January 30, 1998

Fourth Quarter Commentary

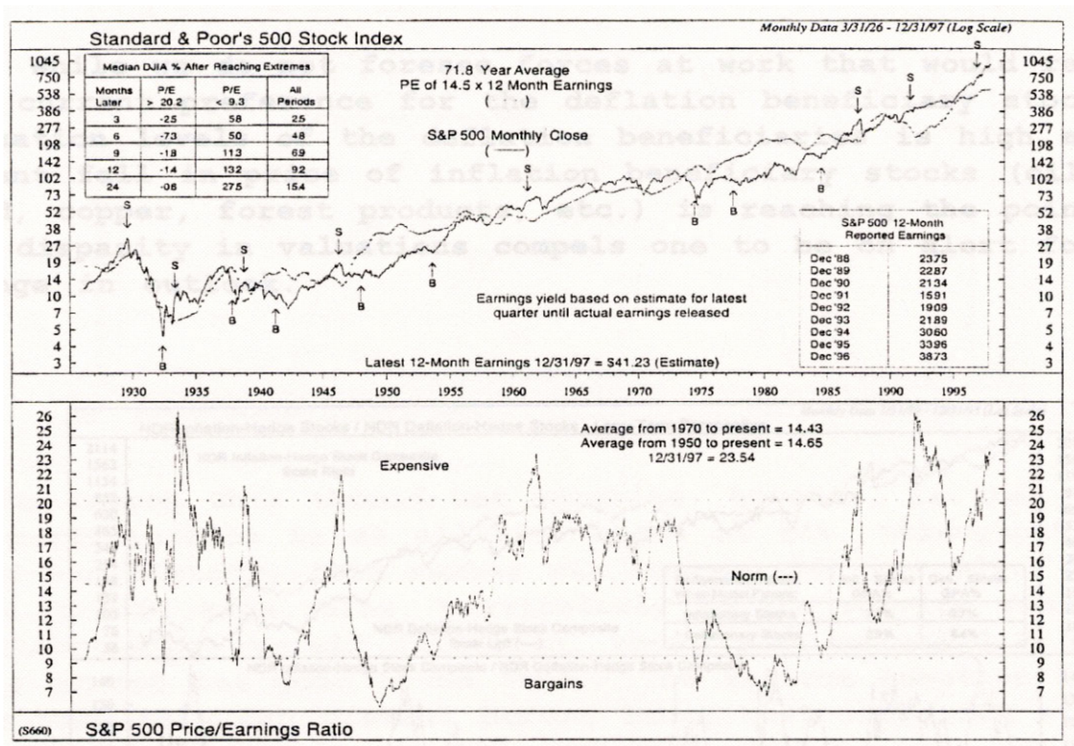
"Examine the record of history, recollect what has happened within the circle of your own experience, consider with attention what has been the conduct of all the great unfortunate… and you will find that the misfortunes of by far the greater part of them have arisen from their not knowing when they were well, when it was proper for them to sit still and be contented."

Adam Smith, 1723-1790
Scottish Economist
The Theory of Moral Sentiments, 1759

The U.S. stock market has finished it's fourth consecutive year of double-digit gains, and third consecutive year of gains exceeding twenty percent, the first such episode this century. Investors might be well advised to reflect upon this experience, consider it good fortune, and as we enter 1998, "sit still and be contented". Of course, Professor Smith of the University of Glasgow, was well known as the founder of the classical school of economics and author of "The Wealth of Nations" and not so well known as a market prognosticator. Nevertheless, his advice and observations are worth considering.

