February 2, 1995

FOURTH QUARTER COMMENTARY

> On predicting the direction of the market and the economy: "There are two classes of people: those who don't know, and those who don't know they don't know. I fall into the former category."
>
> John Kenneth Galbraith
> Professor Emeritus,
> Harvard University

Professor Galbraith's comment seems to capture the 1994 market outcome… no one seems to know whether it was bull or bear, but tough it was. The average equity fund lost 2.3% and fixed income fund 3.3%. The bond market turned in the worst performance in a quarter century.

Critical to understanding the vulnerability of the bond market is to remember the near-collapse of most S & L's and banks in the 1990-91 period. The Fed response to this crisis was to re-liquefy the banking system by making "borrowing short and lending long" extremely profitable. This they did by driving down short-term interest rates to unsustainably low levels… look at it as a wealth transfer from the members of AARP (big savers) to the banks (those who pay the big savers) without the rancorous political debate over taxation… pretty slick! And it worked, all too well, until October 1993, which set the stage for increases in rates to more sustainable levels… which gets us to January 1995. The big question is, where do we go from

here? Certainly the advance of rates has paused since late November, partially due to Fed concern over the Orange County bankruptcy, weaker than expected Christmas retail sales, and now, the Mexican Peso crisis. Seems that Ross Perot was right about NAFTA producing that "giant sucking sound", only it was the sound of foreign capital leaving Mexico, not jobs leaving the U.S. Those enamoured of "emerging growth" have found "submerging growth", having forgotten that double-digit GDP growth is followed mostly by double-digit inflation as devaluations produce necessary corrections to such accumulated distortions. More on this later. The big question is whether or not we have seen the peaks in rates yet, especially long-term rates. The yield curve at present is very flat, witnessing a 30 basis point spread with 30 year maturity yields in the Treasury market only slightly higher than 2 years yields (see chart #1). This should indicate that Fed tightening action is close to being completed. But not yet! The problem is that the Fed must be convinced that the absolute levels of short-term rates are steep enough to produce a cooling-off of the GDP growth rate (from 4.5% in the 4th quarter 1994 to, say, 2.5% by the end of 1995). Cooling off the economy may require a more extended period of higher rates. Therefore, the idea of looking for a meaningful abatement of rates at this point should be met with some skepticism. We would expect to see 90 day T-bill auctions exceeding 7% before Fed tightening is completed, as historically, such bill yields have generally equaled long treasury yields in all 7 Fed tightenings in the last 35 years (see chart #3). However, most certainly, the majority of damage has already been done on the long end, and current coupon long-term bonds do not carry the risk of capital loss they did a year ago. Quality spreads from high-quality Treasuries to low-quality industrials are narrow and favor treasuries over other paper. This is a time to stick with quality (see chart #2).

Peso devaluations are not new. For example, consider the following history of Peso devaluations:

1964-69	**Diaz Ordaz**	**0%**
1970-76	**Luis Echevarria**	**56%**
1976-82	**Lopez Portillo**	**553%**
1982-88	**Miguel de la Madrid**	**1800%**
1988-93	**Salinas de Gortari**	**35%**
1994-95	**Ernesto Zedillo**	**50%?**

Most knowledgeable observers feel that if the 5.6 pesos/dollar rate holds, the 1995 inflation rate in Mexico will be 16% to 20%. Although this could provide us with some opportunities for cheap equities in Mexico, particularly the institutional ex-favorites that have been liquidated heavily in recent weeks, currency concerns persist. Currency risk is a separate assessment when owning foreign securities, and ownership returns are generally enhanced by a falling or weakening dollar vis' a vis the local country currency (see charts #4 and #5). This factor is not in our favor at the moment, as it regards Mexico. Short term Peso loans are being made at 50% to 70% interest rates.

Occasionally, investors ask my opinion of gold. It is this. I believe the price of gold must break it's 15 year downtrend against the three major world currencies, the U.S.$, Deutschemark and Yen. It has broken out positively against the Dollar and Deutschemark but not the Yen. I expect the Kobe earthquake will have caused at least $100 billion in damage (California's Northridge quake is estimated at $25 billion) which will require a massive liquidation of Japanese insurance company bonds and stocks to pay claims to rebuild. This may also mean government assistance resulting in some previously unexpected Japanese inflation which would help gold finally penetrate its long slide against the Yen. Too early to tell, though. Stay tuned (see chart # 6).

