

2004 CHUONG LETTER TO PARTNERS

YEAR	CHUONG	S&P500	+/-
1998	+68.0%	+26.5%	+41.5%
1999	-4.9%	+20.2%	-25.2%
2000	+18.7%	-10.7%	+29.4%
2001	+21.0%	-13.0%	+34.0%
2002	-1.8%	-23.3%	+21.5%
2003	+33.0%	+26.9%	+6.1%
2004	+26.2%	+8.9%	+17.3%

The partnership achieved a 26.2% return in 2004. This marks the fifth consecutive year that the partnership has outperformed the S&P 500 index. The partnership has also beaten the market in six of the last seven years.

In late 2004 the investing landscape became suddenly more risky as prices rose across the board with the S&P index climbing almost 9% in the final quarter. Such quick returns usually influence others to buy, pushing prices even higher, and increasing the subsequent risk of capital loss through over valuation. Although we hold solid cash-producing businesses in the portfolio, the partnership should expect to experience a more turbulent investing environment in 2005 due to continued over valuation. I will do my best to smooth out the bumps.

INVESTING SUCCESS

Investing success can be achieved in a number of different ways. The method adopted by an investor should suit his or her own personality. Benjamin Graham, the “Father of Value Investing”, practiced buying businesses at net net (yes, that’s two “nets”) value. The principle behind this method is buying stocks at prices at a fraction of current assets minus all liabilities. This method does not concern itself with the operation of a business as a going concern, but instead focuses on how much an investor would expect to receive in a liquidation or bankruptcy. Then, a lower-bound purchase price is set below this value in order to achieve what Mr. Graham coined as a “margin of safety”. If the company didn’t go bankrupt and the share price rose beyond a higher-bound target price, the position would be liquidated at a pre-determined profit and a new business (that fell within Mr. Graham’s strict parameters) would be bought to take its place.

Warren Buffett came along in the mid 20th century and was one of the first to suggest that Mr. Graham’s methods were similar to finding a cigar butt on the ground and trying to extract one last puff before discarding it. The problem was that once the last puff was taken, one would be required to scour the ground for another cigar butt, and so on and so forth. Mr. Buffett suggested an alternative approach to investing success. Instead of buying any business at a cheap rock-bottom price to sell it, why not buy a strong business at a fair price and hold it.

There are many benefits to Mr. Buffett's method. First, it is easier to make one intelligent "buy and hold" decision than it is to make a consecutive string of intelligent "buy and flip" decisions. Second, with less buying and selling there are less frictional costs to pay (i.e. taxes, commissions, etc.). Third, compounding can work its magic.

PARTERSHIP GOALS

Each year the partnership seeks to purchase the stock of consistently growing, publicly traded U.S. businesses, at reasonable prices. There are three fundamental features of a company that are used to realize this goal. First, a business needs to have a large shareholder acting as the CEO. In many cases, this shareholder is not only the CEO, but the founder of the business. Examples include: Steve Nichols of K-Swiss shoes, Jim Jannard of Oakley sunglasses, Pasquale Natuzzi of Natuzzi leather furniture, and Tom and Kosta Kartsofis, the brothers that run Fossil watches. Of course, simply having a CEO who owns over 35% of the outstanding common stock doesn't guarantee an exceptional return (nothing does) – it just improves the chances that the CEO's interests are the same as our own – that is to increase shareholder value.

The second important factor is the economics of the business. A prospective business must show predictable profitability over the course of 10 years or more. If the cash generated by a business is not predictable, it becomes difficult to decide what the business is worth. The partnership is not interested in businesses that have erratic, nonexistent or unpredictable cash flows.

The third and final characteristic is determining what the market wants us to pay. Price is the key deciding factor because it is the only variable over which a passive shareholder can exact some control. If you pay a high price for a great business, then you've decided that you have a longer time horizon, and are willing to hold the stock long enough in order to recover your initial investment. To illustrate this concept, let us assume that your buddy Joe has a pinball machine that he's set up at the local mall. This pinball machine routinely collects \$100 per year for Joe. Joe offers to sell you the pinball machine and asks you to come back to him with a price. If you offer Joe \$100 for the machine, you're basically telling him that you want to see your money back within the first year of operation. If you offer him \$100,000 you're telling him that you never want to see your money again.

Before you laugh at the thought of paying Joe \$100,000 for a pinball machine that produces \$100 a year, we should remind ourselves of the "irrational exuberance" of 1999 where "investors" were not only offering to pay a price thousands of times greater than what the businesses could earn, but to pay for businesses that didn't earn anything!

For those who are thinking that investing should be more difficult than this, let me assure you that the concepts of value investing really are as straight forward as described. Unlike Olympic diving, we don't get extra points for more complex dives (we may, however, crack our skulls from the attempt).

