August 15, 2004

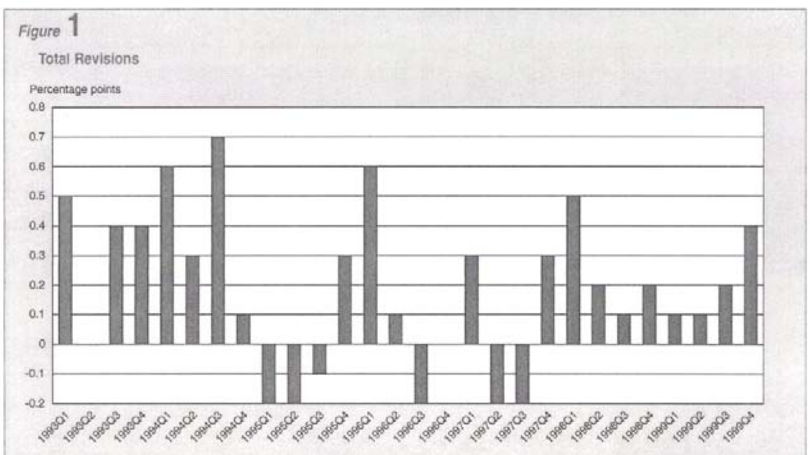
Second Quarter Commentary

"Students (of investing) have to be brought up in a healthy atmosphere of distrust of the "facts" put before them. They must also learn how terribly hard it is to get good data and to find out what really is a 'fact'."

-Oskar Morgenstern, 1902-1976
Mathematics Professor, University of Vienna and Princeton University,
co-author with John von Neumann
Theory of Games and Economic Behavior

The brilliant John von Neumann was better known than his compatriot Oskar Morgenstern due to his efforts on the Manhattan Project and the development of ENIAC, the world's first computer. But in another of Morgenstern's books, On the Accuracy of Economic Observations, the author cites findings that the measurement of national income accounts was subject to a 10% margin of error! Nevertheless, economic policy advisers frequently proposed policy shifts based upon as little as a 1% shift in reported national income. Morgenstern reasoned that such changes were based on questionable data since 1% shifts were well within the 10% margin of error.

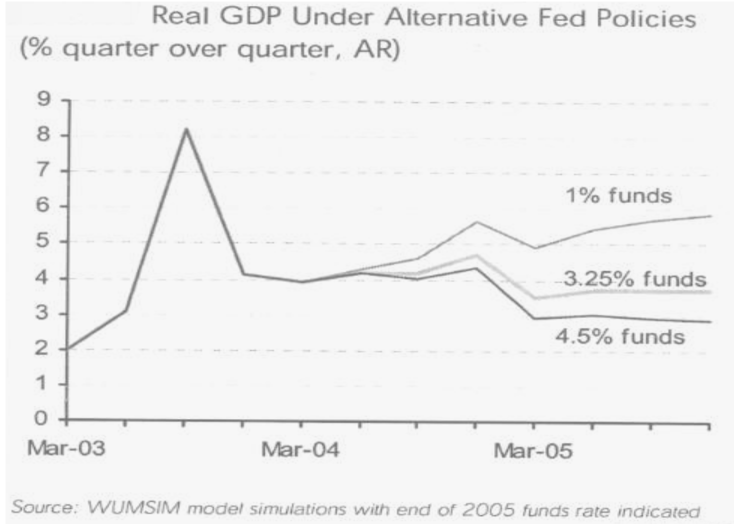
Investors are always left wanting to know the economic "facts"………… as Jack Webb playing Sergeant Joe Friday of the 1950's TV series "Dragnet" proclaimed, "just the facts, ma'am, just the facts". But what are the facts? Take GDP numbers: fourth quarter, 2003 real GDP growth was +7.4% (annual rate). First quarter, 2004 GDP was 4.5%. Last week, second quarter, 2004 GDP was reported at +3.0% with the market expecting +3.5%. The decade from 1992 to 2002 averaged 3.2% per annum. Can we rely on these recent numbers? Or will there be subsequent "adjustments", as is so frequently the case? Should we be expecting a further slowdown or have we seen the slowdown already, with 10-year treasury prices rallying and yields dropping from 4.90% to 4.25%, while the stock market drifted lower since March?



