



QUARTERLY REPORT

Fourth Quarter 2003

We believe that the years immediately ahead will demonstrate the weakness of the investment paradigm now almost universally accepted by investment consultants and institutional investors alike. In one form or another that paradigm takes the form of setting relatively fixed asset allocation guidelines among the major investment categories. Through the extended bull markets in both stocks and bonds in the 1980's and 1990's virtually all such asset allocation models produced strong portfolio returns. Everything went up and different allocation percentages simply produced different degrees of good. To the extent that investment programs diversified into numerous sub-categories of the major asset classes, which certainly helped to keep consultants fully employed, the programs gravitated toward the broad middle of the returns available in the investment universe. That was fine as long as that broad middle was rising.

Consultants and portfolio administrators alike proved unsurprisingly to be trend followers, and allocations to rapidly rising equities grew as the market approached its peak at the end of the 1990's. The dawning of the new century saw the first equity pullback of consequence since 1987 and the first with any longevity in more than a quarter of a century. Portfolio administrators and their consultants alike, virtually none of whom had any personal experience with a lengthy bear market, were shocked that portfolio values could decline so far.

We believe that a confluence of conditions affecting stocks, bonds, real estate and cash equivalents along with the underlying values of world currencies may dramatically diminish the probability in the current decade of protecting and growing investment assets through traditional avenues. A brief review of the prospects for the major investment categories follows.

Calendar year 2003 was the first positive year for stocks in the last four. Battered and beaten after the most severe stock market decline since the Great Depression of the 1930's, equities staged a noteworthy rally. The Standard and Poors 500 index grew by 28.7%, the 19th best annual gain in the past 78 years. The more speculative NASDAQ Composite index produced an even more remarkable 50% gain. These advances brought the indexes back to their 1998 levels but still left prices about 30% and 60% respectively below the S&P and NASDAQ highs of 2000.

While the major stock indexes rebounded strongly after three years of losses, high quality bonds began to show weakness after several years of strong returns.

Waging an all-out fight against possible widespread emergence of deflation, the Federal Reserve has pushed short-term interest rates down to half-century lows. While this has allowed businesses to continue to borrow at historically low levels, it has made it very difficult for the nation's retired or others attempting to live on the returns from fixed income securities. When risk-free rates are below 1%, the only hope for a return above the rate of inflation can come by accepting investment risk. While risk acceptance was rewarded in 2003, the three and five year returns for most individuals and institutions who ventured very far out on the risk spectrum were punished.

The question every investor has to address is what investment will be rewarded or punished in the period ahead. We know that in the current environment domestic cash equivalents, even actively managed, will provide low single digit returns. Most investors' needs and expectations are for more, so on an absolute basis such investments are unattractive. Those returns will, however, be positive, and the assets liquid, leaving them readily available to move strategically to more attractive longer-term investments. At best, such short-term investments will prove attractive on a relative basis.

Moving out on the risk curve, investors can obtain more yield on fixed income securities by either investing in longer maturity securities or by owning lower quality issues. After having been pummeled for a few years, high yield junk bonds exploded upward, outperforming more conservative forms of bond investing in 2003 by wide margins. Investors' quest for yield was so strong that the spread between high quality and low quality debt narrowed substantially. Over the decades, the time to buy junk bonds has been when no one wants them and yields are far above those of high quality issues. Conversely, when investor confidence is high and the spread between junk and high quality bonds is small, as it is now, the wise investor has learned to stay away. Junk bonds offer far above average risks today.

How about buying longer-term, high-quality bonds to increase yield? Just this week, Bill Gross, the manager of the largest bond mutual fund in the country, said that "... the bond market is on its heels." Noting that interest rates are so low that there is nowhere to go but up, Gross said that the bond investor "... is pretty much backed into a corner." We believe that the huge jump in bond yields in June and July of 2003 were very likely the first major leg up of a much larger move yet to come in intermediate and longer-term interest rates. If that rise in interest rates becomes substantial, bond total returns in the year ahead could be negative. We see little chance that rates will move significantly lower unless the country falls back into recession, possibly accompanied by deflation. While we don't rule that scenario out, the bulk of the evidence at the moment points toward future inflation rather than deflation. What investments will succeed in an inflationary environment will be very different from those that could protect assets in a deflation. Should the far more destructive deflationary scenario begin to unfold, we will remain ready to move as needed to the appropriate asset categories.