PORTFOLIO OVERVIEW

COMPANY	% OF PORTFOLIO
FOSSIL	36.2%
BERKSHIRE HATHAWAY	16.9%
K-SWISS	15.2%
NATUZZI	11.3%
CASH	12.0%
OAKLEY	6.7%
GENERAL EMPLOYMENT	1.7%

The following are brief descriptions of these businesses:

FOSSIL

2280 N. Greenville Ave.
Richardson, TX 75082

Fossil is in the watch-making business. They are a leading mid-priced watchmaker in the U.S. Two thirds of their revenues come from watch sales. Fossil brands include: Fossil, Relic, Giorgio Armani, Michael Kors, Donna Karan, Eddie Bauer and Walt Disney. Fossil also sells fashion accessories such as leather goods and sunglasses. Brothers Tom (chairman) and Kosta (CEO) Kartsotis own 40% of Fossil.

BERKSHIRE HATHAWAY

1440 Kiewit Plaza
Omaha, NE 68131

It is difficult to define Berkshire Hathaway. The company holds large positions in well-known companies such as Coca Cola, American Express, Gillette, and the Washington Post. They also operate large insurance and re-insurance businesses such as National Indemnity, GEICO, and General Re, and control wholly owned subsidiaries such as Dairy Queen, Kirby Vacuums, and Borshiem Jewelers. Berkshire Hathaway is currently holding tens of billions of dollars in cash, poised for a big acquisition. The “Oracle of Omaha”, billionaire Warren Buffett owns 40% of the company.

K SWISS

31248 Oak Crest Dr.
Westlake Village, CA 91361

K-Swiss sells shoes, apparel, and accessories. Their closest kin is shoe-giant Nike. K-Swiss was first introduced as an all-leather tennis shoe in 1966. K-Swiss manufactures a large number of their products in China and sells them in department retail stores primarily within the U.S., but in 30 other countries as well. Chairman Steven Nichols owns more than 90% of the company.

NATUZZI

47, Via Iazzitiello
70029 Santeramo in Colle, Bari, Italy

Natuzzi was founded as a small workshop in 1959. Formerly Industrie Natuzzi, Natuzzi is now the world's largest producer of leather furniture. It commands leading market shares in both North America and Europe. The company operates 15 factories in Italy and exports some 90% of its products to customers on five continents. In Italy, Natuzzi sells its goods through more than 130 franchised Divani & Divani stores. Founder/CEO Pasquale Natuzzi, along with his family, owns half the company.

OAKLEY

1 Icon
Foothill Ranch, CA 92610

Oakley makes sunglasses for the sports and fashion market worldwide. Its line of eyewear features high-tech designs, including interchangeable, high-clarity, damage resistant, optical lenses. The company also offers athletic shoes, watches, apparel, and accessories. Founder/chairman/CEO Jim Jannard owns 62% of the company.

GENERAL EMPLOYMENT

1 Tower Ln., Ste. 2100
Oakbrook Terrace, IL 60181

General Employment Enterprises specializes in finding permanent and temporary employment. The company provides both full-time employee placement and contract staffing. The firm places permanent employees for a fee based on a percentage of their salaries. Contract workers remain employees of the company, which bills clients hourly for their services. The family of chairman/CEO Herbert Imhoff Jr. owns about 11% of the company.

DISCUSSION

In 2004, the rapid rise of Fossil stock has caused it to become one of the partnerships largest holdings, commanding over 35% of the portfolio. Partners should be aware that Fossil may not always be irrationally priced in the future. Despite the price rise, there are no fundamental issues with the business (i.e. revenues and earnings continue to rise and debt is negligible). As such, the company remains in the portfolio. Fossil is currently experimenting with the Wrist Net watch which gives users access to email and the Internet.

Berkshire Hathaway's per share price remained relatively flat this year, increasing only 4.7% in 2004 due to concerns surrounding CEO Warren Buffett's age and ability to deploy the company's cash hoard (at last count, Berkshire had \$38 billion in cash and \$30 billion in short-term securities). Not helping matters, the company's insurance division was impacted by a series of natural disasters resulting in the worst year for the U.S.

insurance industry. Berkshire Hathaway is the longest-held stock in the portfolio and sells everything from vacuums and encyclopedias to jewelry and chocolate sundaes.

K-Swiss was added to the portfolio in the second half of 2004. The company has been unexciting in 2004, quietly selling its wide variety of athletic shoes. Q1 results released at the end of April reported an increase in revenues and earnings of 32% and 59.5% respectively. Q2 results released at the end of July reported a decrease in revenues of 4% and an increase in net earnings of 4.5%. Q3 results released at the end of October reported an increase in revenues and earnings of 12% and 37% respectively. The Q3 report goes on to state that there is a slight decrease in total (domestic and international) future orders going into Q1 2005. K-Swiss stock was added to the portfolio after the market responded badly to the lukewarm Q2 report, falling in price from \$27.50 to \$17.50 per share.