That the market is most generously valued at 23 times trailing earnings is beyond question. What is a most interesting observation from the chart below is that

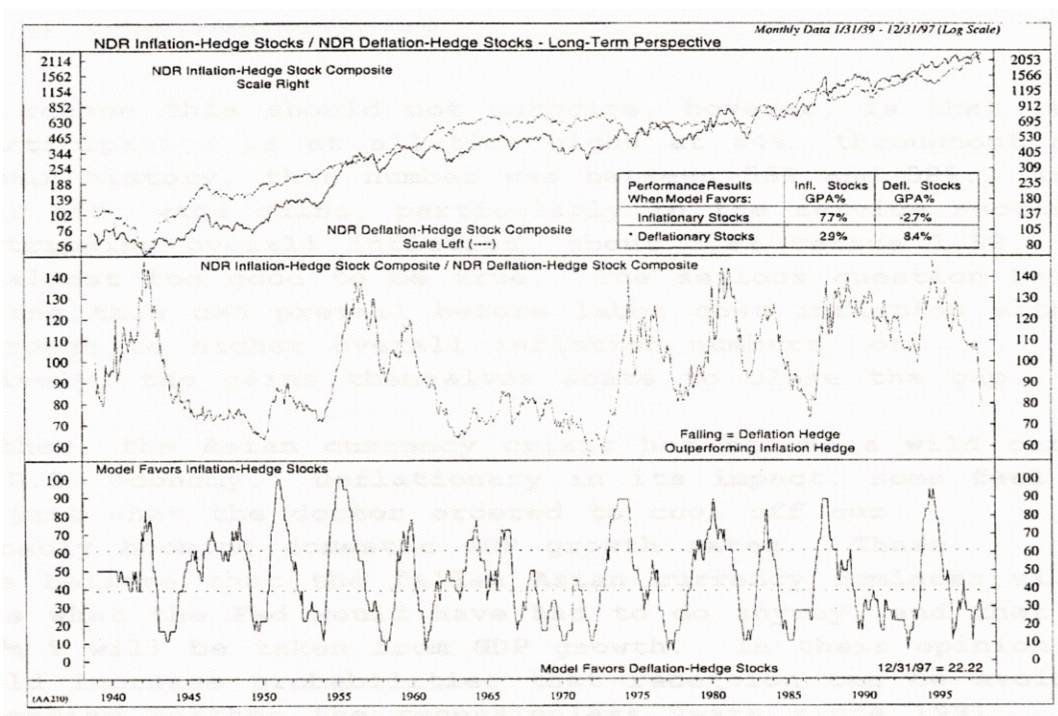
historically, once the P/E ratio exceeds 20 times on trailing earnings, expected returns from the stock market going forward become slightly negative for all time periods up to two (2) years.



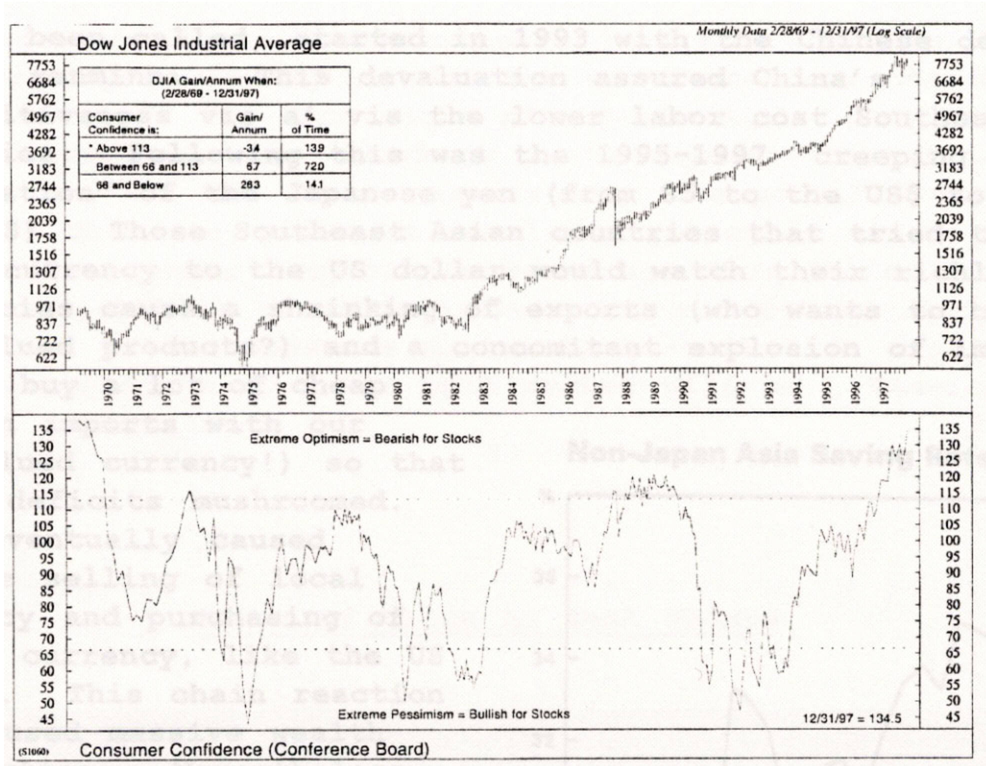
Particularly difficult in investing is the temptation to conclude that a major turning point must surely have arrived; one that must be acted upon with respectful immediacy. Market tops are particularly difficult to identify. We ask ourselves, have we seen the market top? But perhaps this is not the most important question. A more important question may be what is the probability of meaningful gains, given elevated price-earnings ratios, low yields, high multiples of price to both cash flow and book value. Answering this question relieves one of the bravery required in determining if a market at Dow Jones 7700, down from 8300, is simply catching its breath (and breadth) for a fresh assault, or, down some 7% on its way to doing more serious damage. We must remember that an often critical component of successful investing is to avoid total participation in negative years. A 25% decline requires a

