

January 11, 2002

The Three Eyes

Most investors generally fall into one of two camps: those that believe that the stock market is rational, or predictable, and those who believe the markets are irrational, or random. We have dealt with markets and investors for many years and our conclusion as to which of the two camps is the larger may surprise you. Our experience tells us that most people believe that the markets are random. Many would deny that they hold such a view, but their actions clearly reveal, whether they are aware of it or not, that they believe very little can be known about the future direction of the stock markets. This random approach to investing manifests itself in two common investment approaches: (1) They follow the crowd in their buying and selling decisions; or (2) They hold a stock, or a handful of stocks, for years because somewhere in the past the stock rose well above its purchase price. Because they now have a big paper profit, they continue to hold the stock even when realizing that it has not produced any meaningful return in years.

We belong to the camp that believes a great deal can be known about the future direction of stock prices. Our own research and that of others has convinced us that in the long run the markets are rational. We are, however, quick to add that in the short run the markets are often irrational because stock prices are always at least partially affected by the emotions of investors. We often hear the boast of an analyst or commentator claiming to have developed a stock selection process that will take the emotion out of investment decision making. We think the reason these guys come and go like the latest diet gurus is because they are attempting to do something that can not be done, excise emotions from human beings. Emotions are an integral part of human beings and thus they must always be included in the investment decision making process. Thus, we are left with a dilemma. **The stock markets are rational in the long-term but irrational on any given day, week, or even year.**

How do we reconcile this dilemma? At Donaldson Capital Management we use an investment selection process we call "watching the markets with three eyes." By this we mean, we study and observe the markets and individual stocks from three perspectives (1) the direction of the economy, (2) industry and company fundamentals and valuations, and (3) confirmation of points 1 and 2 in the current price trends. Put another way, we begin by looking at the overall economy, we identify industries and companies that the current economic landscape should favor, and we follow the trends of the economy, industries, and companies to assure that our analysis is correct and still in force.

The Three Eyes

In the remainder of this letter, we will share with you how we use the Three Eyes to make investment decisions.

1. The First Eye: The Economy

As a result of multiple rate cuts by the Federal Reserve and the military success in Afghanistan, we believe the economy is in the process of shaking off the psychological blow of September 11 and is building momentum for solid growth in 2002. Many analysts believe the economy will not show much improvement until the second half of the year. We do not agree. **We believe there is a good chance of economic growth returning by the end of the first quarter of the year.** The main reason the current recession will be short and shallow is because the banking system has remained in good shape and will not experience the gut wrenching clean up of bad loans that is so often present in recessions. Research into previous recessions shows that the stock markets bottom on average five months before the economy begins to rise. We are convinced a bottom was reached in the markets at the end of September. Thus, counting from October 1, the economy could be expected to show some signs of growth by early March. The economy we see unfolding should be positive for almost all stocks, however, history tells us that some industries do better in the early stages of a recovery than others. We will zero in on the best industries in our view from the second eye.

