

January 15, 2000

## **Surprise, Surprise, . . . Surprise**

We have been making the case for the last year that the strong economy in the US and rebounding economies around the world would spark inflation fears and cause interest rates to rise. We thought the early evidence of this would be rising commodity and energy prices. We forecasted that this combination of strong worldwide economic growth and rising commodity prices and interest rates would put the Federal Reserve on the prowl, thus limiting stock market gains. We stated that we were not putting forth a bearish view of stocks, we were just not as bullish as we had been for the last several years. In the environment that we saw forming, there would still be great opportunities in selected industries, which we identified as Technology, Communications, Health-Care, Retail, and Financial asset managers, but we believed the winners beyond this group would be few.

Table 1 shows that our overall prognostications were accurate for the strong US economy, improving Asian economies, and their effects on commodity prices and interest rates. As you will see later, most of our targeted industries were among the big winners during 1999. We did, however, undershoot the strength of the overall stock market. At the beginning of the year we forecasted high single digit growth for US stocks. In our October client letter, Mike Hull upgraded our stock market growth targets just a bit, but the near 20% gains recorded by the major indexes in 1999 were higher than we would have thought possible in the face of three Fed rate hikes.

Much of what happened in the US stock market in 1999 was predictable from a classic macroeconomic perspective, but the powerful surge in stocks in the final quarter of the year led by Technology was a surprise to most observers. Let's begin by looking at the major forces that drove the markets in the past year and discuss some of the outcomes that we would have expected to see, and also those that seem to have fallen from the sky, or should we say, those that seemed to kiss the sky.

**Table 1**  
**1999 Economic Indicators**

Indicator	12/98	12/99	% Change
Commodities Prices	190	208	9.5%
Oil Prices	14.00 bbl	24.75 bbl	76.8%
Nikkei Index (Japan)	13,813	18,906	36.9%
CPI	1.7%	2.7%	58.8%
30 Year US Yield	5.1%	6.5%	27.5%
S&P 500	1229	1464	19.1%

At the beginning of the year, we were convinced that interest rates would rise because of the stimulative monetary and fiscal actions of central banks around the world. This is just basic economics. The Asian economic collapse in 1998 created a flight to safety into US Treasury bonds,

which drove interest rates at year-end 1998 to multi-year lows. The collapse also drove down the prices of most commodities to levels not seen since World War II. With Asian central banks pouring money into their economies in 1999 through public works projects and increases in their money supply, it would have defied gravity to have expected that the Asian economies would not have improved. It was also not a great leap of faith to predict that raw material prices would rise. This is simple supply and demand. Our prediction of a rise in interest rates was also not a great call because the mere stabilization of the Asian economies would reverse the flight to safety into US bonds that had occurred during the collapse. If fear drove money into US bonds, it would follow that improving Asian economies would pull money back out, driving bond prices lower and pushing US interest rates higher. Even the actions of the Federal Reserve were fairly predictable because, in the past, Mr. Greenspan has stated that rising commodity prices and interest rates were early indicators of building inflationary pressures.

### **1999 Stock Market Sector Analysis**

The fact that Technology stocks had a good year was not a surprise, but the magnitude of the good year was amazing. Another very big surprise was how the market zeroed in on selected stocks in selected industries with laser-like precision and drove them to the moon, leaving other strong companies in the same industry in their dust.

The following table shows the price returns of the eleven major industry sectors as tracked by Standard and Poors.

**Table 2  
S&P Sectors 1999 Returns**

<b>Sector</b>	<b>1999 Return</b>	<b>Sector</b>	<b>1999 Return</b>
Technology	75%	Energy	16%
Capital Goods	27%	Financials	2%
Basic Materials	24%	Consumer Staples	-8%
Consumer Cyclicals	21%	Health-care	-9%
<b>S&amp;P 500 Index</b>	<b>19%</b>	Transportation	-11%
Communication Svcs	17%	Utilities	-13%

Only four sectors exceeded the return of the S&P 500, and seven underperformed. Interestingly, as was the case in 1998, there was no middle class. Either you were a winner or a loser. The sixth best performing sector Energy produced a solid 16.0%, but the seventh place Financial Sector dropped all the way to only 2.0%.