33 1/3% move up to break even. If one assumes the 25% decline takes place over a year and the subsequent recovery a second year, then a 47% move up is required to achieve only a 5% per annum average return. This is why there are times when "not losing" is more critical than "winning" which requires less than full participation leading up to the market top. But such less-than-full-participation means underperformance as the top is approached. Most likely, this is where we are today in the U.S. market.

While we do not foresee forces at work that would reverse our current preference for the deflation beneficiary stocks, the valuation levels of the deflation beneficiaries is high and the recent fall in price of inflation beneficiary stocks (oils, gold, copper, forest products, etc.) is reaching the point where the disparity in valuations compels one to be on alert for a change in outlook.



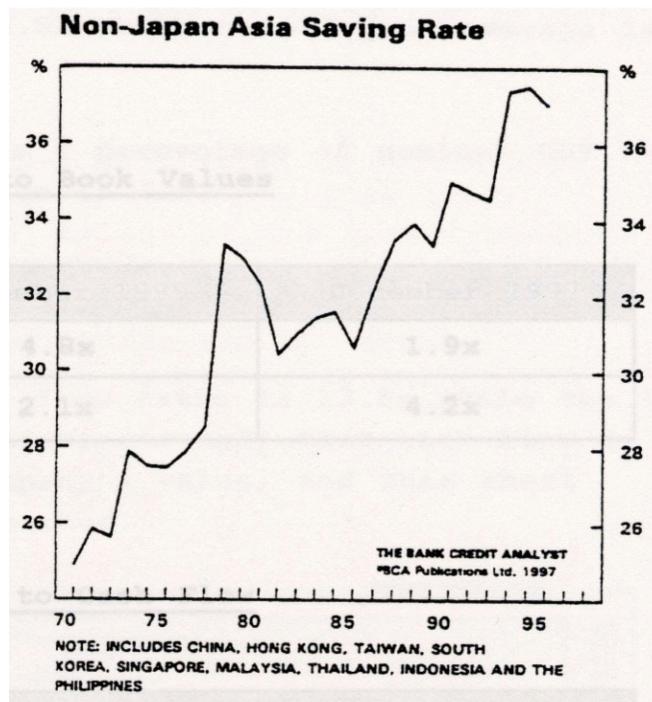
It is not surprising that the University of Michigan Consumer Sentiment Index is at all time highs. Likewise for The Conference Board Consumer Confidence Index. These two surveys have been in existence 40 years and 25 years respectively and therefore such unbridled optimism is statistically rare indeed.



The reason this should not surprise, however, is that labor force participation is at all-time highs at 64%… throughout most of post-war history, this number was between 56% and 58%. And to top it off, wage gains, particularly in the service sector, are outstripping overall inflation… about 3.8% versus 1.8%. This is almost too good to be true. The serious question here is how long this can prevail before labor cost inflation either flows through to higher overall inflation numbers, or alternatively, the gains themselves abate to close the gap.

