

April 15, 2002

Hot News, Cold Facts

Off and on for many years we have taught courses in investment analysis and strategy at local universities. Our aim in the courses has always been the same: to help students understand the risks and rewards of investing and enable them to make choices based on weighing facts, not emotions. We have never, however, advocated totally eliminating emotions from the investment process. In fact, we think emotions are often very helpful in alerting us to dangers and opportunities. But our experience has shown us over and over that emotions aroused by the latest news cannot have the final say in our decision-making.

To prove this point, for years we used to keep old copies of the Wall Street Journal. In class we would review the "Heard on the Street" column from the previous year and then grade how well the Journal's picks and pans had fared a year later. It was remarkable how off the mark the Journal's most important column generally was in whatever position they had taken. We did the same thing with Forbes magazine. In the case of Forbes, we used just the cover page of year old copies. We would then ask the students to judge in retrospect whether Forbes had made the right points and drawn the correct conclusions. We usually found that Forbes was even less reliable in their prognostications than The Wall Street Journal.

At first, many of the students could not believe that these "bibles" of American capitalism could be so consistently wrong on the long-run conclusions of their feature articles. How could they stay in business? We would then engage the class in a discussion of what these two publications' real role in society was. Most students eventually, and correctly, concluded that they were both in business to make a profit, not provide unbiased, balanced investment information. A few students would reach the further insightful conclusion that the real business of the Wall Street Journal and Forbes magazine was entertainment. This was made somewhat more understandable when considering that another major business magazine of the day, Money, was owned by Time Warner, an entertainment conglomerate. Once the students realized that almost all of the popular financial media of the day were competing for entertainment dollars, not investment research dollars, a final reality was inescapable: bad news sells better than good news, but the best news of all is hot news. The students had come face-to-face with a bare truth: hot news is hot because it appeals to your emotions. Thus, trying to understand the value of an individual stock or the markets was almost impossible by reading the popular media because the media's goal was to elicit an emotional response, while as investors we were trying to get beyond emotions to the facts. The Wall Street Journal and Forbes magazine have prospered over the years, not by being right in their investment opinions, but by offering well-written, entertaining articles about subjects that captured the emotions of the day.

Today there is a new "bible" of investment authority on the scene, CNBC. We think it is great entertainment, but we are convinced it is not profitable from an investment perspective to make decisions based on how well we like Joe Kernan or Maria Bartiromo. Indeed, when the markets get particularly volatile, we often tell people to turn off CNBC. This is because we have found that CNBC is an expert at reporting hot news, and therefore, more times than not, only adds to the already difficult task of trying to extrapolate today's events into tomorrow's profitable investment decisions.

E I E I = O

If the popular media only adds to our confusion, how do we ever find the real story of companies or the economy? From the very first class we ever taught, we have advocated using three tools, (1) a fundamental evaluation service such as Valueline or Standard and Poors, (2) A technical or chart service like Daily Graphs or Stockcharts.com, and (3) an overall stock market model. The evaluation services provide the story of the market, the technical services offer a picture of the market, and the stock market model can offer insights into how fertile the current economic environment is for stocks. For many years we have used a very simple stock market model that goes by its acronym, E I E I = O. E I E I = O is not in danger of winning any Nobel prizes for economics, but over the years, we have found that it provides useful hints as to the prospects for stocks based on the strength or weakness of the underlying forces that we believe drive stock prices. Additionally, E I E I = O can offer hints about where interest rates and inflation are headed.