**Two hundred forty-one stocks in the S&P 500 were up, while two hundred fifty-nine were either even or down. Excluding Technology, the average stock in the S&P generated a 2% rate of return.**

### **DCM Performance**

Donaldson Capital Management offers three styles of growth stock management: Blue Chip Growth, DCM 20, and ValuTech. Although our year-end audit is not complete, it appears all three exceeded the S&P, achieving rates of return between 25% and 35%. This strong performance was the direct result of our holdings in Technology, Capital Goods, and Consumer Cyclical. Blue Chip Growth's performance was also aided by the performance of its holdings of asset managers such as American Express, Northern Trust, Marsh and McLennan, and Kansas City Southern. This group of stocks beat the financial services sector by a factor of 10 to 1. DCM 20 benefited from its heavy weighting of Technology stocks, such as Sun Microsystems, Cisco, EMC, Intel and Microsoft. Our fourth style of stock management, Rising Income/Endowment, had a poor year compared to the S&P 500. This is our income style of stock management and is our most conservative. Stocks in this portfolio must

have a dividend yield equal to that of the average stock and have dividend growth greater than the rate of inflation. By their very nature, income stocks are sensitive to interest rates. This is the reason Rising Income/Endowment enjoyed such strong performances in 1997 and 1998 when interest rates were falling. This portfolio primarily consists of stocks in Capital Goods, Communications Services, Consumer Staples, Energy, Financials, Health-care and Utilities. While some of these sectors enjoyed strong performances, the majority were underperformers. We own very few Technology stocks in this style of management because so few pay a dividend. This was a disappointing year for Rising Income/Endowment, but this is a management style that rewards patience and most of these great companies are now very cheap and ripe for a turn around. We would not be surprised if Rising Income/Endowment was among our best performing management styles in the year ahead.

## A Market of Stocks

There is an old adage on Wall Street that says it is wrong to talk about the stock market, because it isn't the stock market that goes up and down but the individual companies that are represented in the stock market indexes. Thus, it is more correct to see the financial markets as a market of stocks rather than a stock market. I think this concept may be a lot more understandable as we take a close-up view of the stocks that are represented in the Dow Jones 30. We are choosing to analyze the Dow because it is much easier to investigate its 30 stocks than the 500 stocks in the Standard and Poors Index. Study the table below for a few moments to see if you can pick out some of the characteristics of the big winners in 1999. The table is sorted by % rate of return for 1999, and separated into the 15 top performing stocks and the Bottom 15 stocks.

**Table 3**  
**Dow Jones Industrials Performance**

A	B	C	D	E	F	G	H	I
	%	%	%	%	%	%		
	1999	12	1999	5 Year	Jan 99 Est	Est 12	Current	Est 12
	Return	Month	Est	Est Earn	5yr Earn	Mo.	P/E	Mo.
NAME		Earn	Earn	Growth	Growth	Earn		P/E
		Growth	Growth			Growth		
ALCOA INC	121.3	2.4	9.2	13.9	10.4	49.2	33.4	13.9
WAL MART	69.7	27.1	23.5	14.9	13.8	26.8	57.4	47.0
HOME DEPOT	68.5	38.8	27.7	23.9	23.0	39.7	67.9	51.7
MICROSOFT	68.3	49.0	31.3	24.6	24.0	18.5	73.8	58.7
CITIGROUP	68.1	26.3	68.7	14.1	10.0	13.0	22.6	14.4
HEWLETT PKRD	66.5	19.7	-4.0	14.8	14.7	13.2	37.3	27.9
AMER EXPRESS	62.2	16.4	13.9	13.5	13.5	13.0	29.4	22.2
GENERAL ELEC	51.7	16.5	13.8	14.1	13.3	14.4	48.7	35.9
INTEL	38.8	28.2	-12.6	20.1	20.2	17.4	41.0	27.7
MMM	37.6	18.7	-3.3	10.5	10.0	10.3	26.4	19.4
HONEYWELL	30.2	14.9	20.5	15.2	13.0	21.0	22.7	15.4
BOEING CO	26.8	136.0	28.5	17.5	16.6	-1.7	19.4	14.8
INTL PAPER	26.0	-51.1	-10.6	5.3	6.8	136.3	127.1	9.9
GM	24.1	123.6	-47.0	7.6	7.3	-2.5	8.1	9.1
DU PONT	21.4	168.7	-14.3	10.5	10.3	14.4	32.5	19.6
Median	51.7	26.3	13.8	14.1	13.3	14.4	33.4	19.6
MORGAN J P	20.5	46.1	-32.0	10.7	10.2	4.3	14.7	N/A
PROCTER & GAMBLE	20.0	-1.6	10.2	13.3	12.7	12.4	44.7	31.6
IBM	17.0	35.5	8.7	12.8	11.4	16.8	27.8	23.6
JOHNSON &	11.2	-3.9	11.2	13.2	13.1	12.5	37.3	24.3