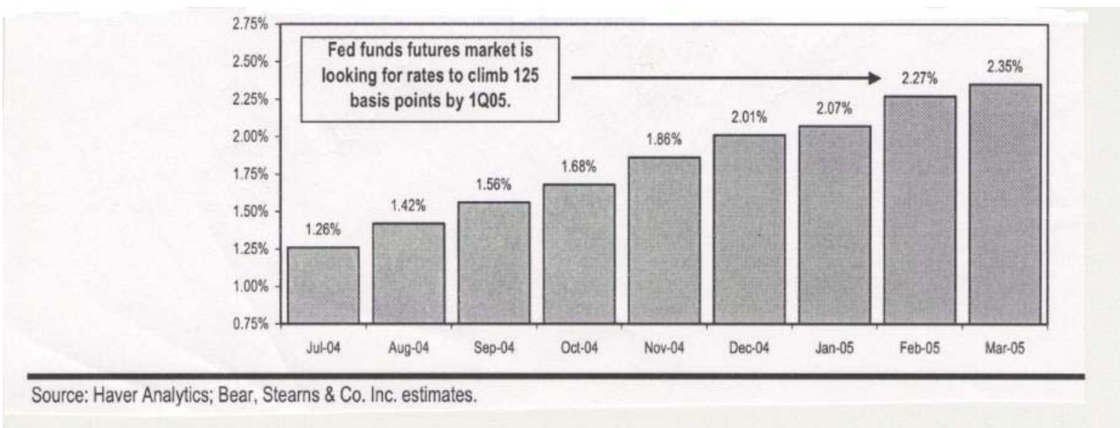
As can be seen above for the United Kingdom, in the 28 quarters from 1-1-93 to 1-1-00, only 2 quarters of GDP numbers were left unrevised, i.e., 93% of the time the numbers were off by 0.29% on a GDP number that averaged 1.1%. Or off by 26% (.29/1.1), 93% of the time. Quite extraordinary! Although the above graph relates to the British experience, we have no reason to believe the American experience is qualitatively much different.

We question the "fact" that real GDP growth has declined from 4.5% to 3.0%, Q1 to Q2. We are inclined to believe the economy is stronger than recent data might suggest. In fact, GDP estimates for the second half of 2004 are all over the map. Merrill Lynch believes second half GDP will average 3.6%, and Mr. Greenspan sees 5.5%, two estimates in stark contrast with differing interest rate implications.

Surely if oil price momentum were to break negatively, economic growth might be expected to reaccelerate, all factors equal.



We have available other tools to get at the question of real (inflation adjusted) GDP growth. If we look to the futures market to see what expectations are built into the Fed funds rate (very short term interest rates), we see an anticipation of a 1.0% increase in Fed Funds by April, 2005, almost double the current rates.



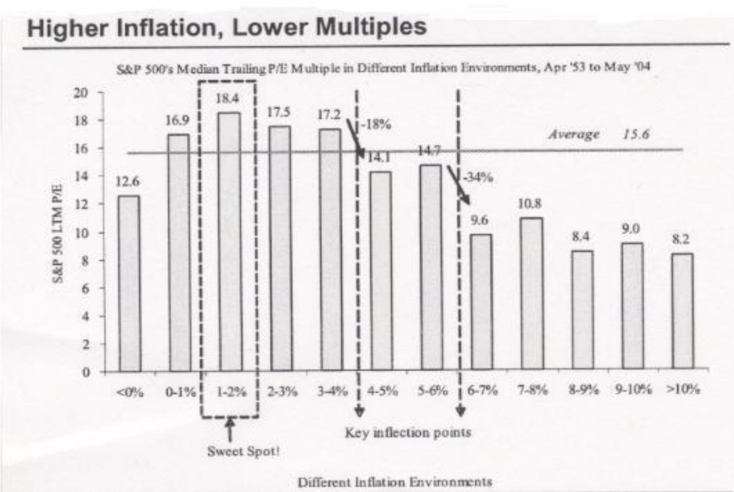
As seen in the chart at the top of this page, this expected 2.5% Fed Funds in April, 2005 would equate to real GDP growth of slightly over a 4% annual rate. This is healthy growth and not predictive of a slowing economy or a recession. Despite the recent weak jobs report numbers, we are still inclined to believe we will see adequate economic growth.

