

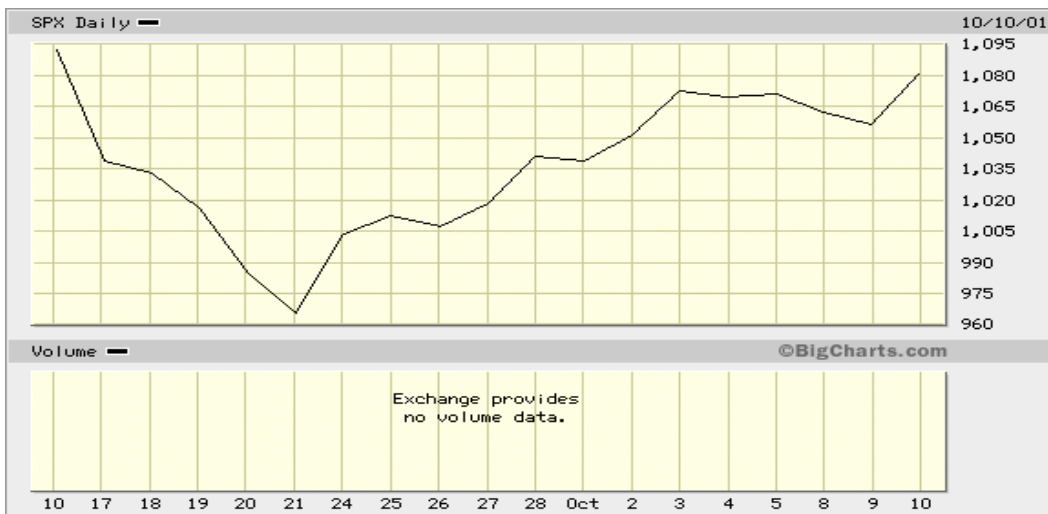
October 12, 2001

The American Spirit

Judging from what we see and read in the financial media, we are more optimistic than many about prospects for the US economy and stock markets in the aftermath of the terrorist attacks.

As our recent Special Reports explained, this optimism stems from our confidence in three important beliefs: (1) The American people are very resilient. They will not faint under the grief or horror resulting from the attacks. (2) The US Government will act quickly to contain further acts of terrorism and bring the terrorists to justice. And, (3) The Federal Reserve will continue to lower interest rates to stimulate the economy. Chart I below will surprise many. It shows that the Standard and Poors 500 Index has recovered almost all of the losses it experienced in the days after the stock markets reopened on September 17th. Most of the other major stock market indices have also recovered to pre-September 11th levels.

Chart I
**Standard and Poors 500 Index
September 10 - October 10, 2001**



Considering all the fear and uncertainty that has been present in the last 30 days, the markets' ability to come full circle in such a short period of time tells us that our optimistic beliefs are justified. But the markets have not recovered quickly because of the patriotism of investors or their blind trust in the fabric of our country. Investors have come back to the US stock markets because all of the aforementioned players in this unfolding drama have done their duty and then some.

Heroes and Heroines

The American people have exhibited a spirit and unity that could have only been imagined a few weeks ago. To say Americans have been resilient is an understatement. We are reduced to clichés to describe the igniting of the spirit of resolve demonstrated by Americans. Borrowing from Chevrolet and Timex, "The heartbeat of America has taken a licking and kept on ticking." From the thousands who lined New York City streets to applaud the rescue efforts of firemen, policemen and other emergency personnel, to the millions of people who have organized or participated in blood drives, food drives, fundraising, and prayer services, Americans have shown their grit, their love for their country, their faith. America is awash in heroes and heroines; ordinary people plucked from everyday life and thrust into the history books by the confluence of place and time.

Perhaps the person who most exemplifies this phenomenon is George W. Bush. Where did this new guy come from, anyway? He has gone from being George Bush, "Jr." to President George Bush, leader of the free world. It is as though the challenge of the moment and the illuminating and contagious spirit of the American people inspired him to accept his place in history. He grabbed the wheel of our republic and his resolute determination to bring the killers to justice has calmed our nation in a powerful way. President Bush addressed Congress on September 20th saying, "Whether we bring our enemies to justice, or bring justice to our enemies, justice will be done." His ultimatum was laid before the Taliban and Al Qaeda -- turn over bin Laden or go to war with the most powerful nations in the world. Since that speech, in which the President also urged Americans to do their part to keep this economy healthy, consumer spending and consumer confidence have shown signs of rebounding. We have noticed that, following his address to the nation, the stock market tends to tick higher whenever he speaks publicly during market hours.