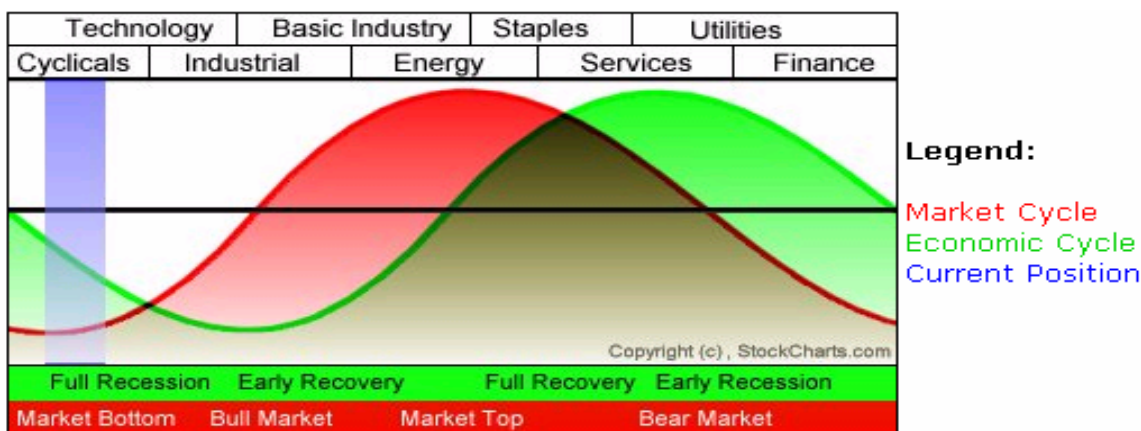
2. The Second Eye: Industry Sectors

The Chart 1 is based on [S&P's Guide to Sector Rotation](#) and shows that different sectors are stronger at different points in the economic cycle. The graph shows these relationships and the order in which the various sectors *should* get a boost from the economy. There is a lot going on in this chart, so let us point out what we believe are the most important messages. First, you will notice that the Market Cycle precedes the Economic Cycle. This is the result of the well-known capacity of the market to discount the future. It occurs because investors try to anticipate economic effects and invest accordingly.

The various stages of the Economic Cycle are identified in green along the bottom of the chart, and the Market Cycle stages are in red. At the top of the chart each Industry Sector is positioned over the part of the Economic and Market Cycles where it has historically experienced its best relative performance. The blue column to the left of the chart is the current position. The whole chart covers approximately four to five years.