<b>JOHNSON</b>								
<b>EXXON MOBIL CORP</b>	<b>10.2</b>	<b>5.2</b>	<b>-19.0</b>	<b>9.3</b>	<b>6.7</b>	<b>35.8</b>	<b>41.8</b>	<b>23.5</b>
<b>UNITED TECH</b>	<b>9.1</b>	<b>-6.6</b>	<b>18.7</b>	<b>15.2</b>	<b>13.9</b>	<b>14.9</b>	<b>30.0</b>	<b>16.4</b>
<b>MCDONALDS</b>	<b>4.9</b>	<b>14.0</b>	<b>9.4</b>	<b>12.1</b>	<b>12.6</b>	<b>12.4</b>	<b>30.8</b>	<b>22.7</b>
<b>CATERPILLAR INC</b>	<b>2.3</b>	<b>-37.6</b>	<b>-2.9</b>	<b>10.1</b>	<b>10.7</b>	<b>23.5</b>	<b>18.4</b>	<b>11.6</b>
<b>AT&amp;T CORP</b>	<b>0.6</b>	<b>27.7</b>	<b>28.5</b>	<b>13.7</b>	<b>11.8</b>	<b>4.5</b>	<b>24.0</b>	<b>19.4</b>
<b>DISNEY WALT</b>	<b>-2.5</b>	<b>-29.3</b>	<b>3.5</b>	<b>14.4</b>	<b>15.5</b>	<b>4.1</b>	<b>56.9</b>	<b>40.3</b>
<b>EASTMAN KODAK</b>	<b>-8.0</b>	<b>227.6</b>	<b>25.6</b>	<b>10.4</b>	<b>11.0</b>	<b>12.6</b>	<b>17.2</b>	<b>10.1</b>
<b>MERCK &amp; CO INC</b>	<b>-8.9</b>	<b>13.9</b>	<b>15.0</b>	<b>12.4</b>	<b>13.7</b>	<b>13.2</b>	<b>30.6</b>	<b>24.0</b>
<b>SBC COMM</b>	<b>-9.1</b>	<b>11.1</b>	<b>10.2</b>	<b>12.8</b>	<b>10.4</b>	<b>7.0</b>	<b>20.3</b>	<b>17.0</b>
<b>COCA COLA</b>	<b>-13.1</b>	<b>-16.8</b>	<b>-13.4</b>	<b>14.4</b>	<b>16.1</b>	<b>18.0</b>	<b>47.4</b>	<b>33.7</b>
<b>PHILIP MORRIS</b>	<b>-57.0</b>	<b>-3.9</b>	<b>8.5</b>	<b>12.2</b>	<b>13.5</b>	<b>11.6</b>	<b>9.5</b>	<b>5.7</b>
<b>Median</b>	<b>2.3</b>	<b>5.2</b>	<b>9.4</b>	<b>12.8</b>	<b>12.6</b>	<b>12.5</b>	<b>30.0</b>	<b>23.1</b>

