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Heavy Weather

Volatile and uncertain. That's the only way to describe the stock market of recent weeks. The forces behind this volatility and uncertainty are the same as we have been discussing for most of the last year: (1) Earnings worries on Wall Street, particularly the Tech stocks, which are causing an unwinding of the excesses of 1999; (2) Interest rate and inflation worries that appear to tie the hands of the Fed. In addition, we believe there are two other worries that have surfaced in the past few months that are also adding to the uncertainties: The rapid run up in oil prices and the anti-business tone of Al Gore.

Earnings Worries

This is the biggest worry facing the market. In our April client letter we discussed in detail why we thought the remarkable performance of Tech stocks in 1999 would be unwound in 2000. The following is a quote from our April letter.

"If you think it is normal for Tech stocks, or any investment for that matter, to go up everyday like the Techs did in 1999; you have not spent much time looking at the history of booms and busts. Such price action is a sure sign that a mania is underway, and manias do not end gracefully. . . . During the remainder of 2000 the markets are likely to readjust themselves to a more realistic appraisal of all stocks."

Like most manias, however, the Tech story had some truth to it. Indeed, it is clear that a technological revolution is underway. The Internet will change the way we communicate, shop, and select our entertainment. Wireless or cellular telephones equipped with Internet access will one day be as ubiquitous as old fashion telephones. Biotech will shape the future of medicine. Few people doubt the truths of these statements, but to think that Dotcom companies were going to wipe out every brick and mortar company was a pipedream. However, the illusion was fed by its ring of truth and the incredible explosion in sales of its early success stories like AOL, Yahoo, and Amazon. The illusion became a full-fledged mania when AOL and then Yahoo actually started making money. The widespread belief was that the so-called New Economy companies would engage in a type of creative

destruction, whereby Amazon would supplant Barnes and Noble, Ebay would take out the shopping malls, Drugstore.com would snuff out Walgreens, Auto.com would put an end to the local auto dealers, and so on.

But the Tech mania was more than just the Dotcom companies. There were hundreds of companies involved in various segments of the technology industry that were huge benefactors of the ramp up of the Internet. These were small to medium sized companies that offered niche products in switching, high-speed data, wireless, or fiber optics. Most of these niche companies had a very limited clientele such as the telephone companies, education or the military, but their technology was advanced, which allowed them to produce solid revenue and earnings growth, often near 20% per annum. As more and more companies began pouring resources into the internet, these niche companies began to grow at a faster and faster rate because not only was the internet a whole new market for their products, but the new players in the industry dramatically expanded their customer base. As the rate of earnings growth of the niche companies accelerated, a wider investment audience became aware of the importance and success of these companies, and began to bid up their prices on the bet that the earnings acceleration would continue. This is what we have dubbed the "earnings acceleration craze" that was so common in the last few years. Most serious investors steered clear of the Dotcom game, but these niche tech companies with their strong revenue and earnings growth and leading edge technologies became the darlings of the mutual funds and, ultimately, of individual investors.

Arithmetic of the Craze

Table 1

XYZ Technology Corporation

	(1) Earning per Share	(2) % Annual Earning Growth	(3) Average Price/ Earning s	(4) Market Price	(5) % increase in Value of Investme nt
1996	\$1.00		25X	\$25.00	
1997	\$1.25	25%	30X	\$37.50	50%
1998	\$1.63	35%	45X	\$73.00	95%
1999	\$2.30	40%	70X	\$161.00	120%
2000E st	\$3.10	35%	40X	\$124.00	-25%

Let us give you an example of the earning acceleration craze. Above is a Table of the earnings and price growth of XYZ Tech Corp, a high tech company in the communications business. XYZ had 20% annual earnings growth for the period from 1990 to 1996. During this time it sold at an average of 25 times earnings (P/E, column 3). In 1997 earnings grew at 25% and the average P/E rose to 30X. Thus, we see the genesis of the acceleration in both the rate of earnings growth and the price to earnings ratio. Please study Table 1 for a few minutes to familiarize yourself with the power of this dual acceleration phenomenon.