There are some who believe the late November bottoms represent a "bear market bottom". Certainly the chorus of bearish voices became loud as negative market sentiment reached 59% (high and bullish) on the Investors Intelligence Survey, NYSE 10 week net breadth totals plunged to levels only recently seen at bottoms in October '87 and October '90 (see chart #7 and #8) as well as percent stocks above their 10 week moving average at 21% (see chart #9). All these measurements are bullish. However, for a market bottom to be in place, we would need, in my opinion, the following:

1. **Mutual Fund cash to exceed 11% (currently 8.6%) (see chart #10).**

2. Shrinkage of margin debt from peak by 30% (currently 5%) (see chart #11).

3. Major decline in consumer confidence (none yet) (see chart #12).

4. Percent bullish on the bond market 20% (currently 57%) (see chart #13).

5. A spiking up of the IBES (Institutional Brokers Estimate System) downward earnings per share revisions… See chart #14… this would show that analyst earnings estimates were too high and being lowered into the aggregate… usually 60% to 70% of estimates need to be revised downward to fully discount a coming recession.

In conclusion, the current market picture is particularly muddled. We must remind ourselves that the first principle of making money is to avoid significant losses. Part of this process, of course, is to attempt to purchase assets or a future dollar's worth of earning power for as little as possible. There are times, however, particularly in the latter stages of a monetary tightening cycle, wherein it may be very difficult to make desired returns in the short run. Evidence suggests now may be such a time. Resolution may be just a few weeks or months away, but until that time, we will remain defensive in posture for the most part.

A few comments on stocks we own… if you are a newer account, you may not own all or any of these…

IBM… now with a $10.8 billion cash hoard, Q4 earnings of $2.06 per share vs. $0.55 and a blitz of new hardware offerings, the market is concerned with personal computer revenue growth not only for #2 IBM but #1 Compaq as well. IBM shipped 3,960,000 PCs last year vs. 4,800,000 for Compaq. CEO Gerstner plans further cost-cutting and payroll shrinkage to boost profitability.

Santa Fe Energy Resources… we trimmed our holdings by half to become a bit defensive. Crude and natural gas prices have not increased with worldwide economic recovery, inhibiting earnings improvement at SFR. A $1 per barrel increase in oil prices is worth $0.16 in incremental earnings. Historically trading in a range of 2.6 to 11.0 times cash flow per share, SFR is trading at 4.8 times '94 and 3.4 times projected '95 cash flow. Average corporate realizations dropped from $13.50/barrel to 12.00/barrel in 1994.

RJN Nabisco… the world's #1 cookie and cracker company (Ritz, Triscuits, Lorna Doone, Fig Newton, Oreo, Grahams, Wheat Thins, Chips Ahoy!, etc.) successfully completed a partial IPO of Nabisco holdings on January 19th, capitalizing the food part of the company at $7.2 billion at current market prices. Since the total company is capitalized at $6.5 billion (1,147,650,000 shares times $5 7/8 per share), this means the tobacco part of RJR Nabisco is worth -$700MM… yes, that's a negative number and not a "typo". Amazing. The separate capitalizations are good news as this action most likely is a precursor to splitting up the company, which can only enhance shareholder values longer term.

Lehman Brothers… book value is stated at $25.13 per share which excludes another $3.00 in Italian equity assets but includes about $4.00 in goodwill. Therefore, consider hard book value $24.00 or so with the stock at $16.00. Insider buying is heavy and cost cutting continues to shrink head count from 9300 a year ago to 8500 which accounted for higher than anticipated Q4 earnings of $.32 per share.

Cytec… we sold this in tax-exempt accounts at 36 ¾. As soon as we are long term by California tax law (1 year) we will sell in those accounts also, anticipated to be the first week in March. If only all our investments worked out this well this fast!

Caremark… the earnings are fine but the government investigation concerning physician "inducements" to recommend therapy has taken a heavy toll on the stock. Rumors have CK settling for $300 million, worth $4 per Caremark share if true. Prescription drug benefit business estimated to be worth $25/share alone, based on what Eli Lilly paid for McKesson's prescription management company and Merck for Medco Containment. Q4 earnings were $.36 and '95 should be $1.45.