From the earlier sector analysis, we would expect to see Technology stocks as the big winners with Capital Goods, Basic Materials, and Consumer Cyclical also showing up near the top. A look at the results immediately begins to reveal some surprises. The top Tech stock, Microsoft, finished in fourth place behind two Consumer Cyclical stocks, Wal-Mart and Home Depot. But the biggest winner in the Dow Jones 30 was a company straight out of the industrial age, Alcoa, a Basic Materials stock. Indeed, the Basic Material stocks (Alcoa, International Paper, and Dupont) in the Dow Jones all finished in the top 15. They are commodity-based stocks and, as we showed earlier, commodity prices moved higher during the year. Thus, it would follow that companies that produce commodities should have enjoyed strong earnings and rising prices.

### **Top 15**

The Top 15 stocks on Table 3 are all in the sectors we would have expected with two exceptions: American Express and Citigroup, which are both Financials. As shown earlier, the Financial sector had a very difficult year, so two Financials finishing in the Top 15 is a big surprise. We believe there is an easy explanation as to why these two stocks, in particular, did well. They are not traditional financial services companies, but have both recast themselves as, primarily, asset managers and providers of other fee-based services. This is one of the themes we have been speaking about for the last couple of years. The asset managers are less sensitive to changes in interest rates than are the traditional banks. In addition, the aging of the baby boomers and their need for getting serious about building up resources for retirement is a strong tailwind for the asset managers.

### **America Shops and Shops**

We believe the powerful performance of Wal-Mart and Home Depot is revealing a secondary trend that is becoming more and more apparent. These are not just retail stores. These are dominant low-cost, discount stores. America used to shop at Sears, but not anymore. Today America shops at Wal-Mart and Home Depot. These companies are reaping the rewards of the huge increases in family incomes that the strong economy has produced in the 1990s. Much is made of the Silicon Valley millionaires, but on a comparative disposable income basis, we believe middle and lower middle income households are experiencing almost as profound a change in their relative standards of living as are the "dot-comers." Mom or Dad, or both, are getting higher pay, working more hours and overtime, and experiencing fewer layoff days. The kids are working more hours at substantially higher wages than just a few years ago. Perhaps no one member of the family is experiencing exploding earnings, but taken together, as a unit, they have greatly increased their disposable income. We believe this is a trend that is not widely recognized and has profound implications for the US economy. We will be discussing this phenomenon in a future special report.

Three Capital Goods stocks, GE, MMM, and Boeing, made the Top 15. During the year, Mike Hull pointed out that the Capital Goods stocks were poised for better performance as a result of the improving worldwide economy. We think there is more to come here.

## The Bottom 15

A look at the Bottom 15 stocks also reveals a somewhat expected pattern. The Consumer Staples--Procter and Gamble, McDonalds, Coke, and Philip Morris, are well represented in the Bottom 15. We think the underlying story here is the collapse of Asia in 1998. Many of these companies derive a large portion of their earnings outside the US. For example, Coke generates over 75% of its earnings abroad. The collapse of most of the Asian currencies against the dollar in 1998 caused an inadvertent huge increase in prices for US goods. The typical Asian consumer had fewer resources after the collapse and more uncertain job security. Thus, there would be some natural pulling back on luxury items such as a bottle of Coke in that part of the world. In addition, the collapse in the local currencies against the US dollar meant that the price of a Coke either had to go higher or Coke's profit margins were going to take a hit. Coke takes a very long view of these occasional jolts to the world economies and they kept prices low to defend their market share. Their profits just evaporated. As the Asian and Japanese economies strengthened throughout 1999, Coke was able to announce some price increases. The effects of these will be seen in 2000 and beyond.

