



QUARTERLY REPORT

Second Quarter 2003

Through the second quarter of 2003, investors experienced the fifth significant stock market rally since the bear market began in 2000. We know in retrospect that the first four rallies provided profits only for successful traders. Those four failed rallies notwithstanding, a great many market participants are more excited about the prospects for the current levitation. While this rally could continue to progress, we strongly suggest that the only long-term beneficiaries will be traders who take profits before the next major decline begins.

Our concerns about longer-term stock market danger are nearly as acute as they were in the late 1990's. Once again we want to make the case that following the commonly accepted investment paradigm of remaining fully invested in relatively fixed asset allocations could lead to once in a lifetime destructive losses. Many market, economic and monetary conditions today are weaker than ever before in U.S. history. To continue to pay among the highest ever prices for a dollar of earnings, dividends or book value is to take a huge risk that these valuation measures will not soon revert to their historic norms, as they always have in the past.

It is very difficult for most people to imagine events outside their life experiences. With two decades of nearly unblemished stock and bond market rises before the last three years of stock declines, almost none of today's investors, or portfolio managers and consultants for that matter, has lived through an extended period of portfolio losses. On the contrary, experience after experience has reinforced the lesson that investors should buy more on every market decline. Lessons learned over decades are not forgotten quickly. Despite having just experienced the worst stock market decline since the Great Depression of the 1930's, investors today are more worried about missing the next bull market than of losing more money. As we outlined in detail at our April client conference, investor mindset is the antithesis of that which has characterized every major bear market bottom in U.S. history.

After three years of significant declines, stock market investors are weary of declines and are ready for relief from the pressure of losses. This helps to explain the level of optimism that has quickly come back into sentiment surveys during the recent rally. Almost 24 hour a day financial coverage by networks which stand to benefit more from bull markets than bear helps to provide fuel for such optimism. An administration that wants to retain power next year will continue to try hard to paint as rosy a picture of hope as it believes will be accepted. The Federal Reserve, which perhaps understands more clearly than most the ramifications of failing to revive the economy soon, continues to offer the same hope for a business turnaround that they have voiced for the past few years. Obviously, the Fed's earlier stated reasons for hope have been, if not wrong, at least premature.

An interesting observation about the second quarter's stock market rise is that, contrary to typical market experience, stocks with very high price to earnings ratios did far better than those with lower PE's. Companies with no earnings at all did even better than either of the other two groups. Such a phenomenon occurs from time to time, and it typically occurs when traders hold sway over investors, as they clearly have recently. In fact, relatively few true investors remain involved in markets. Over the past generation they have been replaced by investment managers who have been pushed by the consulting fraternity and their own unwillingness to venture too far from the safety of the broad middle into benchmarkers and indexers. The great fortunes built over the years from benchmarking and indexing have largely been those of the managers, not of the customers.

The great enduring fortunes accumulated over decades in securities came not from benchmarking and indexing but from recognizing value wherever it exists. More often than not that has been in stocks. There have been, however, many multi-year periods in which stocks have become extremely overvalued, and in which the best rewards have come from bonds or even cash equivalents. In simple terms, the lesson of history is to buy value when it is available, and not to force purchases to meet a fixed asset allocation level when value is absent.

By all traditional valuation measures, value is clearly not present today. The *Wall Street Journal* shows the price to earnings ratio of the S&P 500 to be 32 times trailing 12 months earnings. Curiously they show the forward looking PE to be 19, and most analysts interviewed on television or in the press prefer to use that number. The fact that most of them have been employing such an unrealized PE valuation for the past few years hasn't dimmed their current enthusiasm, at least in public. There is an undiscussed irony, however, in their use of that less egregiously overvalued PE multiple. Virtually nobody expects the earnings of the S&P 500 to grow by 70% over the next 12 months, yet *simple mathematics demands such a 70% earnings increase to reduce the current 32 PE multiple to the projected 19.*

This discussion ignores the dirty little secret about earnings quality. Through the stock market's boom years in the late 1990's, and even beyond, companies became bolder and bolder in categorizing expenses as "extraordinary," thereby excluding them from the computation of earnings. Snide comments were common about many companies' "annual extraordinary." The Standard & Poors Corporation and others are eager to provide investors with a clearer picture of what corporations actually earn. The major revisions revolve around expensing options and providing an accurate picture of corporate pension plan conditions. Various analyses of the effects of such accounting changes suggest cuts in reported earnings of from 20% to 40%. The current PE multiple for the S&P 500 is already above that of market multiple levels at the peaks of history's great bull markets. Current accounting investigations are suggesting that the historical PE disparity is even more severe than it appears.