In a November article in Barron's, Warren Buffett commiserated with investors' lack of attractive alternatives. Acknowledging that his Berkshire Hathaway shareholders hate to see his portfolio populated with so many low yielding investments, Buffett admitted that it would be easy to increase the portfolio's yield by \$1 billion a year. He rejected that option, however, because to pick up that added return would entail accepting risks that he believes will ultimately prove destructive. He counseled that there are times, like now, when his best advice would be patience, rather than an aggressive attempt to improve returns. We agree that the potential

rewards from either high yield or longer maturity fixed income securities are far outweighed by the attendant risks.

After the roaring success of common stocks in 2003, bullish enthusiasm has clearly been rekindled and rewarded. After two decades in which there were no extended bear markets, today's investors are heavily conditioned to believe that any market move that builds up a head of steam is fated to have durability. In an era in which momentum players have become such a significant market force, rallies in motion have a tendency to remain in motion. And as the economy and corporate earnings continue to grow, it is easy to justify Wall Street's universally bullish forecasts. Factor in the lowest interest rates in decades and the election cycle, and most investors look askance at anything less than an aggressively bullish outlook on equities.

While we recognize that this rally could certainly move higher, we insist on drawing people's attention to the difference between investment and speculation. We also constantly remind ourselves and others that this is a probability business, not a certainty business. The unprecedented can always occur, but the frequently preceded is far more probable. And our investment approach is strongly probability based.

Clearly the short-term trend for stocks is positive. Prices have moved consistently upward; the advance/decline figures are bullish; and volume has finally expanded. While very short term, the market is a little overbought and in need of a correction, the technical picture is certainly bullish. That has led the individual investor statistics to their most consistently bullish extremes in decades. Unfortunately, at their extremes, those sentiment statistics are egregious contrary indicators. The major bear market tops of 1987 and 2000 were both preceded by strongly bullish readings, although less extreme than today's. In contrast, corporate insiders -- generally considered the "smart money" -- are selling their own companies' securities relative to purchases more aggressively than at any time since records have been kept. They are apparently not caught up in the enthusiasm powering this rally upward.

In 35 years in this business, I have seen huge numbers of people attempt to time relatively short-term market moves. Very few have produced good results with any consistency. Undoubtedly, in every cycle some investment managers stand out and investors are inexorably drawn to the latest hot horse. Too often it comes after that phase of the market cycle that most rewards the hot manager's specific investment style, leaving new investors wondering why the manager suddenly cooled off after they became clients.

We take a relatively long-term view of markets. Important in that effort is the understanding that the equity markets move in long cycles in which they alternately do far better and far worse than average. Over the past two centuries, these strong and weak periods have alternated in lengthy cycles typically ranging from eight to twenty years each. Seven weak and seven strong periods divided the 200 years almost evenly into each category. The real, after inflation return during the seven weak periods comes to just about zero. A century of weak periods just covered the rate of inflation, essentially producing no spendable return. Conversely, the century of strong periods produced all of the market's return over the rate of inflation. Each of the seven strong periods produced a double-digit return, even after subtracting inflation. The most recent strong period, from 1982 through 1999, was one of history's most profitable. For the better part of two decades, the equity market provided an annualized return of 15% after inflation. It ended in the greatest bubble in U.S. stock market history.

Very clearly the market began a new weak period in 2000. If the nearly three-year bear market that followed comprised the entire new weak cycle, it will have broken two centuries of precedent in which the shortest prior weak period has been eight years. After a 17-year strong period which ended in severe excesses, it is even less likely that the corrective cycle would be the shortest on record. Far more likely is that this rally is a positive countermove in a weak cycle that will take several more years to reach its bottom. Neither weak nor strong periods unfold as a major move in just one direction. Movement of tides offers a helpful analogy. An outgoing tide, like an extended weak cycle, moves ultimately to lower levels. But incoming waves, like countertrend rallies, intermittently raise the water's level temporarily. Far more likely than not, we are experiencing a significant incoming wave in a longer period in which the tide is still going out.

