ADDING VALUE

Volume 1: Edition 3 Fourth Quarter 2002

SUMMARY:

It was a strong fourth quarter, but another rough year for the markets. It has been sixty years since the market has fallen three straight years, and 2002 was the worst single year since 1974. Still, we are pleased that most client portfolios have materially outperformed their benchmarks during the bear market as well as over all longer time periods.

There are valid positive and negative arguments on the near-term outlook and we think it is difficult to make successful investment decisions predicated on accurate short-term forecasts. Instead, we take a longer view that emphasizes areas we think we can assess with confidence; valuations are at the top of this list.

As we discuss valuations, we introduce an extremely important concept in portfolio construction-“margin of safety.” We define what the concept means, why we are always applying the logic of safe and cheap to your portfolio, and why its application allowed the portfolios to outperform during this bear market.

Adding Value is mailed quarterly to our clients and friends. The intent of this publication is to share some of our more interesting views and research with our cli-

Investment Review and Outlook

While the fourth quarter was strong for stocks and high-yield bonds, this was small consolation in a tough year. Most client portfolios fell into the red in 2002 as there was nowhere to hide in the stock market. Every single Standard & Poor’s sector was in the red and eight of ten sectors experienced a double-digit loss. Diversification into other asset classes was not helpful.

Blame the Bubble

Bad bear markets tend to be blamed on a variety of factors, depending on who is doing the blaming. In our opinion there are a number of factors that contributed to the bear market, but without question the biggest was that people lost sight of the concept of “margin of safety.” Terrorism and war fears didn’t help, but these only contributed at the margin to the magnitude and length of the bear market. Corporate governance also contributed, but was not the driver—it was more of an outgrowth of the environment of bubble-driven greed.

The stock market bubble created three key problems. First, ***valuations*** got way out of line and, while improved, they are still not in “screaming-buy” territory. Second, there was over-investment in the general economy as corporate management became ***overconfident*** in their growth expectations (this was particularly acute in the tech sector) and the resulting excess capacity has not yet been fully absorbed despite the fact that business capital spending is way down. Third, investors forgot about ***risk*** and were more heavily weighted to the technology sector, and stocks in general, than they had been in any prior bull market. The question we now face is whether it will take years for investors to regain their appetite for risk. In the past, investors have remained cautious for several years after the end of a major bear market.

Intellectual Integrity, One-Year Forecasts and the Future

It’s almost a tradition for investment professionals and the financial media to issue a forecast at the beginning of each year. But in any particular year there are many factors that may play out differently than expected, and other potential issues that simply can’t be foreseen.

This makes accurate forecasting very difficult. Of greater importance, it makes it dangerous to base any investment strategy on a one-year market forecast. Take 2003: it's relatively easy to play either side of the fence with respect to the general investment environment.

Arguing along with the bulls we'd point out that monetary and fiscal policy is stimulative and should allow the economy to build on its slow recovery. The recent economic news is becoming increasingly positive and even manufacturing is showing signs of improvement. Inventories are lean so corporate spending should rise. A rebound in capital spending is inevitable and appears imminent and that will combine with continued consumer spending to put the economy on sound footing. This will encourage investors who are sitting on a mountain of cash and have an opportunity to buy stocks at a discount.

The bears would respond that investor sentiment has been seriously damaged and therefore investors will not pile back into stocks anytime soon. In the past, stocks were much more undervalued after a serious bear market than they are now. Moreover, falling interest rates have fueled refinancing and auto purchases, helping to support the economy. But with rates so low it is likely that we've seen the last major wave of refinancing for some time. Without more refinancing opportunities and little pent-up demand (unlike other post-recession periods), this will probably mean that consumer spending will grow more slowly. And capital spending will not save the day because even though it might seem primed for a rebound, existing excess capacity and uncertainty over consumer demand will keep businesses from aggressively expanding.

Then there is the risk of war and the unknown of the ultimate cost of waging the war. On top of that is the terrorism wildcard and increased security costs, which weigh on the economy. Uncertainty leads investors to demand a high risk premium as compensation. That suggests a cap on stock prices.

There is truth in both the bullish and the bearish arguments. THE POINT IS: WHO CARES? The total system that we call the capital markets is so complicated that we cannot know in advance the consequences of anything we do. After the stock market dropped 22 percent in one day in October 1987, new rules were implemented to prevent such precipitate declines in the future. But there was no way to know in advance whether the new rules would work. Similarly, even with the Bush economic proposals being proposed today, there is no assurance that these rules and changes are not simply another calculated risk on the part of the government. As another example, in 2002, the U.S. government projected a budget surplus of $300 billion, instead the U.S. government recorded a $150 billion deficit for the year, a difference of $0.5 trillion dollars. That's a large error factor!!! In fact, it's equivalent to ____.