If buying or holding large amounts of common stock at these levels represents good investment value, as opposed to speculative value, we would logically have to be looking forward to the most compellingly attractive business and corporate profit prospects in history. Why else would market participants be willing to pay close to the highest prices ever for those profits? Is such a rosy scenario a realistic expectation?

In the market decline from the 2000 peak, profits for the S&P 500 companies were roughly cut in half. This was the worst profit decline since the 1929-32 period. In the most recent five quarters we have experienced a recovery of a small portion of those earlier earnings losses. While investment analysts, who have a vested interest in being bullish, have remained steadfastly optimistic, very few corporate CEO's have yet pointed to a growing flow of new orders. Profit growth remains sluggish.

The expectations for improved corporate profits have been based for the past few years on several factors. Prime among them are: low inflation, low interest rates, and a strongly accommodative Federal Reserve. Those conditions have prevailed throughout most of the three-year bear market yet have not prevented the halving of the profits of S&P 500 companies.

It is clear that during the term of this bear market very few companies have been constrained by either inflation or interest rates. It is unlikely that even lower rates would have any appreciable effect on corporate profits.

For decades most investors have had implicit faith that an accommodative Federal Reserve could ultimately rescue both the U.S. economy and our equity markets. While that faith has typically been well founded, the Fed's staunchest efforts failed to prevent this country's most destructive 89% stock market decline from 1929-32. Is it possible that the Fed has similarly lost control in the current situation? With interest rates at 50-year lows, at the very least the Fed has limited ammunition remaining. Thinking people had to react with shock last week at the voice of the Federal Reserve Chairman pointing to strongly inflated home values as a possible continuing source of spending money for a historically overindebted consumer. No responsible financial advisor would advocate such action, yet the head of this country's central bank is implicitly condoning such increased borrowing at a macro level. Perhaps he understands all too clearly that if the consumer doesn't continue to spend in earnest, this economy will not bounce back, and the mountain of debt at the consumer, corporate and government levels may begin to crumble. The long-term consequences would be devastating.

It is in this uncertain economic environment that investors continue to pay more than \$30 to buy \$1 of earnings in the companies that comprise the S&P 500. That has never before been profitable over the long term. Not even the most optimistic stock market prognosticator believes we are in a strong economic environment. All we have is hope and the knowledge that many conditions that normally lead to economic progress are in place, as they have been for the past few years. One marvels at the faith that bullish investors exhibit when they are willing to pay more for corporate earnings than almost ever before in an environment in which corporate insiders are selling their companies' stocks more aggressively than at any time since 1986.

We remain sanguine about the prospects for neither stocks nor bonds. While short-term rallies could occur in either asset category, the dangerously weak U.S. dollar poses a significant longer-term danger for both stocks and bonds. Recent statistics showed foreign investors holding 17% of all U.S. common stocks and a mammoth 42% of all U.S. Treasury debt. Having endured in the past year a 20% decline in the U.S. dollar compared to a basket of the world's currencies, foreign holders will be increasingly less tolerant of continued dollar weakness. The Treasury and the Federal Reserve, however, are obviously more intent on preventing deflation and

rekindling the U.S. economy than on supporting the dollar. Should foreign patience for a sinking dollar run out to any significant degree, the volume of selling of U.S. securities to repatriate funds could be huge, potentially penalizing both our stock and bond markets.

The confluence of both massive debt levels throughout our economy and a seriously weakened dollar are unprecedented and create a dangerous uncertainty about how our investment markets will progress over the next several years. In a dangerous environment, prudent investors should logically pay less for the ownership of stocks or bonds. Puzzlingly, today's investors are eager to pay far more for both than nearly ever before. Curious in the extreme.

Where we are charged with the asset allocation responsibility, we are lightly invested in equities, simply because we are finding very few with growing earnings that are selling at attractive levels of valuation. Because we believe that intermediate and long U.S. interest rates are more likely to rise than fall, we have no exposure to bonds with maturities beyond three years. We have the bulk of client assets in cash equivalents and government and agency securities laddered out as far as three years. Some of those are Canadian Government bonds and guaranteed Australian CDs. We have benefited nicely from exposure to the currency strength of the Canadian and Australian dollars relative to the weaker U.S. dollar. About 20% of clients' portfolios stands to benefit if the U.S. dollar continues to weaken, as we expect.

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