The partnership took notice in Oakley when CEO and founder Jim Jannard purchased 191,000 shares of Oakley stock for approximately \$2 million in August, 2004. Oakley achieved a number of milestones in 2004, including an exclusive worldwide agreement to manufacturer face shields for The Hockey Company (a Reebok subsidiary which operates under the CCM, JOFA, and KOHO trade names), Oakley is also the preferred eyewear vendor for the U.S. military, and negotiated, an as of yet undisclosed, business arrangement with Luxottica.

Natuzzi is a manufacturer of leather furniture. Over the last few years, after encountering stiff price competition, the company began moving its production facilities to low-cost regions such as South America and Asia – specifically Brazil and China. A third of the company's production will come from these countries, and it is expected that this percentage will increase. The price of Natuzzi stock has yet to notice these improvements - it increased only marginally in 2004. Natuzzi is one of the smallest companies in the portfolio with a market capitalization just shy of \$600 million.

A successful business is one that is continually increasing shareholder equity. However, increases in shareholder equity should always be compared to increases in share price (or market value). The risk of capital loss increases for every year that the increase in share price exceeds the increase in shareholder equity.

To illustrate this, let us take a look at Fossil as an example. The following is a table outlining Fossil's price and shareholder equity performance since 1996:

Year	Fossil equity	Fossil price
1996	\$ 74.6	\$ 2.54
1997	\$ 95.3	\$ 4.78
1998	\$ 134.9	\$ 8.79
1999	\$ 191.2	\$ 8.64
2000	\$ 220.7	\$ 8.58
2001	\$ 264.0	\$ 10.41
2002	\$ 340.5	\$ 12.33
2003	\$ 423.4	\$ 19.30
2004	\$ 487.6	\$ 25.00
Annual Growth Rate	26.4%	33.1%

The equity value is in millions of dollars and the price is the split-adjusted price per share. The chart shows that the percentage increase in Fossil's share price has been roughly similar to the increase in Fossil's shareholder equity.

The risk of capital loss increases as the increase in price begins to diverge from the increase in shareholder equity. If, for example, the price of Fossil's stock begins to increase at 60% annually, this signals the uncoupling of price from business performance. If this occurs on a prolonged basis, it is possible for the stock to suffer a catastrophic price decline even though there is no fundamental problem with the business. In our previous pinball analogy, this would be akin to the pinball machine (generating \$100 per year) dropping in price from \$100,000 to \$10,000. This would represent a 90% loss in price even though there is no problem with the business.

However, sometimes the exact opposite can happen. That is, the growth rate of shareholder equity may far outpace the growth in price per share. In fact, there have been instances where there is a price decline even though shareholder equity has increased! The most popular large-scale examples include 1973-1974, 1987, and more recently, 2000-2002. Indeed, the best time to be a net purchaser of stock is during sharp price declines that mask the increases in shareholder equity of an underlying business.

Now, before you go thinking that investing is all roses, consider why such a contrarian strategy is so difficult to employ: you need to buy when everybody else is selling. That is, to buy when the price is declining, sustaining losses over a period of time. Having done this in the past, I'll tell you that it's not a walk in the park - even when you know that shareholder equity is increasing. However, as long as you haven't leveraged yourself beyond your means, and you can wait for a recovery, there will be light at the end of the tunnel when the panic subsides and investors once-again recognize the value of a consistently growing business.

The 2005 year will be very challenging as the market takes away opportunities with increases in prices. Although prices are not as irrational as they were in 1999, they are by no means cheap. With the 9% run-up in Q4 2004 many business have become fully valued if not overvalued. Cash becomes more and more attractive as prices continue to rise. I will look for opportunities to add to our positions during periods of weakness and intend to move forward as I have in the each of the last seven years – slowly and carefully, adding, on average, only one or two cash generating businesses per year. However, looking at the companies in the current portfolio I do not anticipate that any new businesses will be added in 2005.

Chuong Investment Management seeks to outperform the S&P500 by purchasing the stock of consistently growing, publicly traded U.S. businesses, at reasonable prices. The Partnership has outperformed the S&P500 index in the last five consecutive years and in six of the last seven years. Jim Chuong, general partner of Chuong Investment Management, has been featured on the CBC Money Show, The Globe and Mail Report on Business, and other business publications. MoneySense Magazine will be interviewing Jim Chuong in April 2005 for a summer feature entitled, "Canada's Best Small Investors". This will be Jim's second interview with MoneySense Magazine. For a look at the Partnership's record vs. the S&P500 index along with the aforementioned interviews, please visit: <http://www.ticonline.com>.

© Copyright Chuong Investment Management