Chart 1

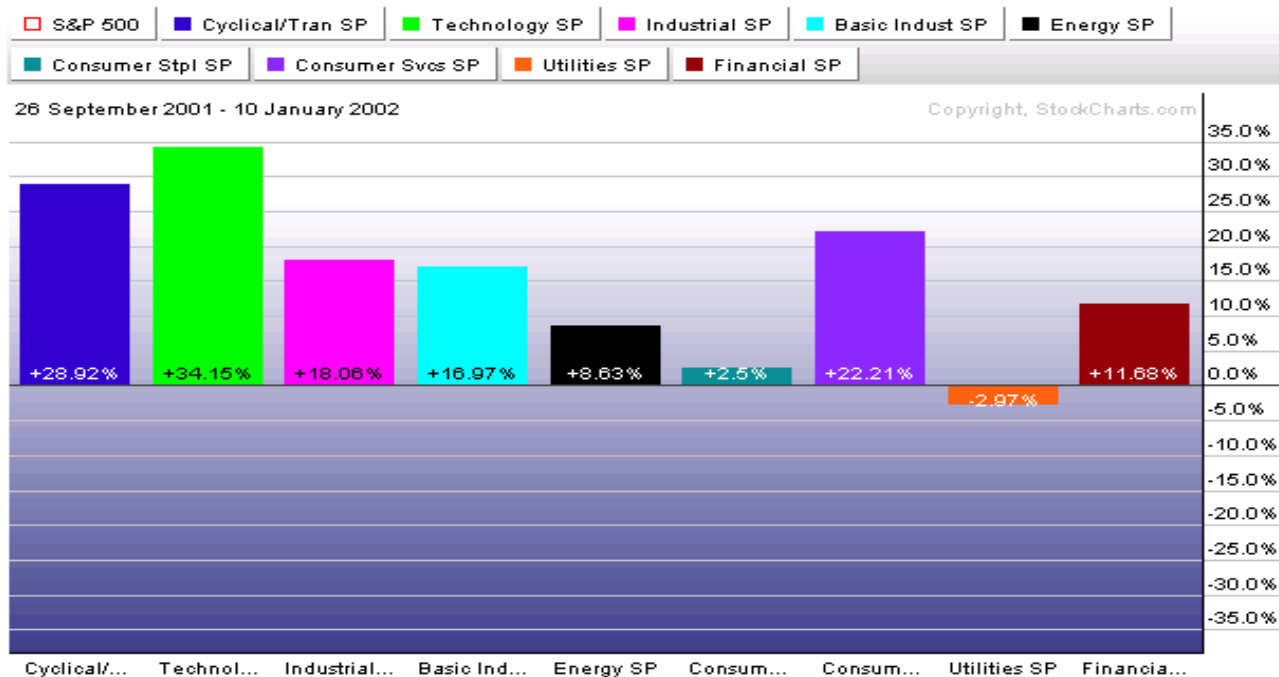
Sector Rotation Model



According to the chart, the Cyclical (retail, auto, furniture) and Technology (semi-conductors, software, internet) sectors should be currently producing the best results. Depending upon how close we are to exiting the recession, the Basic Industries (metals, lumber, chemicals) and Industrial (machinery, manufacturing, aerospace) sectors should also be picking up. Intuitively, these sectors would not seem to be the best choices for good performance in the midst of a recession. Almost all of the products they make involve discretionary spending by individuals or businesses. This means new purchases can be omitted or delayed. It would seem that the more non-discretionary sectors such as Staples (food, healthcare, beverages), Energy (oil and gas), and Utilities (electric, natural gas, telephone) would be faring the best. We must use these products everyday no matter how strong or weak the economy. Chart 2 below shows the performance of these nine sectors since the end of September.

Chart 2

Sector Performance
(since the market bottom)



The best performing sectors since the market bottomed, indeed, have been the ones predicted by Chart 1. But there are a few surprises. Consumer Services (entertainment, publishing, advertising) and Financial (banks, brokers, insurance) are also performing well. Chart 1 on page 2 shows that these two sectors' prime spots are later in the Economic Cycle. We think the Consumer Services sector is running a bit ahead of itself as a result of the blockbuster movies (Harry Potter and Lord of the Rings) currently in the cinemas. We do not believe the current strength is sustainable. The strong performance of Finance is a

direct result of the point we made earlier about the banks being in better shape than normal from a loan loss perspective. We think the Financial sector will continue to surprise the market with its earnings growth and stock performance.

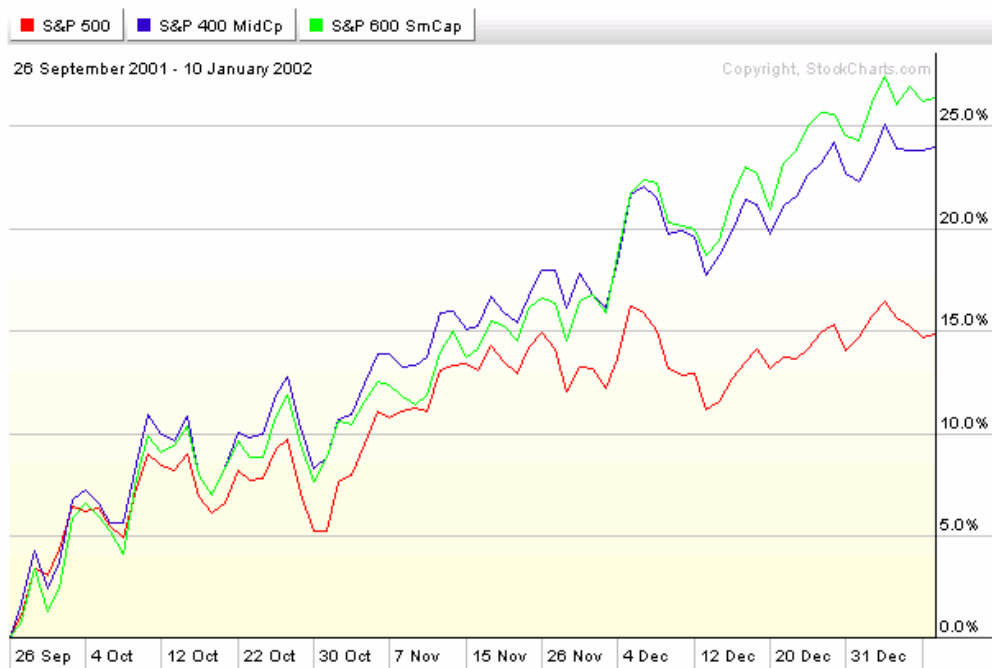
The action of the market since its bottom, while counterintuitive, is rational when compared to the majority of other economic turnarounds. However, the charged

emotions that September 11, the anthrax attacks, and the hunt for Osama Bin Laden produced have caused many investors to become more defensive at precisely the wrong time. This defensive posture caused many to pull out of stocks entirely or buy the defensive stocks, which the chart shows have fared very poorly.

