

QUARTERLY REPORT

Fourth Quarter 2004

A renewal of speculative sentiment led stock prices higher in the year's final quarter, rescuing a desultory year-to-date of essentially no gain. Bond yields remained relatively unchanged from their year earlier levels, despite the Federal Reserve Board's aggressive actions to push up short-term rates.

While corporate profits have risen, valuations of common stocks remain extremely high by all traditional measures such as price-to-earnings, dividends, book value or cash flow. Remarkably, despite the stock market losses in 2000 to 2002, the most severe since the Great Depression, investors are extremely eager to be back in the game. Memories of unrelenting stock market gains in the 1980's and 1990's are so strong that many investors are uncomfortable not holding a significant portfolio of stocks. Confronted with data showing that stocks are unlikely to perform well when purchased at today's valuation levels, large numbers of investors respond that they are simply more comfortable owning stocks.

This is the flip side of investor reactions during the mid-1970's to early 1980's. While stock valuations back then were dirt cheap on a historic basis, investors' painful memories of sharp stock market losses in 1973-74 dissuaded them from buying stocks that would ultimately move dramatically higher. We suspect that investors in most equities at today's levels will ultimately see stock prices lower as stocks return to more normal valuations.

Contrary to the widely-held position that the bear market that began in 2000 is now just a memory, investors need to recognize that no lengthy bear market in U.S. history has been a "one-shot wonder." All earlier major declines have been interrupted by at least one significant rally. While most are much shorter, the longest rally took place in the middle of the weakest long cycle in U.S. history. After dropping 89% from September 1929 through July 1932, stock prices began a four and a half year rise, increasing by 372% through March 1937. Although investors' optimism was rekindled by that lengthy rally, it proved premature. A subsequent 52% decline through April 1942 brought stock prices back to a point 76% below their 1929 high.

Most rallies in extended bear markets have lasted for less than three years. The current rally is more than two years old. The key for long-term investors is NOT to try to time the top of the rally; it is to recognize that we are in a rally phase of a longer-term weak cycle. Contrary to popular wisdom, a buy and hold strategy will probably be penalized as it has been in each extended weak cycle over the past two centuries.

We believe, instead, that an opportunistic approach to equity participation will prove more profitable until we enter the next extended strong cycle. That could be five or ten years from now if historic averages apply this time. For part of the fourth quarter we used that opportunistic approach. We bought Standard & Poors Depository Receipts (Spyders) to boost portfolio returns during the most significant stock market rally of the year. In 2003 we employed foreign government bonds to take advantage of weakness in the U.S. dollar relative to stronger foreign currencies. In an environment in which we believe that traditional domestic stock and bond returns may prove unproductive, we are expanding our search for assets in which we can make productive, relatively low-risk investments.

The fixed income market has confused most people this year, including Alan Greenspan. After clearly advertising its intent, the Federal Reserve Board raised short-term interest rates several times and committed to continuing those increases at a “measured” pace. The three-month Treasury bill yield rose in 2004 from 0.8% to 2.2% by year-end. Fed Chairman Greenspan made the point more than once during the year that it was highly likely that bond gains earned during the lengthy decline in interest rates from the early 1980’s would be eroded as rates moved higher. Surprisingly, while short rates rose, long rates actually declined a bit through 2004. We still expect, however, that the path of least resistance for interest rates will be up. We agree with Chairman Greenspan that bonds will be unattractive in the period ahead, unless the economy is soon to fall back into recession. While this is possible, we do not accord that scenario a high short-term probability.

Rising short rates have led to investors being paid more in risk-free securities while waiting for more attractive longer-term alternatives. Yields on one-year securities have risen to over 3% and appear likely to move consistently higher through the year ahead. We believe that if we are again able to find a strategic opportunity or two during the year, the resulting full portfolio return will exceed that of the broad stock and bond market averages.

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