The performance of Consumer Staples and Financials makes sense to us: Asia did in the Staples and the Federal Reserve did in the Financials, but the rough treatment the Health-care and Communication Services stocks received needs some explaining. Rising interest rates normally do not beat up Health-care stocks as they did in 1999. Because of their steady earnings, the Health-care stocks can usually shrug off higher interest rates. We think there is one main reason Health-care stocks fared poorly in 1999: politics. All the politicians are talking about offering some form of prescriptions to Medicare recipients. The stock market just detests the thought of the government getting more involved in negotiating (setting) drug prices for Medicare. This subpar performance of the Drug stocks has left them as the most undervalued sector we follow. The Communications Services sector, as represented by AT&T and SBC Communications, is a simple case of old technology versus new. Both of these companies have large stakes in slow-growing, traditional telephone services. Even though both have been aggressively moving into the new areas of communications services, the market is betting that the younger, more focused companies will ultimately be the big winners in the battle to offer more and faster telephone, Internet, and entertainment services.

## Winner Takes All

Follow very closely as we start to take an in-depth look at the data in Table 3. We believe you will find some of the information as surprising as we did. **Column B on the Table shows the Top 15 stocks produced a median rate of return of 51.7% compared with the Bottom 15's median return of 2.3%, a striking difference of over 22 times.** Almost as striking is the comparison of the earnings growth of the top and bottom performing companies. Column C shows that the top companies produced median annual earnings growth of 26.3% versus 5.2% for the bottom companies. This is, obviously, the primary reason for the price performance differential, but it only explains part of the difference. We think there are two additional factors. The chart shows the Top 15 outperformed the Bottom 15 in price by over 22 times, but the difference in earnings is only about five times. Why was the market paying such a high premium for growth? We believe the first reason is what we will call the theory of headwinds or hurdles. We have often noted that in periods of rising interest rates, stocks that can produce earnings growth at a higher rate than the rate of growth of interest rates can overcome the headwinds that higher interest rates impose. Is it not curious that the 26.3% earnings gain for the Top 15 is nearly the same as the percent rise in long-term interest rates as shown on Chart 1 of 27.5%? This is a kind of winner-takes-all game where the few companies that can jump the hurdle or run faster than the headwind get to collect all the money on the table. There are, of course, exceptions to this line of thinking in both the top and bottom lists of stocks, but I'm speaking here of the median returns.

## Surprise, Surprise

The second contributing factor to the outsized performance of the Top 15 was the element of surprise. Column D shows the consensus estimates of 1999 earnings growth for each of the companies by Wall Street analysts as of the first week in January of 1999. The analysts projected that the Top 15 stocks would have 1999 earnings growth of 13.8%, while the Bottom 15 were targeted at just 9.4%. On the surface, the Top 15 had a higher hurdle to clear at the beginning of the year than did the Bottom 15. But, in fact, as column C shows, the Top 15 stocks nearly doubled the analysts' projected earnings targets for 1999, while the Bottom 15's median earnings growth was only about 60% of Wall Street's targets. **This combination of positive earnings surprises for the Top 15 with negative earnings surprises for the Bottom 15, in our judgement, was the prime contributor to the winner-takes-all difference between the top and bottom stocks.**

## Technology Rules

Technology stocks were the biggest benefactors of the winner-takes-all game. They had three things going for them that propelled their ascent. (1) As a sector their earnings growth of almost 30% not only cleared the interest rate hurdle, but far-exceeded the growth of any other sector; (2) no industry had more positive earnings surprises; and (3) the incredible free publicity surrounding Internet and telecommunications revolution drew Mr. & Mrs. America and all ships at sea into these stocks. The only thing that seemed to be able to stop the Tech stocks was Alan Greenspan. The Tech stocks went into a sideways motion from April through late October, a time when the Fed was raising rates and growling about a bubble forming under stocks. **However, when the Fed made it clear that they planned no further moves in November, the Tech stocks exploded once again.**

### Who Dunnit?

But if 1999 was a story of surprises, we believe there are more characters in the drama whose actions we must investigate. The first are the Wall Street analysts. The markets rely heavily on the expertise and opinions of these powerful individuals. The top analysts at Goldman Sachs, Merrill Lynch, Morgan Stanley, and Salomon Smith Barney wield tremendous clout and are the main drivers of earnings estimates for most large companies that trade in the US. Other Wall Street firms and regional firms may also have an analyst or two that has gained a national reputation. Among the scores of analysts that cover each company there is a certain homage paid to the one or two seasoned professionals who seem to be in the know, so to speak. Table 3 shows a multitude of surprises top to bottom for earnings of the Dow stocks, which are the most widely followed companies in the world. When we say the Top 15 had surprisingly good earnings growth, the surprise lands, primarily, at the feet of the major analysts in the stock. Likewise, when we say that the very poor earnings growth of the Bottom 15 stocks surprised the market, that is not entirely correct. The poor earnings were mostly a surprise to the big name analysts that cover the stocks.

