half years, would not have been achieved without being fully invested throughout this entire period.

Jerry Bainbridge, President