An Investment Strategy Based on Confidence, Not Hope or Speculation

This leads us back to our basic philosophy. To achieve long-term investment success we believe it is essential that we base our strategy only on analysis that we are highly confident in. Valuation analysis is at the top of our list of variables that we can confidently analyze and that matter. To invest successfully over a lifetime does not require a high IQ, unusual business insights, inside information, or a large marketing budget. Instead, as told by Warren Buffett: "What's needed is a sound intellectual framework for making decisions and the ability to keep emotions from corroding the framework." As simple as this seems, it is not easy. It requires one to be analytical, to think creatively, to reject mainstream data, and to follow the courage of one's convictions.

Margin of Safety

If one were to express the secret of sound investing in three words-those words would be ***margin of safety***. Ideally, one wants to buy the common stock of a company at a price such that the earnings power of the company is considerably above the going rate for bonds (otherwise you would just invest in fixed income securities). <u>All</u> of the managers in our portfolios have a specific technique for determining the price that should be paid for any security; although many employ different definitions of what they consider to be "safe." We have spent our investment lifetimes understanding which of these formulas work best.

Losses to investors can come in many ways:

1. Purchase low quality securities at a time of favorable business conditions. The economy hits some weakness, sales of the company's products don't materialize, the debt load is so high that there is not enough income to cover fixed charges, and in the worst case, the company has to declare Chapter 11. This is known as a "value trap."
2. Purchase rapidly growing companies at a time of favorable business conditions. The market has a tendency to set prices at a level that rewards immediate past performance. If the growth rate is unsustainable because of slowing business conditions or overexuberance of growth forecasts, the price of the security plummets. This is known as a "growth trap." The worst known period for this trap was the period of the speculative bubble in technology stocks.
3. Purchase good-quality companies at too high a price. Although this may not be a chief hazard confronting the average buyer of securities, it is one that is very difficult to understand for most people. Even the "best" blue chip companies in the world may sell for a price that is too high to provide any return to investors for an extended period of time. Unfortunately, the next several years may be such a period.

The common theme to all of these examples is the same. **The margin of safety is always dependent on the price paid.** This safety cushion is available for absorbing the effect of financial miscalculations, gross negligence, greed, worse than average luck, or any other adverse developments-to which everyone is susceptible.

Diversification

There is a close logical connection between the concept of safety margin and diversification. Even with our best financial analysis to buy a stock at the right price, that individual security may work out badly. Remember our margin of safety only guarantees that the investor has a better chance of a profit than a loss-not that the loss is impossible. However, as the number of stocks is increased based on an individual, independent analysis of each stock, the more certain does it become that the aggregate of the profits will exceed the aggregate of the losses. Therefore, we look for managers who will construct a 20-stock portfolio of individual securities where the new purchases are selected on a strict margin of safety basis and the older securities in the portfolio have appreciated in value to near a sell target, but that in aggregate the portfolio still appears "safe and cheap" compared to the overall market. But we still don't stop here-we put another deadbolt on the door. Just in case, the manager of this portfolio suffers a major calamity (and it happens), we pick 10 other managers with a purchase criterion just like the first one but in different areas of the market to further insure that the portfolio will have a positive return. The common intellectual theme of all of the portfolio managers is that they search for discrepancies between the value of the business and the price a piece of that business sells for in the market. Surprisingly, even with this theme, there is very little overlap among managers with the securities in the portfolio.

Investment versus speculation

We take our responsibility of protecting your capital very seriously. We have spent years reflecting on the variations of portfolio construction and the ways to minimize losses. From this research, we suggest that the margin of safety concept may be used as the foundation to distinguish an investment operation from a speculative one. There is no doubt that most speculators believe (truly believe) that each purchase is done at a time that is propitious, that his skill is superior to the crowd's, and that his advisor and system is trustworthy. It pains us to hear that our system is "too conservative." It revolts us to view the destruction of portfolios over the past three years by these trustworthy advisors. It upsets us to receive the marketing calls by smoooooooth-talking advisors (yes, we get them too) extolling the virtues of a system where immediate past performance is the only statistical basis for recommendation of the purchase. We wish there was someway to protect investors from these problem areas, to give them some statistical basis for making better decisions. Our only solace is that our portfolios have weathered the negative investing environment of the past

three years. We continue to support the concept of margin of safety and believe strongly that to have a true investment there must be a true margin of safety.

In Conclusion

Every investment should be viewed as an ownership interest in a specific business enterprise. (It is amazing to see how many capable businesspeople try to operate in Wall Street with complete disregard of all the sound principles from which they have gained success in their own undertaking.) Keep away from purchases from which you have too much to lose and little to gain. Expected profits should be based on arithmetic not optimism. We greatly doubt whether the man who stakes his view on a belief that the market is headed up or down can ever be said to be protected by a margin of safety in any useful sense of the word. So throw out the talking heads' economic mumbo jumbo, question the smooth-talking marketing investment specialist, think independently, understand the risks of your investment program and consider in simple terms about what it means to have a return on your investment.

We welcome your questions.

Best Regards,

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