There is one more step in our analysis of the broad sectors of the stock market. That step is to check the performance of stocks by market capitalization. Our research indicates that smaller companies perform better than larger companies in the early stages of a recovery. The reason for this is straightforward. Smaller companies tend to do a greater percentage of their business in the United States than the very large companies that are in the Dow Jones 30 and the Standard and Poors 500. As we stated in our July quarterly letter, smaller companies tend to be more hardwired to the US economy, whereas, larger companies are more sensitive to the world wide economy. If smaller companies are doing better than larger companies in the current market rally, it would add significantly to our bullish forecast for the US economy and the stock market in the coming year. Chart 3 shows the performance of stocks broken down by size.

Chart 3

Performance by Market Capitalization (since the market bottom)



This is exactly what we were hoping to see. Small and Mid Cap stocks are pulling away from Large Caps. Again, at first this may seem somewhat counterintuitive. The large multinational companies are usually considered to be a safer place to put money in troubled times. On a relative basis, however, the current markets are favoring the more aggressive smaller companies. As in the case of the sector analysis, the market is choosing more economically sensitive companies over defensive ones. **The action of small versus large companies further corroborates the premise that the market is looking ahead to an improving economy.**

In this part of our analysis we are normally very concerned with valuation. At market bottoms, however, we are much less concerned with valuation than other times. History again comes to our rescue. Price to Earnings multiples are almost always high at recession bottoms because of depressed earnings; however, earnings should grow sharply as the economy begins to expand. We believe the most important valuation data to follow in the near term are earnings revisions. We expect Wall Street analysts to begin ratcheting up 2002 earnings estimates in the weeks and months ahead. This will fuel the market to move even higher. At present, the market is moving higher even though earnings will continue to be poor for at least another quarter or so. The projections we have laid out here are dependent on the economy and corporate earnings getting progressively better as 2002 unfolds. Wall Street analysts will play an important early warning role in this process. They talk with the companies they cover every day, and even if corporate executives are not allowed to share non-public information with them, their tone of voice and body language can speak volumes, as the executives begin to see brighter business prospects emerging.

3. The Third Eye: Trend Watching

In this part of our analysis, we watch the indicators that we have identified in building our investment strategy. In short, we need to see their trends hang together and continue to confirm our opinion that the economy will improve sooner rather than later. As we have made very clear throughout this letter, we like what we see very much, but we know that markets change.

With the third eye we attempt to understand the unfolding drama that is registered in the cumulative buys and sells of investors. In this way we attempt to ascertain the mind of the market. We know at times it can be almost amazing in its capacity to see the future. At other times, we know it seduces us with impossible promises, or frightens us with its black forebodings. **In the end, however, the sustainable price trends are born of true economic growth and not the incantations of Wall Street nor the worries of Main Street.**

Discipline, Patience, and Humility

At Donaldson Capital Management our motto is discipline, patience, and humility. Those values serve us well in managing your money, and they should serve us well in the market over the coming year.

Discipline – Once the sectors that lead us out of this recession have run their course, the market will rotate toward the sectors that recover later in the cycle. The news from the leading sectors may still be good – expanding earnings, growing sales – but the market will look elsewhere before the news turns boring. Your portfolios will benefit from this only if we demonstrate the discipline to move on before the news does.

Patience – Above you saw a chart showing which sectors will likely lead the economy and the market out of this recession. While the entire stock market is rising in value, the best approach will be to patiently wait before adding positions in those sectors that will not improve until late in the cycle (Staples, Utilities, and Consumer Services).

Humility – As noted above, our “third eye” watches the markets. You have heard us mention at times that we try to follow the big money. Big money moves the market. Billions of dollars are cast as very real votes each day by knowledgeable, experienced, and wise minds. Regardless of the opinions we form about sectors of the economy and specific companies, the market will determine their worth. While we have shared with you our

opinion that the economy and the market are headed back to brighter times, the humility to listen to the market and take what it gives us will provide greater rewards than trying to force our opinions on a market that will not listen. **As this market moves through the next business cycle, we will overweight and underweight sectors not based upon what Wall Street is saying or on the emotions of the day. We will move when the market tells us it is time to move.**

Regardless how far this next move in the market takes us, it cannot erase how tough the past year was. For many of us, at many levels, nothing will ever be the same. You have been wonderful as clients. You have shown us graciousness that, frankly, at times we feel was undeserved. Your belief in us and your support keep us digging and working and, yes, watching for opportunities and dangers. We look forward to serving you and your family for many years to come.

Blessings,

Greg Donaldson

Mike Hull