We are perpetually skeptical of what are represented to be “facts” to us in our business. Nevertheless, we are required to make decisions based on the weight of the evidence presented to us, imperfect though it may be. And because of this, we rely to a substantial degree on sentiment measurements to tell us how to avoid crowd behavior, how to outflank the herd.

We recently read that 86% of investors expected higher interest rates and falling bond prices. Well, in any auction market, 86% of participants all thinking the same thought cannot be right, except possibly in the very short term. Therefore, although we agreed that all available "facts" seemed to point to higher interest rates and lower bond prices, we knew that the majority of investors had already so acted, making highly probable a counter-trend move of some significance. Which is exactly what has happened.

We have previously maintained that we felt the stock market's P/E (price earnings ratio) was sufficiently low to withstand higher rates of inflation, even though we believe that additional inflation flow-thru will materialize from the commodity price pipeline, even if prices themselves were to go flat for several quarters. The year-over-year CPI (consumer price index) has already kicked up from 1.7% to 3.3% in the February to June, 2004 time frame.

On Merrill Lynch's 2005 estimated earnings, the S&P 500 is trading at a multiple of 15.5 times. This is virtually identical to the average P/E of the last 50 years. Furthermore, looking at the relationship between historical P/E ratios and varying inflation environments (see chart at left), even if inflation were to run up to the 5% to 6% range, the average associated P/E is still 14.7 times earnings, a drop from the market's current P/E that would presumably be overcome by one year's worth of earnings growth. On the other hand, if a slowing economy produced a declining commodity price complex with inflation falling back to 2% or so, that could argue for a P/E of 18.4 producing about a 20% gain from the current P/E of 15.5 expected in 2005. Therefore, with this



Data skewed by '70s/early '80s, which were marked by high inflation, lackluster economy (four recessions in 13 years!), and weak equity markets. Source: Standard & Poor's, Bureau of Labor Statistics, Morgan Stanley Research

outcome range of zero to +20% over the next year, it seems prospects for the S&P 500 are weighted in line with historical equity returns.

And finally on a lighter note we observe that since 1886, any year ending in the number 5, such as 2005, has never been a down year in the market…………ever! Not only that, the mean return for years ending in 5 is +24.2%! We acknowledge that statistically there are only eleven observations in this series, but nevertheless, since 40 out of 118 observation were negative, the probability of eleven consecutive positive numbers is only 1% (for you Morgenstern-like mathematicians, that's [1-(40/118)]^n where n=11)! Now, that is a Fact!

So for the nattering nabobs of NASDAQ negativism (credit to Spiro Agnew) we offer up this astounding statistic…………along with the Super-Bowl theory, the rising-hemline theory, the pink-clothing theory, the planetary-alignment theory, the toenail-of-dog's-paw-lying-down-on-the-Wall-Street-Journal theory, the chimpanzee-throwing-darts-at-the-Wall-Street-Journal theory and other ancillary coincidences we may have forgotten.

It has been a tough year for investors in both stock and bond markets, with returns not even reaching low single digits for most. Investors are being forced to choose sitting it out and earning paltry money market returns or accepting the political election-year turmoil, the possibility of renewed terrorist attacks, etc. Although staying the course may be emotionally taxing, we continue to believe it to be the best course of action among largely unexciting alternatives.

We were reminded this morning that investors in 11 of the 15 largest mutual funds would have been better off doing nothing from 2000 to 2004 to date. We are grateful that our client accounts (equity accounts, taxable and tax-exempt) are up 41% in the same 4½ year timeframe, after fees. It has been a hard slog.

Very truly yours,

Alan T. Beimfohr **John G. Prichard, CFA**