Focus on 1997 for a moment. XYZ Corp's earnings grew 25%, but its share price grew 50%. These outsized gains are the result of simple math, but at first, hard to understand. Since we have a whole table of these dual accelerations, let's work through 1997 to be sure we understand just exactly how a 25% increase in earnings could have produced a 50% increase in the value of the stock (column 5). It begins in 1996, our baseline year. XYZ earned \$1.00 and the market gave it an average P/E (from column 3) of 25X. Thus, to compute the price of the stock we simply multiply 25 times \$1.00, which results in a per share price of \$25.00. In 1997, earnings grew 25% to \$1.25, but because of the acceptance of XYZ's new fiber optics products, investors bid up its P/E to 30X. This resulted in a stock price at the end of 1997 of \$37.50 (\$1.25 times 30), or 50% higher than at the end of 1996. This dual acceleration of earnings and P/E continued through 1998 and 1999, with even greater gains in the price of XYZ's stock. The company's earnings grew almost 130% from 1996 through 1999, yet their stock price exploded almost 550%. Thus, we have a very solid growth performance by the company, but an astonishing pricing performance from investors.

At first glance, this sort of dual escalation is quite common and natural. Investors are willing to pay a higher P/E for companies with higher earnings growth, so long as they believe the earnings growth is sustainable. In XYZ Corp's case, because of the mania that has surrounded the internet and the company's advanced technology, it seemed like a reasonably safe bet to many investors that their earnings would keep growing at a very high rate well into the future. But remember we have discussed other characters in this unfolding earnings acceleration drama. The first characters were the Dotcom companies. Many of them became customers of XYZ, which significantly helped earnings growth in 1997-1999. But, the Dotcom businesses began to tank in the early spring of 2000, and many of them canceled orders that XYZ had booked. Secondly, as we said earlier, there were literally hundreds of companies in the niche Tech business that XYZ occupies. If investors gradually discovered XYZ Corp's fast growing business, then competitors could not be far behind. In mid-2000, QRS, a company that had not formally competed head-on with XYZ, introduced a new switching product. Even though the product does not seem to threaten XYZ very much in the long run, XYZ did lose some business to the new product.

Missed Earnings Massacres

In late September of this year, XYZ Corp's top management could see that the Dotcom's demise and the lost business to QRS would narrowly reduce their earnings for the remainder of the year. In a statement to the investment community, XYZ explained that earnings, which had been expected to grow 40% in 2000, would grow at 35%. They gave every assurance that earnings would again reach the 40% growth level in 2001 when they planned to introduce many new products. They also assured the investors that their business with their primary customers, the big telephone and education, was running ahead of plan. Minutes after this announcement hit the wire services XYZ's stock plunged 25%. XYZ has just been expelled from the world of the "dual acceleration darlings," and landed in a new world called the "missed earnings massacres." As a result, XYZ's strong 35% earnings growth in 2000 is not rewarded with a 45X P/E, as was the case in 1998, but with a 40XP/E (see Table). The market now believes the company's earnings growth may slow even further. The dual acceleration of earnings and P/E that XYZ and so many Tech companies enjoyed for the last three years has now been replaced with double-barreled trouble. Even though the XYZ Corp's earnings are growing nearly three times as fast as the

average US company, the earnings miss has trashed the stock and probably put a lid on any turn around for at least six months.

Since mid-September, we have witnessed many of these "missed earnings massacres." Some have been as a result of the slowing economy; some have been a result of competitive forces or new product failures; some we think were a complete mistake. With each new earnings miss or warning, other companies in the same industry as the massacred company are also being punished. Even though we have thought for a long time that many of the Tech stocks were overpriced relative to their sustainable long-term earnings prospects, the market is now reacting as if all Tech stocks are experiencing an earnings slowdown, which is simply not the case. In short we now believe the markets are being overly pessimistic about the future of many of the leaders in the technology sector.