**Simply said, the analysts' estimates for 1999 missed by a mile.** It was the analysts who were most surprised by the earnings growth of the past 12 months, both good and bad.

## The Not so Silent Partner

There is a certain glee most of us feel when the big guys are wrong, but let me share a word of caution that has great ramifications for stocks in 2000 and beyond. Big name analysts maintain power and longevity by cultivating a very close relationship with the people who run the companies they cover. Most of these analysts have an unspoken approval by the company of their official earnings estimates before they publish them to the world. **If the big name analysts were surprised, then it was because the companies they cover were surprised. If the companies were surprised, we have the making of a very unstable situation developing. Without accurate guidance from the companies, estimating earnings becomes more and more just a guess.**

## Volatility Will Increase

Earnings surprises of the magnitude we saw in 1999 are not sustainable, and thus, create a more volatile and potentially dangerous market. Why? Because the value of a stock is based on an investor's ability to project a stream of earnings far into the future. Donaldson Capital Management's valuation model uses a 20-year time horizon to determine the present value of a stock. The more volatile a company's earnings are, the less confident we are of what growth rate to use in our computations. Volatile earnings, even if they are positive, are not as valuable as earnings that are more predictable. A surprise is a surprise is a surprise. By their nature, surprises are neither good nor bad. But the fact that something has occurred that was unexpected raises the probability that sooner or later another unexpected event will occur. The continuing string of positive earnings surprises that we witnessed in 1999 is worrisome for two reasons, (1) one day the surprises will end, and (2) just as many companies get into trouble with too much success as too little. The following is an amazing statistic: **The Top 15 stocks of the Dow Jones 30 had an average of 3.2 positive quarterly earnings surprises for the four quarters of 1999.**

## Whisper Numbers

It is important to remember that the stock market is a discounting mechanism. It has a mind of its own and factors in events that it expects to happen before they actually happen. **If corporate earnings are beating street estimates quarter after quarter, and the companies exceeding their estimates are also making the biggest stock market gains, it is just a matter of time before investors begin to bet on earnings surprises.** This would mean that companies that have been beating estimates must keep beating them or face the wrath of the market. Secondly, if the official earnings estimates are consistently low, the market will find another source of information that is more accurate.

In the past twelve months, the term "whisper number" has crept into the language of Wall Street. The "whisper number" is the unofficial estimate of what a company is really going to report. There are Internet web-sites solely devoted to "whisper numbers." A person who runs one of these sights was recently asked how he could investigate thousands of companies more accurately than the Wall Street analysts. He answered that he did not investigate the companies. He just did mathematical computations of each company's trend of earnings growth and projected it into the next quarter. He reported that an independent company had analyzed his earnings estimates and reported they were statistically more accurate than the Wall Street estimates. Now think about this for a moment. **The question that should immediately jump into your mind is, how long can this go on?**

As I said before, Wall Street analysts are proud, powerful people. Do you think they can continue to have their numbers this far off the mark? How long before management at Wall Street investment firms starts to insist on tighter numbers? How long before the analysts advise the companies they cover that if some guy with a website and a computer can predict quarterly earnings better than people inside the company, they might as well listen to the guy with the computer? **Wall Street analysts are paid for being right, not for being close.** But perhaps, most importantly, how long before some analyst from a regional firm decides to stop following the pack and starts to do the same thing as the guy who runs the website? And what happens if the regional analyst's estimates are closer to the actual results than the Wall Street analyst, and he wins the "Institutional Investors" All-American award (the industries highest award)? Worse, what if the Wall Street Journal does an investigative report and says that the big Wall Street firms have lost their touch in estimating earnings? The impact of that kind of news would resound through every mutual fund, bank trust department, insurance company and the financial media.