Earnings growth rate is at least a sustainable 15% per year and P/E 11 times earnings… cheap.

Thank you for taking the time and grind through this tome… I am going to try to shrink it in the future to enhance readability. As this written for an audience of divergent financial sophistication, I apologize in advance for being either too presumptive or too basic. My best wishes for a continuation of your good health and personal prosperity… we all have so much for which to be thankful.

Sincerely,

Alan T. Beimfohr

Chart 1

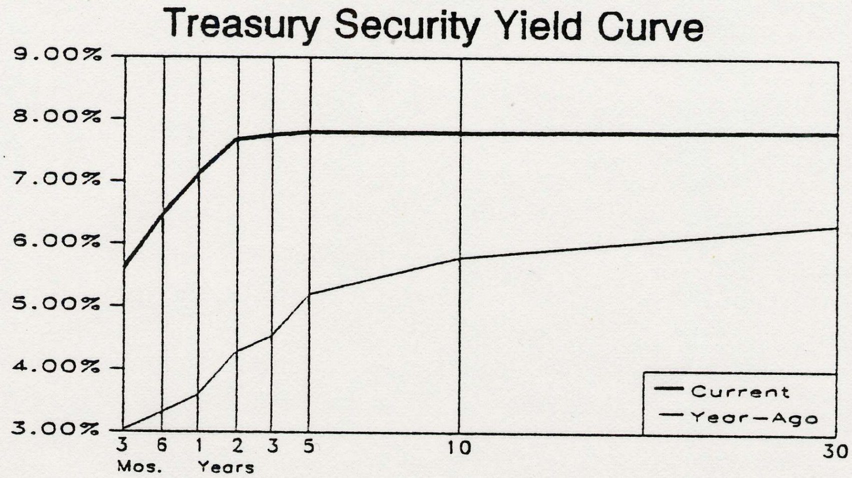


Chart 2

Spreads in corporate bonds are the lowest in years...

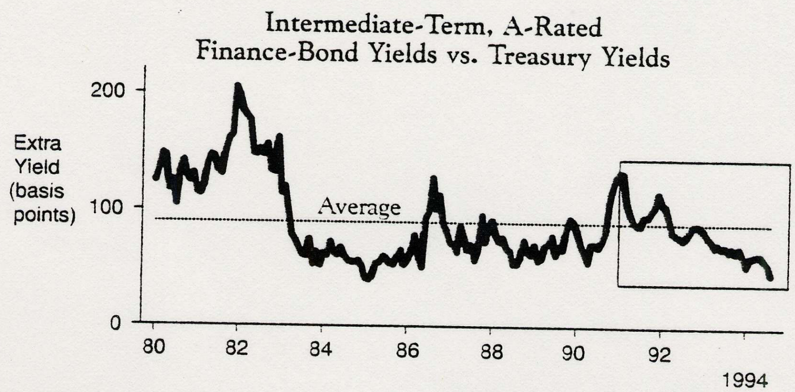


Chart 3

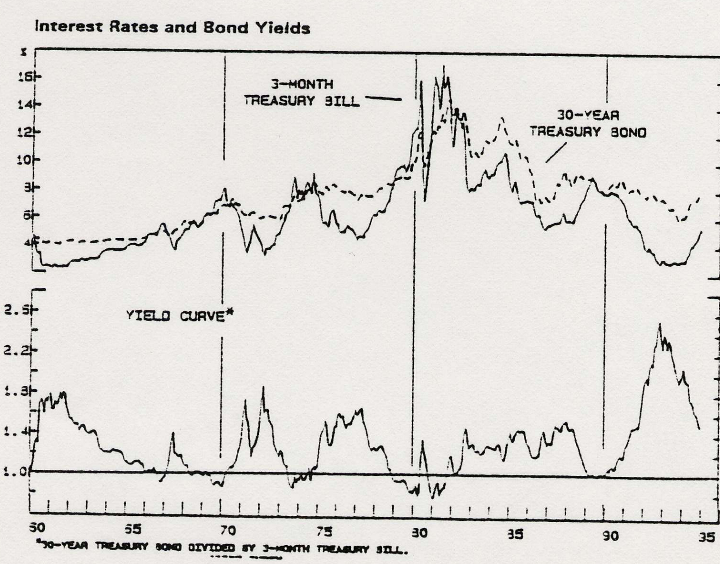
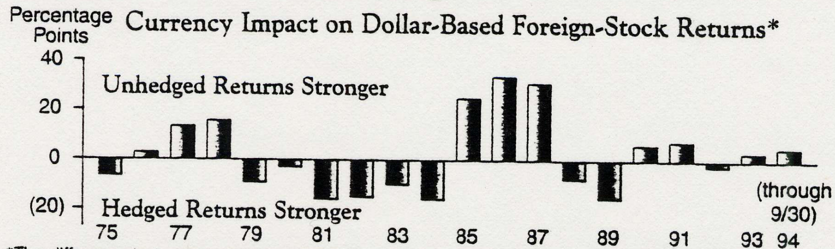