The interesting thing about these guilt by associated massacres is that we are only one week into the earnings-reporting season and it will run for another six weeks. There is just no intelligent way of knowing how corporate earnings fared in the third quarter until the midpoint of the reporting season, which is still another two weeks away. But for now the September earnings warnings and the few early October missed earnings estimates have cast a cloud over the entire market. We think this pessimism is unwarranted. We believe that when all the earnings are reported, US corporations, as a whole, will have had another record quarter, and the market will stage a strong rebound.

Earnings Weather

We believe this overpricing and then underpricing, and the volatility that it has caused is the result of investors' inability to agree on a valuation methodology that works with high growth companies. Old faithful valuation tools like P/E and book value are just are not very helpful in ascertaining the correct value of companies that are growing three times as fast as the average company. New valuation methods such as the PEG ratio (next year's P/E, divided by the projected five-year growth rate) are gaining some followers. Peter Lynch of Fidelity Magellan fame popularized this method of valuing companies, but no one agrees on what the PEG ratio really means or what it should be for the average company. We believe that calculating the present value of future earnings or cash flow is the only way to achieve any sort of realistic valuation of a high growth company. Some Wall Street firms use a discounted cash flow valuation model, but the results for any given company vary so widely, that, again, we are left with no real benchmarks.

Since there are no long-term benchmarks for valuing high growth stocks, we believe investors have settled on valuing them on a short-term basis. The short-term valuation method of choice at the present is to bet on the quarterly earnings. Without a doubt this is what Wall Street touts as the basis for almost all of its buy and sell recommendations. Thus, the daily fluctuations of many high growth stocks resemble the movement of commodities, which are priced on the basis of the weather report. The term commodity investor is an oxymoron. People who put money in commodities are called commodity traders. This is true because most commodity contracts have a duration of one year or less, so the long-term prospects of corn have little or no meaning to a commodity trader because he is not making a value judgement of the intrinsic value of a bushel of corn. He or she is only making a trading decision based on the forces of supply and demand and the weather. That is what is now happening to many technology stocks. In a way, this is terribly unfair to companies in a high growth industry. Radical change is what the technology revolution is all about. As a result, steady earnings growth (like you would see in Old Economy companies, say Merck or Freddie Mac) is simply not going to happen. This means we either invest where the long run looks best and live with the whipsawing the

market will give those companies, or try to play the earnings weather game, and trade with the traders.

Many institutional and individual investors buy into a stock because its "earnings weather" looks favorable. The moment the short-term picture changes the short-term "earnings" trader sells out. In our opinion, there are far more investment decisions made these days on Wall Street based on the "earnings weather" than on the long-term prospects of the underlying company. At first this statement can be a bit worrisome, because it means that there is a lot of good old fashion gambling being done these days on Wall Street. But, in some ways this is nothing new. There has always been a lot of pure gambling on Wall Street. It is just more prevalent today than it has been in a long time.

A Better Way

Knowing the day to day movements of many stocks are really just gamblers betting back and forth, makes the volatility and gyrations become less worrisome. But, just knowing this is not enough. If we had a valuation tool that could tell us what a high growth company is really worth in the long term, then we could take advantage of the inevitable excesses in the market with more confidence. But as we said earlier, no one has been able to satisfactorily construct such a valuation model, including us. We have, however, developed another valuation tool that has proven itself to be remarkably revealing and useful. This tool uses the current market price of the stock to compute what long-term earnings growth rate is implied by that market price. Now, this is not Nobel material, but it is extremely valuable in what we believe it reveals. So while we have not yet found the magical stock valuator that pin points what a stock is worth, we have found something that can give us a generalized notion of a stock's relative valuation. Mike Hull calls this approach a "cloud of knowing." He means by this that we can not see exactly what a company is worth, but we can determine with some confidence its relative value. The best way to understand how our price implied earnings (P-I-E) growth model works is to try it out on some stocks.

