



QUARTERLY REPORT

Fourth Quarter 2002

In the worst investment environment since the Great Depression of the 1930's, we are extremely pleased to report that our portfolios escaped damage and actually grew in 2002. Even more remarkable, every client that has been with us for the past three years has had a positive portfolio return in each year of this bear market. Even our common stock returns have been positive in each of those three loss-riddled years. While there is probably another investment management firm somewhere who can make that claim, we haven't heard of it.

The economic fallout to the bursting of the 1990's stock market bubble has been massive. At the market's October low about one half the peak value of U.S. stocks, roughly \$8.5 trillion, had been lost, the largest loss of wealth in history. The carnage was hardly limited to the United States. Every major world stock market was severely battered in 2002 and has declined from 40% to over 70% through the now three year old bear market. In this country the most severe casualty has been the NASDAQ market, which has lost nearly three quarters of its peak value. Even more dire was the fate of the Neuer Market, Germany's NASDAQ, which was closed a few months ago after plunging 96% from its 2000 peak.

Anyone who watches financial television or who reads brokerage house research hears a constant drumbeat of patter about why the market will head higher in 2003. In a year-end *Business Week* poll of "the smartest players on Wall Street," 95% of analysts expected this year to produce stock market gains. Similarly, a Merrill Lynch survey of global investment managers uncovered an 85% bullish majority. Obviously it's not difficult to find support for the idea of buying stocks.

Should we become emboldened by such enthusiastic forecasts? Perhaps not. Prior to the disastrous experience of 2002, the same surveys revealed 88% bullish sentiment among the analysts and 74% among the managers. Dead wrong in 2002, they are even more enthusiastic about stocks in 2003.

Most investors are comforted by others expressing positive outlooks. The history of markets and investor sentiment, however, caution against such confidence. Bull markets end on almost universal enthusiasm. Conversely, this nation's most serious bear markets have all ended on pervasive pessimism. Despite the horrendous damage done by three years of market declines, investors, analysts and investment managers are more afraid of missing the next upturn than they are of losing more money. It would be unprecedented if a serious bear market (in this case, the worst in 70 years) should end amid investor optimism.

That the long-term bear market may not be near its end certainly does not mean that we will not experience intermittent rallies, some quite significant, even profitable. Every major bear market in history experienced frequent countertrend rallies. In the current bear market, which most date from about March 2000, there have already been four rallies ranging in scope from about 20% to 30% in the S&P 500. The NASDAQ index, which has been under even more severe pressure, has had rallies in the 40% to 50% range.

While we believe that weak fundamentals and lingering severe market overvaluation point toward substantially lower stock prices over time, we recognize that there will probably be more good rallies before the ultimate bottom is reached. The cult of momentum investing, so popular in the late-1990's, is not dead. When even technical trading bounces get the market started up, there are still many momentum investors ready to jump on to ride the wave. The birth of thousands of hedge funds in the 1990's puts in place huge numbers of traders willing to buy or sell stocks rapidly in search of even minimal trading profits. Few have done it profitably over long periods of time, but in the aggregate they can promote substantial short-term market volatility.

To prove how significant and surprising countertrend rallies can be, we need to look at the least likely time period for such a rally, the Depression of the 1930's. The most profitable four-year period in U.S. stock market history ranged from 1933 through 1936. In that anomalous 48-month period, despite dismal social conditions, the S&P 500 rose by 200%, an annual return of 31.6%. That dramatic rally began, not because the long-term bear market was over, a point not reached until April 1942, but because stock prices had been beaten down so far, and valuations had reached extremely low levels. Price-to-earnings ratios had fallen into single digits.

Today, the price-to-earnings ratio of the S&P 500 is just slightly below 30 despite that index having fallen about 45% from its all time high in early 2000. While significant rallies can begin from any level, valuations today are still above the levels at which every stock market rally ended before the late-1990's, hardly a level from which a new bull market might begin. Any advance from here will simply make expensive stocks more expensive, not likely a lasting condition.

Most of TV's talking heads base their bullish forecasts on a resurgence of corporate earnings. In recent quarters, what limited improvement in corporate earnings has occurred has come from significant cost cutting. The prime benefits of corporate cost cutting, however, have already been realized. Earnings growth from here will have to rely heavily on increasing sales. Unfortunately, well into year-end earnings season, virtually no CEO's of major corporations have yet presented evidence of orders picking up. So far, there is lots of hope and plenty of hype from analysts and commentators but few signs of the order growth necessary to fuel significantly growing earnings.