Chart 4

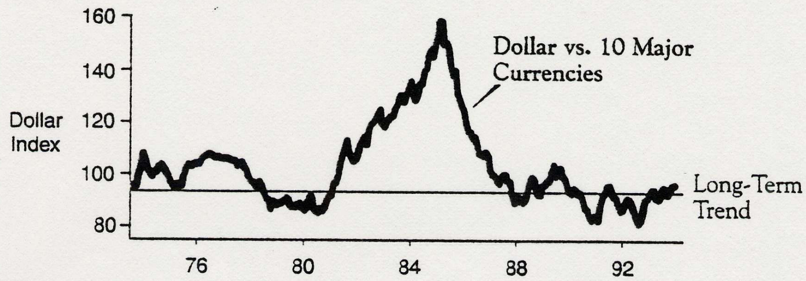
Currency movements have had a huge impact on foreign stock returns, adding almost 35 percentage points one year, subtracting 16 in another



*The difference between unhedged and hedged returns for the seven largest countries within Morgan Stanley Capital International's EAFE index of major stock markets in Europe, Australia, and the Far East, plus Canada, with countries weighted according to gross domestic product
Sample: Japan, Germany, France, Italy, U.K., Switzerland, the Netherlands, and Canada

Chart 5

In the long run currency movements have balanced out—but with significant interim ups and downs



