



Sigma Summaries

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Shopping for New Ideas

One of the most frequently asked questions we receive is: "How did Sigma decide to buy the stocks in my portfolio?" While there are many different answers to that question, we decided to review one of our more recent purchases to give you some insight into our process. The company we have chosen to review is a specialty retailer, Williams-Sonoma, Inc. (WSM).

Within Sigma, each portfolio manager is also a member of our Investment Committee. Ideally, when we vote on a particular action, we hope that the decision is unanimous. When there is a split decision, the majority vote will typically win although our Chief Investment Officer (Roger Steed) and President (Bob Bilkie) have the authority to overrule the decision.

Each member of the Investment Committee is responsible for following specific stocks, both in our model portfolio and those that we are researching for future consideration. While research assignments are very fluid, it is common that each portfolio manager specializes in specific sectors. For example, I follow most of our retail stocks.

One of the ways we generate new ideas is by starting with something we are very familiar with. I love to shop. There is almost nothing else that I would rather do than spend an entire day shopping. It does not matter if I

am in a Neiman Marcus or a Dollar Store, I am happy. I sometimes do feel guilty spending money on what some would refer to as frivolous. However, I have found I rarely feel guilty when I am buying something for my home. I can easily justify buying new towels (for guests to use, of course.) It is much harder to justify buying an adorable new Louis Vuitton purse.

Many people are choosing to spend more time at home. This is somewhat due to the lingering effect that the September 11 terrorist attacks have had on travel habits. Since more time is being spent at home, people are motivated to improve their surroundings. At the same time, 2003 was a record year in the housing market and it still appears to be going strong. More and more people are buying second homes, and new furniture to fill up these houses. Therefore, I was compelled to look further into the home furnishings industry and was led to Williams-Sonoma, Inc.

In 1956, Charles Williams founded Williams-Sonoma, Inc. with the opening of his first kitchen store in Sonoma, CA. With the addition of the Pottery Barn stores in 1986 they have branched from a seller of just kitchen supplies to a more complete company that includes items for the living room, bedroom, and bathroom. Their vision is to "own the home", in other words to be the first place you go when you

need to buy something for any room in your home.

Williams-Sonoma, Inc. is well diversified across product lines as well as demographics. In addition to their flagship Williams-Sonoma stores, their brands include Pottery Barn, Pottery Barn Kids, Hold Everything and West Elm.

Presently there are 242 Williams-Sonoma stores. They sell everything one would need to outfit a kitchen. Their products range from wooden spoons to wine glasses and from mid to premium priced goods. Recently I visited one of their stores because I was thinking of buying an espresso maker. The \$799 automatic model looked like a good deal sitting next to the \$2,199 fully automatic top of the line espresso maker. I did not end up buying one that day, but I did buy one of their new heatproof spatulas and two new cookbooks as gifts.

There are currently over 150 Pottery Barn retail stores and 98 million Pottery Barn catalogs are distributed each year. They feature a large assortment of items in casual home furnishings, flatware and table accessories that are designed internally and sourced from around the world.

In 1995, the company noted the substantial sums that consumers spent on their children. Pottery Barn Kids was developed to meet the growing

demand of children's furnishings. The company first introduced the line through catalogs. In locations where the catalog was well received, they began opening stores. Williams-Sonoma, Inc., now believes they can expand the Pottery Barn Kids brand from 57 stores today to at least 200, and their target is to open 20 kids' stores in 2004.

The Williams-Sonoma and Pottery Barn divisions are targeted at a somewhat wealthy demographic, and the newly launched West Elm is having initial success with a younger, less affluent demographic. West Elm sells moderately priced furniture aimed at twenty and thirty-somethings, and is currently available by catalog only. The company plans to open West Elm stores in 2004 that will be located in areas most receptive to the brand. It will be opening the first retail store this month in Dumbo, Brooklyn (it really is a place.)

After becoming comfortable with the basic fundamentals of the company, we investigate many different issues when researching a company as a possible investment. We look at what is driving the company's growth. Williams-Sonoma's growth is coming from new stores being built (square footage growth) as well as the existing stores selling more merchandise. The company believes its square footage can grow 11-13% a year. It also believes existing stores will be able to

increase sales 2-4% a year. Direct to consumer, which includes catalog and website sales, currently accounts for approximately 36% of total sales and is growing at a rate of 9%.

We also review the company's competitive advantage(s) and whom it competes against. While the home furnishings industry can be an intensely competitive industry, a large percentage of WSM's merchandise can only be bought at a Williams-Sonoma's store even though there are now substitutes as their products are often imitated. Williams-Sonoma's main competitive advantage is its merchandising expertise. The company has continuously set the trends in home furnishings.

Even with good growth potential, one of the most important considerations is the risk associated with investing in the company. In other words, what could go wrong? The biggest risk we see with Williams-Sonoma, Inc. is the prospect that the company does not keep up with consumer trends. The West Elm and PBTeen brands appear to be well accepted and each company is careful to test market its products prior to introducing them. Another negative could be a rise in interest rates. Mortgage rates have recently hit all time lows, and if they begin to rise considerably we could see the housing market begin to weaken. Williams-Sonoma, Inc. realizes this and is focusing more on seasonal and

accessory type items to mitigate this risk. At Pottery Barn, they are able to convince shoppers to buy a neutral colored sofa, for example, with new pillows and throws for each season. And while Christmas related merchandise has always been a good seller at Williams-Sonoma, it now also emphasizes Halloween, Easter and Fourth of July related merchandise.

We complete a thorough review of the company financial reports including the income statement, balance sheet and cash flow statement. Other issues we look at include the depth and breadth of management, corporate governance, demonstrated effective execution, and brand recognition.

We also do comprehensive valuation work to help us determine an attractive price to buy the company's stock. A company may look like a great idea, but if every other investor also thinks it is a great idea, that could already be priced into the stock. Our goal is to try and find companies that are good investments early, before anyone else discovers that they are good investments.

After reviewing Williams-Sonoma, Inc.'s fundamentals, financials, and valuation we purchased the stock as a long-term holding in our client's portfolios.

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