QUARTERLY REPORT

First Quarter 2005

The year began sluggishly with both stocks and bonds turning in negative first quarter results. The Standard & Poor's 500 index declined by 2.15% in the year's first three months. The Lehman Brothers Intermediate Government Bond index fell by a smaller 0.68%. On the plus side of the ledger, 91-day U.S. Treasury Bills gained a meager 0.64%.

Further distressing was the slowing of stock market momentum in the first quarter compared to the market trading strength evident in 2004's closing quarter. Despite the Dow Jones and Standard & Poor's averages breaking to new 52-week highs in early March, measures of market price momentum declined from their 2004 levels. Such a divergence often precedes stock market declines, and a significant decline did indeed follow the early March highs.

An old saying on Wall Street is: "As goes January, so goes the market." If the saying holds true in 2005, it does not bode well for stock returns through the rest of this year. Stocks declined in January, the S&P 500 by 2.5% and the more volatile NASDAQ Composite by 5.2%. While the January indicator is hardly infallible, it has a pretty good batting average, correctly forecasting the full year's market direction about 90% of the time since 1950. In post-presidential election years, like 2005, market behavior in thirteen of the past fourteen Januarys has accurately forecasted the full year's direction. Since 1950 twenty Januarys have seen declines. From the end of those twenty declining Januarys, the market fell on average another 13% to its low for the year. If this year mirrors the pattern following the past twenty declining Januarys, a double-digit market decline would be necessary to bring stock indexes to their lows for 2005.

The fading stock market received no support from a similarly weak bond market during the first quarter. The Federal Reserve Board continued its year-long pattern of raising short-term interest rates at a "measured pace." Treasury bill rates jumped from about 2.2% at year end to about 2.7% at the end of the first quarter, bringing to mind another old Wall Street adage: "Don't fight the Fed." Historically both stocks and bonds have struggled while the Fed is raising rates.

We continue to encourage patience of long-term investors. Notwithstanding periodic rallies, we believe that stocks continue in a long-term weak cycle that began in 2000 and, if this cycle proves to be of average length, may continue for another decade or so. We have detailed the two-century old pattern of alternating weak and strong stock market cycles in prior letters. During the seven long weak cycles in the nineteenth and twentieth centuries, stocks provided a total return approximating the rate of inflation.

We have recently expanded our research into the three long weak cycles of the twentieth century. Surprisingly, those three weak cycles covered just over 54 years, more than half of the century. Even more surprisingly, unmanaged risk-free cash equivalents outperformed common stocks over those same 54 years. Few people believe this. It runs completely counter to what we know from our own experience and what we have been told by investment consultants and investment managers for years.

Why does such a misperception exist? First, most people don't know the facts. In the long-term data, managers and consultants typically lump together weak and strong cycles and present the combined average as statistically relevant. According to such studies stocks apparently always beat cash. But when the average weak cycle is about a decade and a half in length, computing average performance for both weak and strong cycles together grossly oversimplifies the combined results' relevance for all long-term considerations.

Second, prior to the year 2000, very few of today's investors had any personal experience of a lengthy period in which cash equivalents outperformed common stocks, the most recent of which lasted from 1966 to 1982. As is the case in so many aspects of life, that which we have not personally experienced is rarely a major factor in our decision-making. On the contrary, that which has been familiar and consistent, especially over long periods of time, becomes ingrained and shapes our expectations and behavior. So strong was the stock market's performance through the decades of the 1980's and 1990's, that it became doctrine that the only way to structure a sound long-term investment program was to include a significant, permanent equity component. Despite the fact that cash equivalents have done markedly better than equities over the past five years, most investors simply see this period as a surprisingly lengthy interruption to the inexorable march of stocks to much higher levels.

That belief and that pattern of investor thinking are nearly identical to those of investors early in the last long weak cycle. From 1949 to 1966 stocks were nearly as strong as they were from 1982 to 2000. Consequently, investor expectations in the late-60's were huge and the period spawned a few bubble-type investor activities, although nothing quite so bizarre as the Internet craze of the late-1990's. Stocks' underperformance of cash equivalents for several years at that time was simply viewed as an aberration. While some investors were chased from stocks during the 35% decline in 1969-70, most stayed heavily committed to equities. By the time the 1973-74 45% stock market crash neared trough levels late in its second year, however, huge numbers of individual investors and institutional trustees had lost their enthusiasm for common stocks. Equity portions of portfolios were dramatically reduced from their former weights.

Today's investors are very much in the time phase and mind-set of the investors in the late-1960's and early 1970's. If this long weak cycle unfolds like most of its predecessors, we face at least one more serious stock market decline that will likely demolish the positive outlook for stocks held by most individual and institutional investors. U.S. stock market history tells us that no prior major decline has ended with the majority of investors still optimistic about the prospects for stocks. Almost certainly the current long weak cycle will not end until most investors have once again lost their belief in stocks as the investment for all seasons.

We are certainly not arguing for an abandonment of equities. We are arguing, rather, that a blind belief that portfolios should always maintain significant equity holdings will probably prove counterproductive. In the years immediately ahead we believe that employing strategic opportunism will outperform the more traditional approach marked by relatively fixed allocations to the major asset categories.

Over the very long-term, investors are best served by overweighting equities when stocks are undervalued and underweighting them when stocks are overvalued. By virtually all time-tested measures of value, stocks today are still seriously overvalued compared to all but the bubble years of the late-1990's. That is the fundamental picture.

Over somewhat shorter periods of time, concentration on investor psychology rather than basic fundamentals provides greater insight into probable market direction. In other words, it's not so much economic growth or corporate earnings growth, but rather investors' (speculators') perceptions and anticipations of these factors that best identify short and intermediate term market moves. Susan Ernsky and I will both address various aspects of investor psychology and its effects on markets in our upcoming 22nd annual investment conference.

We continue to anticipate that the investment environment in the period ahead will be difficult and fraught with danger. We will attempt to maximize the return on relatively risk-free investments and look diligently for strategic opportunities to earn larger returns in risk-controlled short to intermediate term speculations. We look forward to future opportunities to buy large numbers of common stocks at far more attractive valuations than exist today.

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