Table 2

Price Implied Growth Rate (P-I-E)

Earnings Growth

	P-I-E Growth Rate	Last 3 Years (Annualized)	Last Twelve Months	Last Quarter	Next 5 Years Projected	5 Year Projected/ P-I-E
America Express Co	12.00%	13.10%	13.50 %	14.80%	14.20%	85%
Cisco Systems	22.00%	25.70%	28.50 %	37.50%	32.40%	68%
Citigroup Inc	9.00%	20.40%	86.60 %	22.60%	14.20%	63%
Freddie Mac	8.00%	23.90%	20.10 %	12.10%	14.80%	54%
General Electric	15.00%	15.60%	18.00 %	21.40%	14.70%	102%
Goldman Sachs	8.00%	-6.40%	43.10 %	22.70%	13.40%	60%
Home Depot	13.00%	36.40%	32.90 %	24.10%	23.70%	55%
Intel Corp	11.50%	12.40%	28.30	80.00%	20.40%	56%

			%			
Merck & Co Inc	12.00%	15.00%	16.10	19.60%	12.10%	99%
			%			
Microsoft Corp	12.00%	45.00%	19.50	10.00%	21.10%	57%
			%			
Texas Instruments	14.50%	185.10%	158.60	275.00%	25.20%	58%
			%			
Vodafone Gp Plc	17.00%	-11.60%	-	61.10%	27.40%	62%
			40.90			
			%			
Wal-Mart Stores	13.50%	26.20%	25.40	28.50%	14.90%	91%
			%			

The first column shows our computation of the P-I-E (the level of long-term earnings growth that is implied by each stock's current selling price). The formula for this computation is somewhat complex, but very simple in its concept. We just plug in the price of any stock and keep adjusting the growth rate until the present value of the company's future earnings stream is equal to its current market price. The next four columns show the companies' earnings growth rates over the last 3 years, 1 year, the most recent quarter, and the Wall Street consensus estimates of their next 5 years growth. Let's take an easy example of how the model reveals. Our model indicates that the current selling price of General Electric implies a long-term earnings growth rate of 15%. Over the last 3 years, 12 months, and last quarter, GE has produced earnings growth of 15.6%, 18%, and 21.4%. Wall Street currently estimates that GE will grow earnings at 14.7% over the next 5 years. The last column on the table is the 5-year Wall Street estimate divided by the P-I-E in column 1. The table shows that the ratio between Wall Street's Next 5 Years Projected growth estimates and our PIE computation are almost identical, as shown by the 102% in the last column. This figure does not mean that GE is fairly priced. It just means that to be worth its current selling price it must achieve long-term annual earnings growth of 15%. That certainly looks doable for GE. It has exceeded the 15% level in each of the periods we are analyzing. Indeed, recent earnings appear to be accelerating away from the 15% level, which is a good sign, but again, this in itself does not mean GE is undervalued. Because our model says GE needs to grow at 15%, we just need to keep an eye on the company to be sure that everything points to at least that level of growth. So long as it maintains that level of growth we should hold the stock.

Let's look at two more stocks: Cisco, the major networking company, and Microsoft, the leading software company. Cisco is one of the dual acceleration darlings that has always hit its earnings targets but has suffered, nevertheless, because of the current uncertainties about Tech earnings. Our model says Cisco needs to grow earnings at 22% to be worth its current selling price. The table shows that for all the periods we are looking at, Cisco exceeded that figure. In fact, Wall Street is estimating that Cisco will grow at over 32% over the next few years, which is almost 50% higher than we need to justify Cisco's current price. Again, the model is not saying that Cisco is undervalued. That will be determined in the future if Cisco can continue to grow earnings above 22%. If it does, we believe the stock will rise appreciably; if it does not, it will go the other way. The key for us, as long-term investors, is to be on the look out for anything that would suggest Cisco can't hit our 22% objective, or evidence to support that it will, indeed, consistently grow at a higher rate. The way we would speak about Cisco from the perspective of our model is to say-- it appears to have good relative value. The evidence that we can see suggests that it should be able to grow above the necessary 22% level of our model. Thus, if Wall Street estimates prove to be accurate, the stock could rise substantially. Under these

circumstances, even though Cisco is a very high P/E stock, we like the risks/rewards characteristics, and we would buy the stock at these levels. [Before we look at Microsoft, we will tell you that we believe that most of the financials stocks on this list (American Express, Citigroup, Freddie Mac, and Goldman Sachs) offer outstanding relative values and from a risk/reward point of view appear to be the best bets for superior performance over the next few years. Please take a look and see if you agree.]