Further, the Asian currency crisis has become a wild card for the U.S. economy. Deflationary in its impact, some feel this is just what the doctor ordered to cool off our unsustainably booming domestic GDP growth rates. These optimists believe that the fallen Asian currency dominoes will do for us what the Fed would have had to do anyway, and that perhaps ½ % will be taken from GDP growth. In their opinion, this would increase probabilities that recession can be avoided thus extending further the recessionless years since 1991.

Less sanguine observers note that the Mexican peso devaluation of 1995 cut U.S. GDP growth from 3¾% to 1¾% at a time when U.S. exports to Mexico were 10% of our total exports. Given that Asian exports without Japan are 22% and with Japan are 34%, the effect could be substantially greater than the Mexican situation of three years ago. The Asian "contagion" as it has been called, started in 1993 with the Chinese devaluation of the renminbi. This devaluation assured China's competitiveness vis a' vis the lower labor cost Southeast Asian countries. Following this was the 1995-1997 "creeping devaluation" of the Japanese yen (from 85 to the US$ to 135 to the US$). Those Southeast Asian countries that tried to "peg" their currency to the US dollar would watch their richly valued currencies cause a shrinking of exports (who wants to buy overvalued products?) and a concomitant explosion of imports (let's buy a lot of cheap foreign imports with our overvalued currency!) so that trade deficits mushroomed. This eventually caused massive selling of local currency and purchasing of strong currency, like the US dollar. This chain reaction has caused massive wealth destruction. Nevertheless, the Asian propensity to save is legendary, and can barely be understood by western cultures. The chart here shows dramatically the savings rate for all but Japan. And Japan has saved, on average, 24% of income since World War II. Moreover, Japan's ability to take corrective action to stem the crisis, including their own banking crisis, is enormous. Remember that Japan, about 120,000,000 people, have 1/3rd of the world's savings! And Japan's GDP per capita is 50% greater than GDP per capita in the United States. All that is required is political willpower and consensus. The Hashimoto regime, as weak as it is, will develop such a political consensus if only because there are no other options available in such a crisis. Most likely the prescription will include tax cuts and government spending, i.e., fiscal stimulus. Monetary stimulus is hard to come by when short-term interest rates are less than ½%! Aside from Japan, where interest rates



are almost zero, the effect of a devaluing a currency is to dramatically raise short-term interest rates. In Korea, the plunge of the won has sent interest rates to the 15% to 25% range. Yearend rates in Thailand and Indonesia were 20% and 30%. Needless to say, these rates act as a powerful magnet to suck money out of their respective local stock markets, just as it did in Mexico three years ago. In Japan, although rates are low, its market is depressed, off 62% from eight plus years ago. But, there is a silver lining in this cloudbank. The Japanese market is cheap, as are all the Asian markets with the possible exception of China. China may consider devaluing yet again since they will have lost their competitive advantage from their 1993 devaluation relative to other Asian nations. But we must take a serious look at the Japanese market because that is most likely where the world's next major bull market will be. Consider the following statistics:

Ratio of Price to Book Values

	December 1989	December 1997
M.S.C.I. Japanese Index	4.8x	1.9x
M.S.C.I. U.S. Index	2.1x	4.2x

Ratio of Price to Cash Flow

	December 1989	December 1997
M.S.C.I. Japanese Index	18x	10x
M.S.C.I. U.S. Index	7x	14x

These statistics demonstrate that the U.S. and Japan have traded places from a valuation perspective, over the past eight (8) years. On a cash flow basis, the Japanese market is 29% cheaper than the U.S. market (10x versus 14x cash flow). Furthermore, in the Japanese over-the-counter market, 60% of all stocks are trading at less that book value! Moreover, the Japanese NIKKEI 225 failed to penetrate its 1995 lows during this entire Asian crisis period. This is very important. For these reasons, we most likely will be looking to increase our portfolios' Asian exposure.

At the same time, there are a multitude of reasons we think the U.S. Market is not without vulnerability, presidential dalliances not withstanding. Rather, most of these reasons pertain to valuation.

