

QUARTERLY REPORT

Second Quarter 2004

The stock market continued to meander during the second quarter with most market indexes ending both the quarter and 2004's first half up by low single digits. Those meager gains have been given back in the early weeks of the third quarter.

As interest rates rose in the second quarter, bonds lost enough ground to take away all gains since mid-year 2003. Holders of all but very short maturity bonds have realized a negative total return over the past twelve months. Because we have anticipated rising interest rates, we have recently held no bonds with maturities beyond two or three years. Intermittent rallies notwithstanding, we believe that the likely course of interest rates over the next few years will be up. Until rates rise to those more attractive levels, ultimately leading to bond yields worth buying, patience will be rewarded. While we do not expect that to occur in the next quarter or two, we remain alert for opportunities to buy bonds to hold for a year or more, should interest rates spike rapidly higher in the near-term for any reason.

More important than trying to anticipate the shorter-term trend of stocks is to focus on the broader picture that identifies "investment" rather than "trading" opportunities. As we have explained over many years, we know from our studies of more than a century and a quarter of data that there is a very clear correlation between the price investors pay for corporate earnings and the returns they may expect to earn. We know that purchasing a stock at a level below its average historical price-to-earnings ratio increases the probability of profit and reduces the potential for loss. Conversely, purchasing a stock at a level above its average historical price-to-earnings ratio decreases the probability of profit and increases the potential for loss. Unfortunately, despite the strong corporate profit growth of the past year, very few companies are selling at below average price-to-earnings levels. Expected long-term market performance from current levels is not good.

Contributing to the unattractive equity investment environment is the market's position in the very long pattern of alternating weak and strong cycles. Throughout the 19th and 20th centuries, as seen on the accompanying table, stocks have moved back and forth between periods of market strength and weakness. That probably surprises no one. What is almost unknown, however, even among investment professionals, is how long these cycles have lasted. The average length of both weak and strong cycles is about 14 years. Each cycle includes a few or several mini-bull and mini-bear markets, but only in the strong cycles do the bull phases ultimately lead to higher real returns.

Long-term U.S. Stock Market Cycles Inflation Adjusted Total Returns

WEAK CYCLES		
Time Period	Real Annual Total Return	Duration
1802 – 15	+2.7%	13 years
1835 – 43	-0.6%	8 years
1853 – 61	-3.0%	8 years
1881 – 97	+3.9%	16 years
1902 – 21	+0.0%	19 years
1929 – 49	+0.8%	20 years
1966 – 82	-1.4%	16 years
STRONG CYCLES		
Time Period	Real Annual Total Return	Duration
1815 – 35	+10.0%	20 years
1843 – 53	+13.7%	10 years
1861 – 81	+12.0%	20 years
1897 – 02	+15.2%	5 years
1921 – 29	+25.2%	8 years
1949 – 66	+14.0%	17 years
1982 – 99	+14.9%	17 years

Since 1802, the inflation adjusted total return has averaged 7.08%.

Source: Robert Powers

The 20th century saw only three weak and three strong cycles. The most recent strong cycle from 1982 through the end of the century was the strongest very long cycle in U.S. history. Without question the market began a new weak cycle in 2000. The initial two and one quarter year decline was the worst since the collapse from 1929-32. The strong market rally from the lows in 2002 and early 2003 has rekindled great investor enthusiasm for stocks. From a long-term perspective we believe that confidence to be unfounded. For several reasons we believe that in retrospect we will identify that rally as a mini-bull market within a much longer-term weak cycle.

The nearly two decade long strong cycle that ended the 20th century resulted in greater excesses than ever before in U.S. history. It is highly unlikely that such excesses would be unwound in less than three years.

The most recent four weak cycles dating back over a century and a quarter lasted 16 years, 19 years, 20 years and 16 years respectively. There is no logic to expecting the greatest ever strong cycle to be corrected in about one quarter of the time of a typical weak cycle. In all likelihood this weak cycle will continue for years to come with additional mini cycles in both directions.

It is instructive to note that during the three weak cycles in the 20th century, risk free cash outperformed stocks over the full 55 years. Buying and holding a diversified portfolio of common stocks was not a wise course of action. Because there were periodic stock market rallies in each of the weak cycles, however, the potential existed for returns above those of a buy and hold strategy. That requires a successful trading strategy, which is rarely successful in the long run, or a strategy of unemotionally buying good quality stocks when they are historically undervalued and unemotionally selling such stocks when they reach their historical fair value. That is the strategy we employ, which results in owning greater percentages of stocks when valuations are attractive and smaller percentages when valuations become stretched. Such a valuation-based selection and sale approach takes emotion and forecasting out of the investment

equation. If such an approach is to be successful in the long run, however, great patience is required through those periods in which markets remain seriously overvalued for a number of years. That has been the condition of the U.S. equity markets since the late-1990's. While our clients' portfolios did not participate heavily in the 2003 stock market rally, each client portfolio has earned a positive return over the past five years during which the S&P 500 has lost a compounded 2.2% per year. We anticipate that our continued disciplined approach will reap further benefits in the years ahead. Any significant decline in prices will undoubtedly lead to the purchase of far more common stocks at much more attractive levels of valuation.

There are many ways to measure stock valuations. By virtually all such measures, stocks are currently at levels typical of the great market tops of the past century. They are more than double the levels of that century's great market bottoms. That supports the probability that this long weak cycle will play out as have its predecessors of the past two centuries.

There are two unique conditions that imperil the prospects for stocks even more today than in cycles past. The combined debt of individuals, corporations and government is greater today in relation to the size of the economy than ever before in U.S. history. This level of debt creates an unprecedented degree of vulnerability whenever the next recession begins. Additionally, the U.S. and foreign economies are functioning for the first time in history in an environment in which terrorists have an avowed intent to disrupt the world's major economies and to kill large numbers of people who do not share their views. Insurance companies have priced the risk of "successful" terrorist activities into their policies. At current levels, the securities markets have not even remotely factored in the potentially destructive effects of terrorism.

None of this dictates the course of the stock market over the next few weeks or months, but it may have a huge effect over the next few years. What is unknowable is precise timing. What we know clearly is that over a multiple-year time period the risks in stocks are extremely high relative to the potential longer-term rewards. We remain ready to buy either stocks or bonds in greater amounts as they fall into ranges of good valuation. That could occur rapidly, but we must remain patient if it doesn't. Short-term risk free yields are rising, which will increase portfolio yields while we wait for more attractive stock and bond valuations. We will also remain open to the potential offered by such non-traditional investments as foreign government bonds denominated in their own currencies as well as gold or other inflation-countering investments.

Thomas J. Feeney
President
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