Source: Federal Reserve Board

Chart 6

D-Mark and Yen Price of Gold

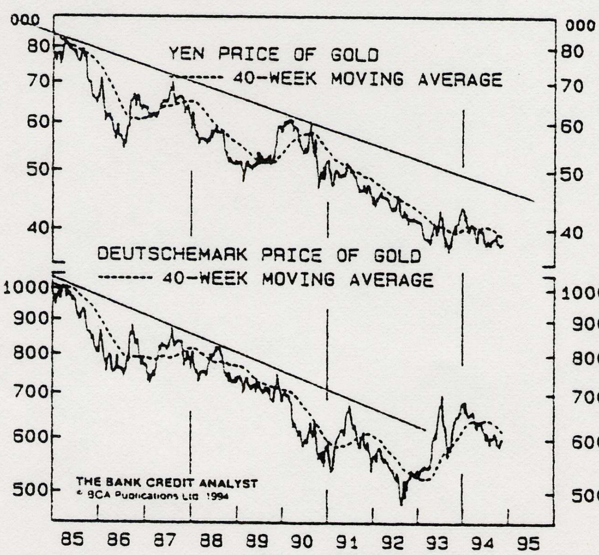


Chart 7

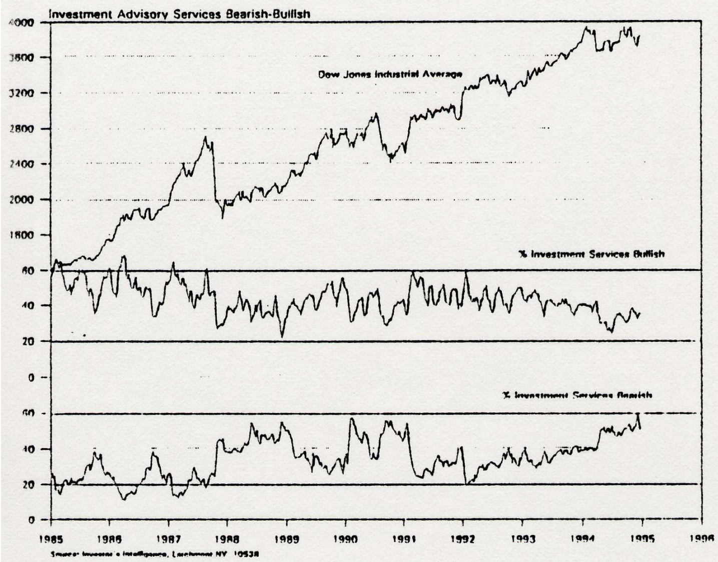


Chart 8

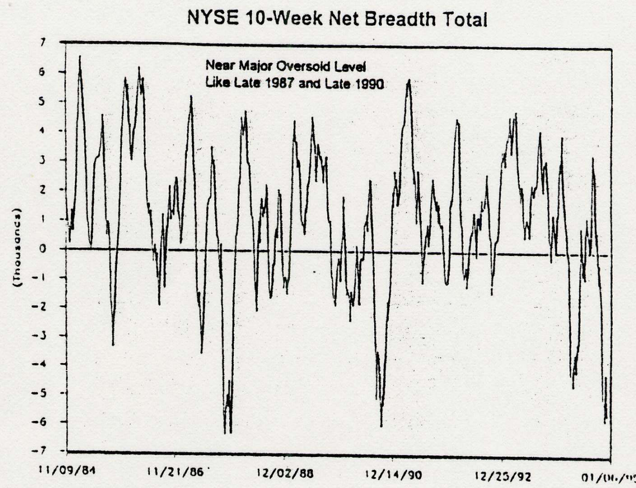


Chart 9

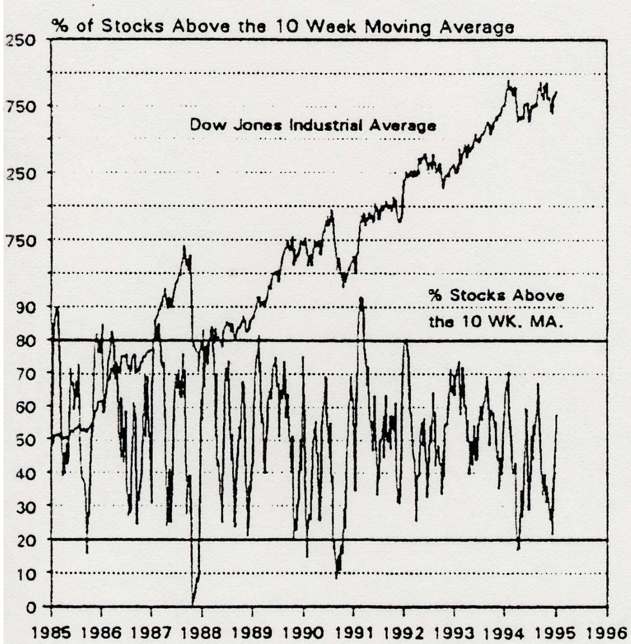


Chart 10

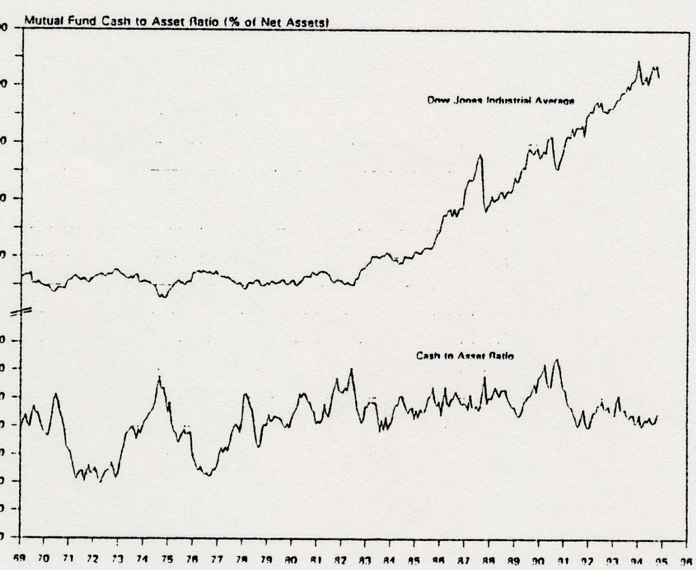


Chart 11

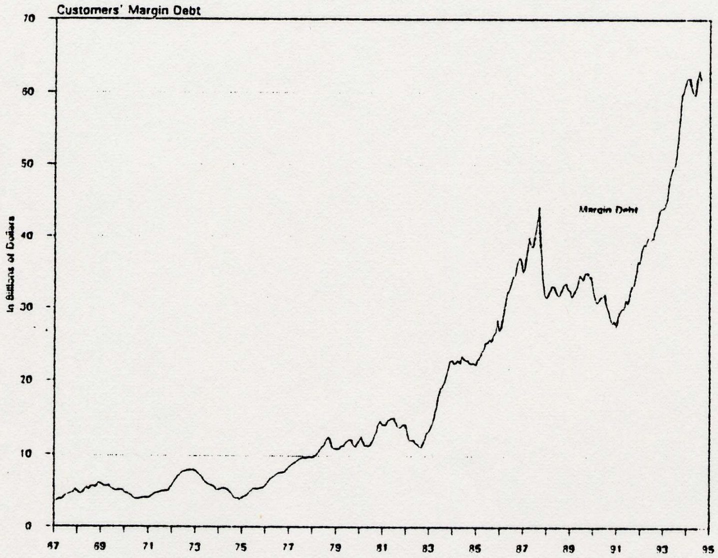


Chart 12

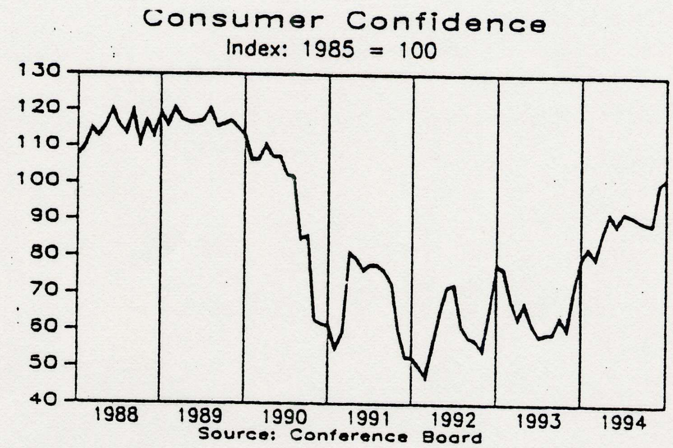
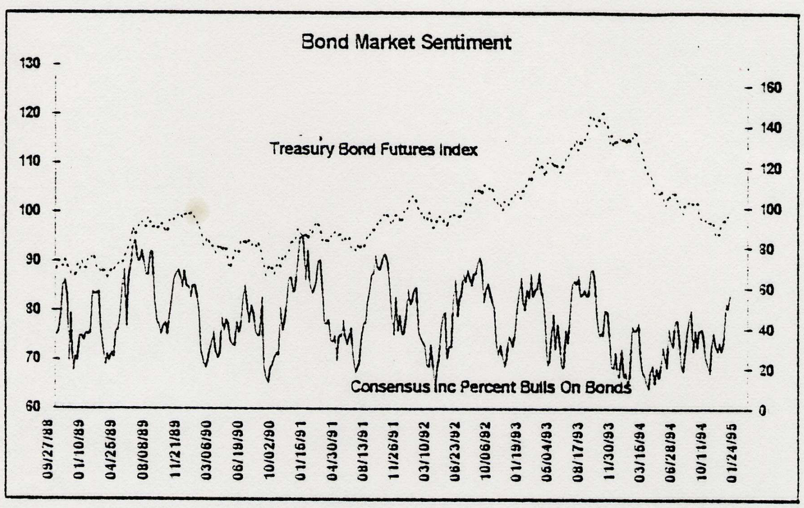


Chart 13



The level of bullish sentiment on bonds move up to 57% this week which is the highest level since the peak in bonds in September of 1993. We think that the more bullish sentiment on bonds suggests that cash is being committed to the market which could drive prices higher over the near to medium term. The more bullish sentiment, however, could leave the market vulnerable again later in the first quarter.

Chart 14