The following are nine (9) such reasons:

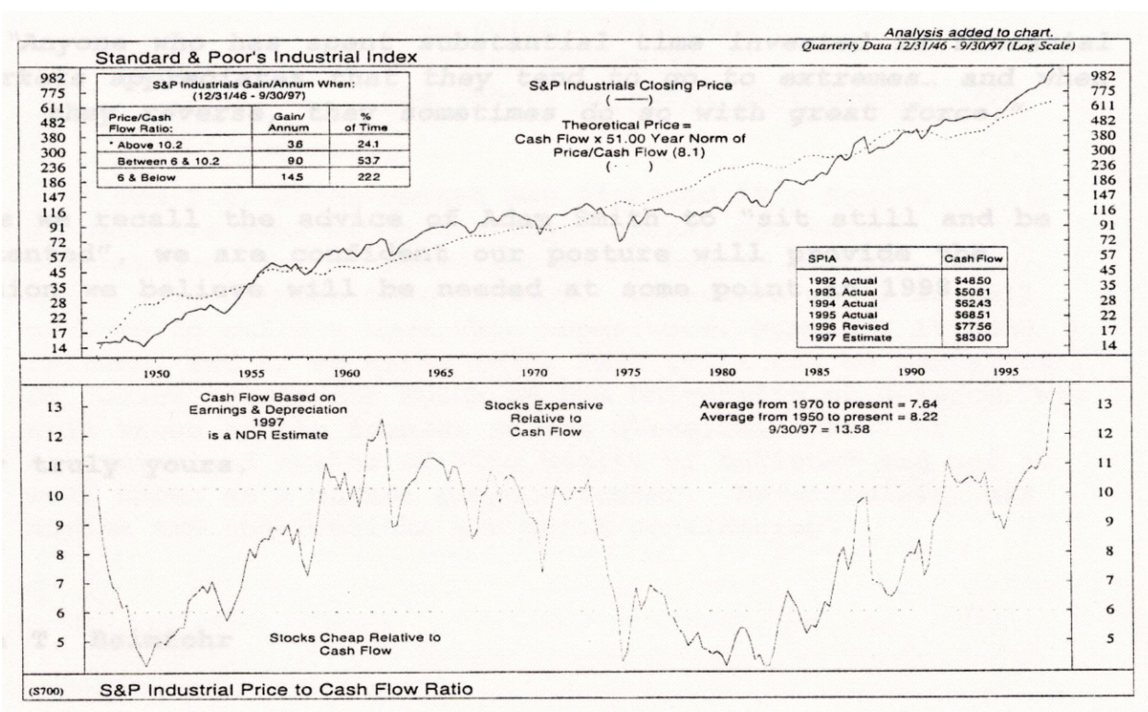
1. Price to sales ratio is 1.47 while the 42 year average is 0.80,

2. Price/earnings ratio is 23.0x while the 72 year average is 14.4x,

3. Stock market capitalization a percentage of nominal GDP is 113%, while the 72 year average is 50%,

4. S&P500 price/book value ratio is 4.6x while the 20 year average is 2.2x,

5. S&P Industrials price/cash flow ratio is 13.5x while the 47 year average 8.2x,



6. **S&P Industrials price/dividend ratio is 60x while the 72 year average 25.4x,**

7. **S&P500 dividend yield is 1.6% while the 72 year average is 3.9%,**

8. **Mutual fund cash plus switch fund cash as a percentage of assets is 3.0% while the 31 year average is 7.4%,**

9. **Number of secondary offerings in 1997 was 67 while the 39 year average is 15.**

In light of the above, we continue stubbornly to resist being fully invested in the U.S. market with the conviction that protecting capital at this juncture is one of the more important facets of our duty. Such conservatism carries a price in terms of relative performance at the end of an extended market move. Although we readily admit that the application of our conservatism has been early, we remain convinced it will prove meritorious action. As Treasury Secretary and Goldman Sachs partner Robert Rubin stated in his January 21st press conference, "Anyone who has spent substantial time invested in financial markets appreciates that they tend to go to extremes… and when they reverse, they sometimes do so with great force." As we recall the advice of Adam Smith to "sit still and be contented", we are confident our posture will provide the cushion we believe will be needed at some point in 1998.

Very truly yours,

Alan T. Beimfohr