Microsoft is still one of the largest companies in the world even after a terrible price performance since their troubles with the Justice Department's anti-trust suit began. We won't go into the merits of the suit, let's just analyze Microsoft on the basis of what our model says is the required level of earnings growth to justify its recent price of \$50 per share. Column one shows that our model computes that Microsoft earnings only need to grow 12% per year to equate to a \$50 share price. Its historical growth rate is volatile and descending. In the last year, the company produced 19.5% earnings growth, but in the last quarter it grew at only 10%. So we are faced with a dilemma. Twelve percent growth seems like an incredibly low earnings growth rate, but recently earnings have been decelerating, and in the most recent quarter earnings are actually less than the required level for its current price. But let's be serious. Let's say that the US Government said that all beautiful women must pay a tax on their beauty, the proceeds of which would be redistributed to less beautiful women, so they could buy cosmetics, have facials, go to beauty spas, and enjoy the benefits that the pretty women so long had enjoyed. Furthermore, the drop-dead gorgeous women would have to agree not to wear makeup and to shave their heads. Finally, they could speak to no one unless they were spoken to. Let's say by an accident of God that you are such a drop-dead gorgeous woman. Don't you think with beauty under attack that the thought might cross your mind that maybe life would be better for you if you could make yourself less becoming?

To think that Microsoft, even if it is split up, can only grow earnings by 12% a year is silly. In our judgement they are taking "ugly" lessons until the appellate court case is heard in early 2001. It is our fervent hope that someone among this new set of judges has a beautiful daughter, or mother, or neighbor, and does not want them to live as an outcast.

Politics

It doesn't stop with Microsoft, Vice-President Al Gore and many of his Democratic colleagues have been making ominous sounds about the evils of a variety of big businesses. Thus far the pharmaceutical industry, the insurance industry, the oil companies, the airlines, and the electric companies, among others, have been singled out as gouging the consumer and in need of some, as yet undefined, governmental intervention. Philip Morris has become the devil incarnate and Bill Gates and Microsoft are being reprogrammed into the largest charity in the world. Unfortunately, too many Republicans, who are supposed to be the defenders of free enterprise, are going down this very dangerous road of business bashing and government intervention. This is a failed concept that stares back at us from Europe and Japan and a thousand other points on the compass. Business needs oversight to ensure they follow the laws, and certainly there are some bad-guys, but the market simply does not believe Al Gore or any politician knows how best to manage healthcare, oil, airlines or any of the other companies or industries they are attacking. No one in Washington does.

Businesses need to be as free from government intervention as possible to ensure that their financial, as well as human capital, is aimed at serving customer needs and developing new products and services. A business that is constantly looking over its shoulder to be sure they are in the government's good graces will ultimately end up climbing into bed with the government and looking out from under the sheets at its customers and competition. Such a company or economy is doomed. That is exactly what has been happening in Japan for years. If we want to continue to be the best place on earth for capital, both financial as well intellectual, then we must continue to offer the fairest and freest markets on earth. Every encumbrance, every potshot, every low blow is noticed by deep pocketed individuals and institutions around the world. If Al Gore's populist campaign carries him to a victory in November, he will have an incredible amount of explaining to do to reassure investors that he is not embarking on a grand scheme of the re-regulation of business. In fairness to Mr. Gore, we believe he knows that to tamper with the free-markets would backfire, but, in our judgement, he is playing with fire. This is not just our view. A recent poll in "Investors Business Daily" shows that among investors with as little as \$10,000 in the stock market, Mr. Gore's popularity is falling rapidly. With nearly 50% of Americans now owning stocks, and with his popularity falling among investors, Mr. Gore's anti-business campaign may be Mr. Bush's secret weapon.