Besides the long-term cyclical picture, there are many more reasons to view the current rise as a strong rally in an ongoing bear market. In last quarter's letter, we examined in some detail results of our studies into the predictive ability of the three major pillars of the bullish argument: growing corporate earnings, a growing economy (GDP) and historically low interest rates. Our studies of the market's performance during the past five or more decades make a conclusive case that the S&P 500 does not do better after strong earnings or GDP growth when compared with moderate growth or even declines. Likewise, the S&P 500 does not do better after low interest rates than after high rates. Counterintuitively, the S&P 500 has done slightly better on average after poorer corporate earnings or GDP growth than after better, and after high interest rates rather than lower. More than a half century of facts contradict the almost universally accepted wisdom of the investment industry.

The consistent predictor of performance over the years has been the price investors pay for the securities they buy. There is a clear reverse correlation over every time period from one to twenty years between the price to earnings (PE) ratio of the S&P 500 and its subsequent performance. On average, the best performance follows low PE ratios and the worst follows high ratios. Standard and Poors reports that the PE multiple of the index's most recently reported earnings is just below 30. Over nearly eight decades, the one-year performances of the S&P 500 from that level have ranged from about +30% to -30%, averaging about zero. Expanding the time horizon to four years, there are only 17 monthly observations of a PE reading of 28 or higher. The four-year performance of the S&P 500 in each of those 17 instances proved negative. Over a much longer 15-year time horizon, the regression line drawn through monthly observations dating back to 1926 suggests an average 15-year return of about 3% per year. Price matters, and current prices suggest that there exists a disproportionate risk vis-a-vis logically expected returns.

Compound extremely unattractive valuation levels with the highest debt burdens ever, the weakest household liquidity levels on record, unprecedented budget deficits and trade deficits and a rapidly declining U.S. dollar, and the stage is set for a continuation of the secular bear market that began in 2000. While the rally could move higher yet in the short run if sentiment remains strong, that will ultimately benefit investors only if they successfully time their exit from heavy equity positions or if the market never again falls below current levels. With corporate dividend levels near all-time lows, except for traders, there is no benefit to heavier equity positions unless the market never returns to this level or lower. We believe that the vast preponderance of the evidence ultimately points to equity price levels far below today's levels, whether or not they move higher first.

Notwithstanding the potential for the current rally going farther, it appears foolhardy to pay prices near the highest ever for U.S. securities in the face of unprecedented structural weaknesses in the economy at a time when there is a realistic possibility that terrorists could again do serious damage to the U.S. or world economy, and certainly to investors' psyches. Today's equity valuations are extreme even without regard to terrorism. To pay today's prices with the specter of terrorism very real is to look at equities through the covetous eyes that led to the bubble levels of the late 1990's.

Our industry has bought into the consultant-led quarter-to-quarter performance derby. That has led individuals and institutions alike to abandon true long-term investment principles. Investment managers and portfolio administrators fear veering far from the mainstream, even if those investments make little or no long-term sense, lest they underperform major indexes for a year. The negative performance most portfolios experienced for the three years from 2000 to 2002 demonstrated the danger of being locked in by convention to a seriously declining asset class. We expect that after the current rally ends, traditionally structured portfolios will again suffer severe losses that could be compounded by losses in the bond area if interest rates rise appreciably.

We argue strongly for the wisdom of adopting a far more flexible portfolio management style able to adapt to conditions in the new century that may be markedly different from those that investors have learned from their own experience. We began to buy foreign bonds in their own currencies beginning early in 2003. We expect to expand those holdings in 2004 to obtain the higher yields available on those securities and to benefit from the probable increase in value of the foreign currencies relative to a U.S. dollar that the U.S. Treasury shows no inclination to defend.

We believe that the forces of inflation and deflation are still locked in a battle that will define the investment arena for the decade ahead. While the two are currently stalemated, they are such massive, worldwide forces that they are not likely to remain in balance for long. One will ultimately dominate the other, and that will determine the winning and losing investments in the years to follow.

We will, of course, find more equities for client portfolios when market declines produce more attractive prices. We are also examining such non-traditional areas as broad-based commodity indexes, should virulent inflation materialize. Gold mining stocks or an exchange traded fund tracing the movement of the price of gold are possible investments if the soundness of the U.S. currency should be called into question in either an inflationary or deflationary environment. No such investments were necessary to defend or increase portfolio values in the 1980's or 1990's. These and very possibly others may be necessary to succeed in the decade ahead.

Thomas J. Feeney
Managing Director
Chief Investment Officer
January 20, 2004