On the contrary, the list of problem areas continues to grow. Corporate profit margins are at their lowest levels since the 1930's. Two months ago the National Governors Association reported that state budgets are in their worst shape since World War II, necessitating the largest tax increases in a decade.

In its December 9 issue *Fortune* declared, “Beware the Pension Monster.” Corporations are \$240 billion short of the \$1.2 trillion owed to current and future retirees. Current accounting rules allow corporations with defined benefit plans to assume a certain level of annual earnings in those pension plans. One quarter of the top 100 domestic companies have earnings assumptions of 10% per year. None of them reached that level in any of the past three years. Most, in fact, lost considerable amounts of money. For years we have argued against unrealistically high long-term assumptions. Eventually assumptions have to be reconciled with reality. The harsh reality of the past three years has led many companies to lower those assumptions, but their portfolio losses are forcing them to add massive amounts of cash to shore up underfunded plans. That is money that will no longer be available to promote corporate growth. Their pension liabilities will weaken earnings growth potential, possibly for years to come.

The U.S. dollar continues to take a relentless pounding relative to the world’s other major currencies. A recent Morgan Stanley report pointed out that foreign investors own 18% of all long-term U.S. securities and 42% of outstanding Treasury issues. Understandably, such investors are increasingly reluctant to hold U.S. securities when they are losing value in the conversion from the dollar back to their domestic currencies. That, of course, is compounded if the securities themselves are declining in value, as equities have for three years running. Clearly, a continuation of dollar decline, which we expect, could lead to a substantial selling of U.S. stocks and bonds by foreign holders.

A growing problem for U.S. corporations is the specter of foreign competition. Profits in any industry typically go to the low cost, high quality producers. Largely because of dramatically lower labor costs, we, among other first world countries, are having an increasingly difficult time competing with emerging third world countries in Asia and elsewhere. Following the “If you can’t beat ’em, join ’em approach,” growing numbers of U.S. companies are building manufacturing plants and service centers in low cost offshore locations. As this trend becomes more prevalent, it will serve to keep costs more competitive, but it will create potential unemployment problems here with the accompanying erosion of aggregate domestic purchasing power. Building long-term corporate strength on a foundation of non-domestic resources is hardly the prescription for enduring U.S. corporate leadership.

While we have no difficulty finding confidence in the opinions of securities analysts and investment managers, the consumer, whose actions really drive economic success or failure, does not share such confidence. In fact, consumer confidence levels are at nine-year lows. Obviously, a three-year bear market in stocks, huge debt levels and a tightening job market are having an erosive effect on the consumer’s outlook.

One very positive influence serving to bolster consumer confidence has been the continuing strength in the real estate market. At the margin there are investors who have soured on recent stock market action and have begun to pour funds into real estate, which has continued to provide good returns. Beneath the surface, however, concerns are growing. In the past quarter Federal Reserve Governor Susan Bies revealed the Fed’s growing concern with the increase in office and warehouse vacancies. Because of serious rent declines in some areas, the Fed is

monitoring the staying power of property owners. It is also ominous to note that for the past two centuries in this country every major stock market decline was accompanied by a serious decline in real estate prices. The declines have not always been coincident. More often than not, real estate prices held up longer than stock prices, as they have currently, but ultimately came down in the wake of declining stock prices. If that should occur in the period ahead, consumer wealth and confidence will be severely eroded.

Every investor is faced with the choice between the confidence of securities analysts and investment managers and the more sober view of corporate CEO's, who fail to see evidence of significant prospective earnings growth. The other conditions just summarized certainly dampen the potential for a noteworthy resurgence of corporate earnings. Add to the mix the possibility of war in Iraq and the avowed intention of terrorists to kill large numbers of Americans in their own land, and we search in vain for any reason but short-term trading profits for buying significant amounts of common stock with the S&P 500 selling at nearly 30 times earnings. Perhaps at a lower than average 10 times earnings; hardly at about twice the long-term average price.

What could provide investment opportunity in the year ahead? Any set of circumstances that might lead to a severe stock market decline, especially if it should occur rapidly, could lead to excellent investment opportunities. Even if the ultimate long-term bear market should not be over, stock prices could rise from a seriously depressed level for a year or more. The key to profitability is to avoid a major commitment to stocks before a major decline, then to have cash available to buy stocks at more historically favorable levels of valuation. We have avoided the declines of the past three years because we refused to buy stocks at inflated valuations. Should the market decline substantially from here, which we believe highly likely, many stocks will reach attractive levels of valuation, and we will eagerly increase our equity holdings. The resulting rally could be eye popping if it begins at a low enough level. We will write more about major bear market rallies if we get closer to a logical starting point.

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