Interest Rates, Inflation and Oil

The main backdrop to this presidential campaign has been a robust US economy, brought to us by neither party, but in our judgment by the Federal Reserve. We have spent the major parts of the last three quarterly letters explaining the actions and inaction's of the Fed. For the most part we think they have done a good job, but we think they are being tested again with the recent spike in oil prices. There is a word that used to bring fear into the hearts of politicians and investors alike. That word is stagflation. Stagflation occurs when inflation is rising while the economy is weak or slowing. Stagflation ties the hands of the Fed and causes periodic bouts of anxiety in the capital markets. In today's market, there is general belief that the economy is slowing. Some believe it is on the verge of a steepening decline, which would call for the Fed to lower interest rates at some point to put the economy back into neutral or on a slow growth path. The problem is the runup in oil prices has brought with it some uptick in inflation. Thus, at a time when the Fed would ordinarily be thinking about lowering interest rates, they cannot because of concerns that a pick up in the economy would increase inflation. Alan Greenspan has been through this before and he understands very well the first order of business: He cannot let the US economy fall off a cliff. If he sees the economy slowing too fast, in our judgement, he will move to lower rates no matter what the inflation trend of the moment may be. He will do this because he realizes very well that rising oil prices in the short-run do push up inflation fears, but they also exert a counterbalancing force of dampening the economy. Rising oil prices hit everyone's pocketbook, and the dollars spent on gasoline are not available to spend on anything else. For this reason, although the Fed will keep pounding the drum about inflation worries, we strongly believe that their next move in interest rates will be down, sometime after the first of the year.

Summary

There is much that is causing worries in the stock market: earnings, interest rates, oil prices, and politics. But think back 12 months. The markets were on fire; tech stocks were going to lead us into a new promised land; oil was old economy stuff; my barber, my kids,

my neighbor's kids, and the pastor of my church were all telling me what stock we should buy. Everyone was swept up in seeing this shining new city on a hill where all our worries could either be entertained away, drugged away, or technologied away. We were all going to be rich and live happily ever after. To a greater or lesser degree many people believed that what we saw unfolding in the events of that time were true and would last for a long while.

Just a year later, we are going through a time that is a little different. The Dotcoms have dotcommed and gone, the major tech stocks are selling off, oil is king again, my kids did not come home for fall break, neither did my neighbors', and my pastor has transferred to another church. That shining new city on a hill ran into environmental problems and now is being constructed in a cornfield that they bought from a farmer who sold the land to get into day trading. Al Gore has promised to save us; George W. Bush has promised to leave us alone. The only upticks we have seen lately have been at the gas pumps. But because the news seems to have changed and the markets are going down, we now conclude that this can only get worse, and a new less optimistic version of reality is seen as the true interpretation of the future.

Greed and fear are the eternal forces of Wall Street. Both of them have an element of possibility that ring true, but in the end both of them are false prophets. Neither of them can ever be satisfied, and neither of them can ever be trusted. The one lives in constantly brilliant light and the other in never-ending darkness. They cannot be trusted because they do not live where we do—in the half-light between knowing and not knowing. Indeed, to use Mike Hull's phrase again, the best that most of us can hope to attain is to come to some "cloud of knowing." Perhaps we cannot know what is, but maybe we can know what is not. I have been in this business for 25 years. I am confident there will be another day when the sun will be shining and somebody will seek permits to build that shining city on the hill once again. So too, am I sure that worries will come again to rob us of our joy and dash our hopes. So how do we invest or live in a world that seems to go from one extreme to another and then back again? We keep in mind that greed and fear cannot be trusted. We stick with companies and investments that are built for the long run -- regardless of the weather.

Blessings,

Gregory C Donaldson
Chairman, Director of Portfolio Strategy

Michael D Hull
President, CEO