The Fed Comes Through

The Federal Reserve has also acted quickly and forcefully. They lowered rates by a half percent on September 17th and another half percent on October 2nd. In their statement accompanying the most recent rate cut, they made it clear more cuts are on the way if they are needed to spur the economy.

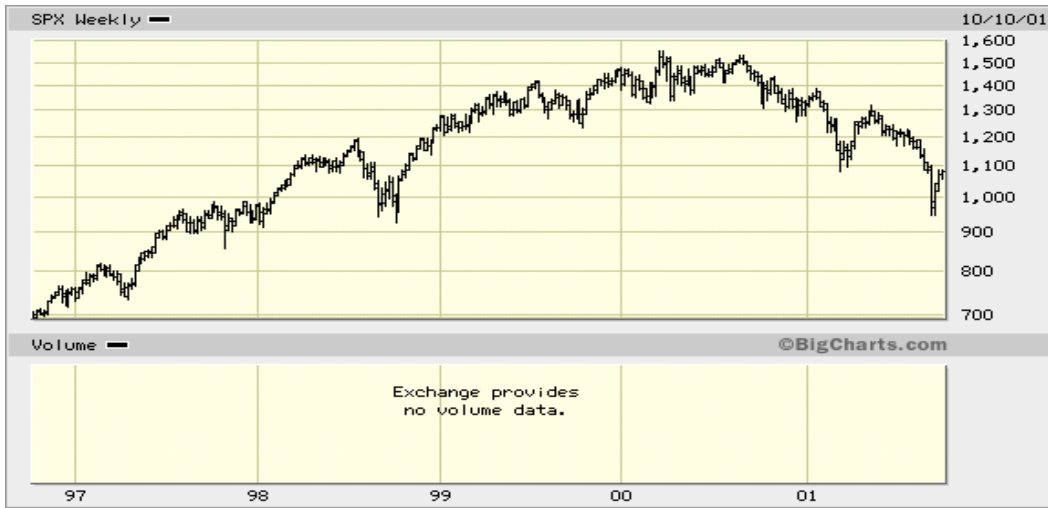
Psychology Not Economics

A look at some longer-term charts of the Dow Jones and the Standard and Poors 500 can help put the market's recent action into greater perspective and offer clues about where the markets might be going from here.

Chart II
Dow Jones Thirty Industrials



Chart III
Standard and Poors 500



These are charts of the Dow Jones and the S &P 500 over the past five years. The bad news about these price trends, as we all know too well, is that the stock markets have been performing very poorly for the last couple of years, but we think there is some good news in how these two major indices have acted most recently. The key things we would like to point out in these charts are their recent turning points. Looking at the far right of both charts, we see a sharp spike down, followed by a shorter spike back higher. These two sharp movements in both indices have created what is called an intermediate turning point. **The good news is both the Dow Jones and the S&P have made turning points at or slightly above the last financial crisis, which occurred in 1998. In addition, it appears as though capitulation has occurred in both indices.** If you remember from

our last letter, we defined capitulation as the process of stock moving from weak hands to strong. Put another way, it is a time when fear rules

Intellect and everybody who wants out of stocks sells out at whatever price they can get. It is certainly not pretty, but the process has a sort of cleansing effect that can put a base under the market and provide the catalyst for stocks to move higher well before the "news" of the economy has turned positive.

Deep-pocketed, long-term investors know the best time to buy stocks is when everybody is running from them, but they also know that they do not need to be in a hurry to buy. **This is why the market always seems to go lower than most people would think possible or the true economic prospects would justify.** The buyers are there and the values are present, but prices keep falling until capitulation occurs and the buyers realize that the sellers have thrown in the towel. At that point, the buyers rush in and stocks begin to rise. In addition, people who have sold stocks short (they have sold borrowed stock) hoping to buy it back at a lower price now see that they are on the wrong side of the capitulation and they begin buying to cover their short positions. Finally, after a turning point has been clearly made many of the former sellers realize they have made a mistake and they begin buying again.