## A Change is Coming

In my judgement, the big analysts on Wall Street will be using every bit of their intelligence, connections, and resources to be more on target with their earnings estimates this year. Herein lies a looming problem. Investors have started to count on surprises. Under the scenario I have just mentioned, positive surprises should become progressively fewer because Wall Street analysts will be trying harder to hit the mark. This leads us to the probability that negative surprises could become more common. Whoops! Eventually the market would adjust to living with the new tighter estimates by the analysts, but not right away. We would be going from a market where 70% of companies either meet or exceed estimates to one where there would, perhaps, be as many companies falling short of earnings targets as are exceeding them. There is no question under this scenario, the stock market would pullback to lower P/Es while it sought to understand what the new methodology would ultimately mean. **Warnings and guidance would increase from companies attempting to keep investors more up to date on the progress of earnings. Every warning or guidance would send shudders through the financial markets. The earnings season that now comes four times a year would essentially be every day. Price volatility would dramatically increase. Throw in the Federal Reserve's probable rate increases in the early part of the year and the soup gets very hot.**

### How Do We Navigate the Approaching Earnings Surprise Volatility?

Our primary investment strategy is long-term growth; thus we invest in companies that we believe can grow earnings at a high and consistent rate for the next three to five years. For this reason, we view the quarterly earnings reports as a kind of window through which we can take a peak at how the company is doing compared to its own goals, as well as our internal estimates. In rare cases do we act on the basis of a single quarter, and we do not buy stocks just because we think they will beat their quarterly estimate this quarter or next. From time to time we do add to existing positions, if we think Wall Street earnings estimates are low, or sometimes we will cut back if we think the consensus estimates are too high. But we do not "bet" the earnings surprise as is done so widely today. Bob Wuerth, our analyst, grades each company's quarterly earnings as to its quality. Our main interest is how real are the earnings from an operational perspective. Is the company stretching to show good numbers, or, worse, "painting" the numbers? We are patient and if a company has a good explanation for a bad quarter, we normally will hold a stock even with a very disappointing price performance. **Our buy and sell discipline is based on what I call the fulfilling of the story. Is this company's unfolding pattern of earnings and business success consistent with the reasons we bought it? If it is, we'll hold it for a very long time. If we see that the company is losing its storyline and not measuring up to our expectations and we see no turnaround in sight, we will sell it. We believe our long-term view of corporate earnings has proved itself as a winning strategy, not just for us but many of the largest and oldest money managers we know.**

### The Coming Year

None of the above strategies can be implemented, however, while ignoring the overall economic climate. For 2000, we expect the economy will begin to slow by the second quarter, if it hasn't already. With that in mind, you can watch for long-term interest rates to peak in the first quarter. Until they do, Technology stocks will continue to do well. Once rates peak and the interest rate headwinds subside, the market should find companies with somewhat more modest, but much more predictable, earnings growth increasingly attractive. These are the characteristics of industry sectors that performed very poorly in 1999 and are now undervalued by historic standards: Drugs, Financials, and Consumer Staples. Stocks of this kind are likely to get an added boost once the earnings surprises in Technology stocks become more balanced. The pressure for more accurate earnings projections for the Tech stocks will mean fewer positive earnings surprises and more earnings disappointments. This will add an element of uncertainty to Technology stocks that has not been present for the last two years. The technology revolution is in no way finished. We just see the year 2000 giving some of the Tech stocks a needed pause.

We think another reason consistent earners are likely to become more in favor are the uncertainties that are undoubtedly going to abound as a result of the 2000 elections. With both parties claiming credit for the economic miracle of the last decade, we have a genuine worry that the real creators of the prosperity, namely American business people, will be asked to share a greater and greater percentage of the fruits of their efforts. In the end, that would stifle the creativity and ingenuity that got us to this point. Unfortunately, history has too often shown that periods of strong economic growth are followed by sub-par growth because of ill-conceived actions by politicians seeking to redistribute the wealth.

Blessings,

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