We said in our September 4th letter that we believed the forces necessary to turn the economy and stock markets higher were becoming apparent. That prediction did not look very good on September 21st after the terrorist attacks and a week of heavy selling had driven stocks down nearly 15%. As it became clear that capitulation was at hand, we were very hopeful that the 1998 lows would hold. The 1998 turning point was important because it occurred during the last major financial crisis. **Based on our belief that the economy was already beginning to strengthen, if the 1998 lows held, it would mean that the downdraft in stocks was largely psychological and, as soon as the fear had run its course, stocks could again move higher.**

At first many people may draw a blank when trying to remember what crisis we faced in 1998. It was a time when most of the currencies of South East Asia collapsed threatening to bankrupt Japan. In addition, Russia defaulted on some loans, which sent a panic through Europe, and finally Brazil and Mexico were teetering on default. Most Americans never really understood how bad the situation was, but from a financial perspective, the world appeared to be coming apart. (We wrote about this period of time in our final quarterly letter of 1998. Rather than discussing it further here, you may request a copy of that letter.)

If, indeed, the collapse of stocks after the World Trade Center bombings was more psychological than economic, we can revisit our September 4th letter and determine if the positive forces we saw gathering are still in place. If they are, the economy should find its balance and return to economic growth by the end of the year. There is no doubt that our country's economy has taken a shot in the short-run and it will temporarily fall into a recession, but if the longer-term forces are still properly aligned, growth will return sooner than many people now predict. We think this is the main message of the recent bounce back in stocks.

The Long List

Our September 4th letter made the following statement:

The year 2000 saw an unprecedented combination of headwinds pressing upon the US economy and corporate profits. Interest rates, energy prices, the dollar, the bursting of the technology bubble, and slowing economies around the world, all took their turns taking the wind out of our sails. Indeed, it is as though the United States has been afflicted with a cold or the flu, but our economy certainly does not have a terminal illness.

In 2001, we have now seen all of the major headwinds that flattened the US economy swing around to become tailwinds. The stock market is acting like it will never return, but in this environment, economic growth is inevitable.

Since September 11th the long list of improvements in the economy we identified has gotten longer.

- The Fed has cut rates by another full percent.
- Mortgage rates have fallen to multi-year lows.
- Energy prices have fallen even lower.
- The US dollar has stabilized at lower levels.
- A number of nations have made additional cuts in their interest rates.
- Technology stock prices have improved.
- An economic stimulus plan is working its way through Congress.
- Huge insurance payments will provide an enormous transfer of wealth back into the economy.
- And, finally, President Bush is pushing for more tax cuts.

This expansive list does not mean all is rosy. There is one, large negative still threatening the economy. Travel within and outside of our country has been curtailed. Most facets of the American way of living have returned except for our desire to travel. As much as that may hurt the airlines, motels and resorts, less travel will undoubtedly boost those companies who help make our homes into places where we can safely and comfortably entertain ourselves. It should also be a boost for companies who help businesses communicate over long distances.

Paradoxically, the turning point for Tech Stocks may result from our avoidance of air travel. We recently heard an analyst say that on September 11th, the internet experienced its busiest day on record. He extended this fact to argue that with faster internet connections now available and people spending more time at home, there is good reason to believe the long awaited increase in e-business may finally be at hand.

For whatever reason, even though the Techs have been on a steady downtrend since the early part of 2000, capitulation had not occurred. Investors had refused to throw in the towel on their Tech stocks and therefore, the cleansing and cathartic effects had yet to come. We think there is better than a 50/50 chance that the recent capitulation in the

major market indices has also now occurred in the Techs. The evidence that the Nasdaq has capitulated is not as compelling as it is for the Dow Jones and the Standard and Poors, but the Nasdaq has also made a round trip over the past thirty days. We think the most desirable direction for Techs to go for the next few months is sideways. A sharp run up would only invite sellers to emerge. If the Techs can build a base here, as evidence mounts that the economy is on the mend, we believe they can break the spell they have been under and start moving steadily higher.

We also believe time is the best medicine for the overall market. The war on terrorism will surely bring us unpleasant surprises and other trials to endure. But, unless the stock market pauses here to build a solid base, any rapid upswings will leave it, just like Tech stocks, vulnerable to sharp corrections on any bad news.

As the long list of economic stimuli listed above begin to take hold, we are confident that news about the economy will begin to improve as the end of the year approaches. Remember, the market always looks forward. As more investors adopt the view we see, the market will respond in a healthy and sustainable way.

Blessings,

Greg Donaldson

Mike Hull