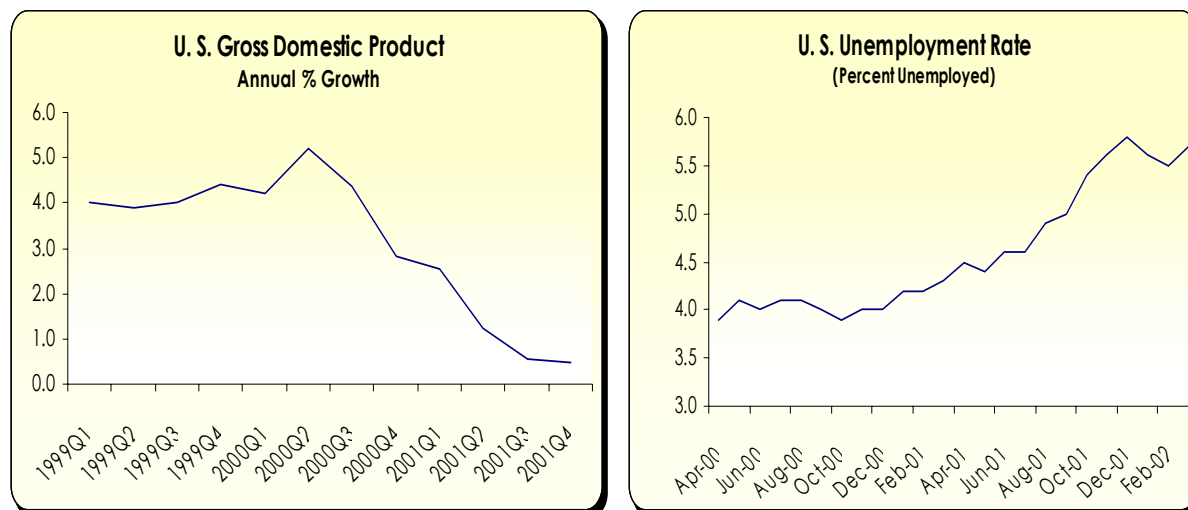
Since 9/11, stocks seem to be suffering from some form of a manic depressive condition. Immediately after the terrorists' attack, stocks fell by nearly 18%. They then turned higher and rose almost in a straight line by 24% by early January. At that time, the market again came under selling pressure as a result of a daily dose of hot news in the Enron/Arthur Anderson scandals and the increasing violence in the Middle East. As a result, the markets closed the first quarter just about where they began. It is in these kinds of markets, full of volatility, breaking news, and investment gurus pointing us in all directions, that the E I E I = O stock market model can be of real value. Let's work through the current readings of the model for clues about what we might expect from stocks the rest of the year.

E I E I = O, stands for Economy + Inflation + Earnings + Interest rates = Opportunity for Stocks. We rate each of the four elements of the model as positive for stocks (2 points), neutral for stocks (1 point), or negative for stocks (0 points). We then add the total points to arrive at a final score, ranging from zero to 8. An overall score of 4 is considered neutral for stocks in the year ahead. Anything higher than 4 indicates a positive environment for stocks; anything lower, a negative environment. Remember, the score we give each element is based on our historical analysis of its effect on stocks and not our rating for the element itself.

Economy

In each of the four elements we use two of the most important indicators. For the overall economy we score US Gross Domestic Product (GDP) and Unemployment.

Chart I
Economy
GDP (left) and % Unemployment (right)

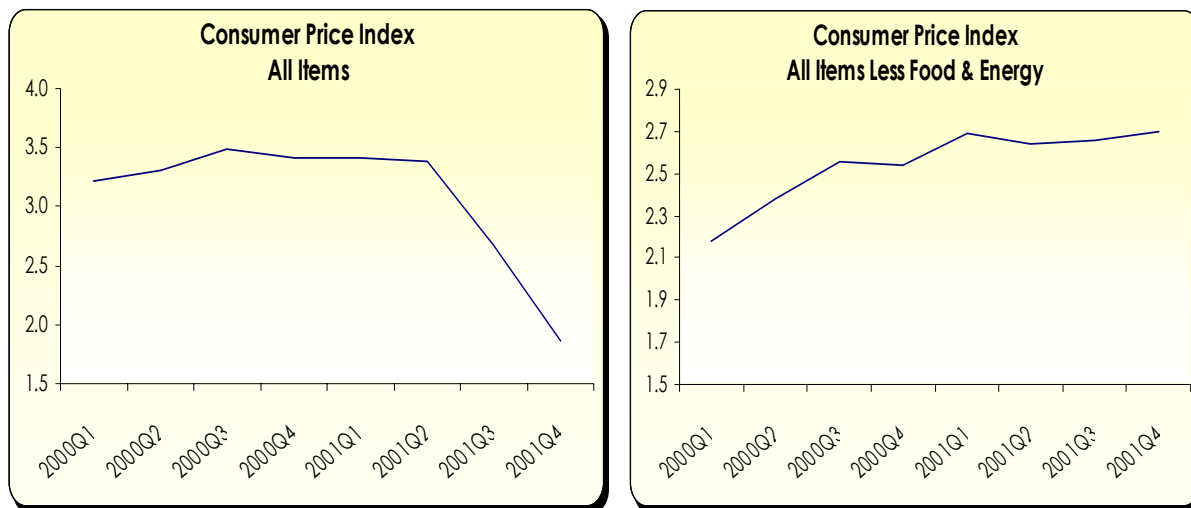


The chart on the left shows US GDP growth over the past three years on a year over year basis. The first quarter of 2002 has not yet been reported. In 2001 GDP grew at less than one percent. GDP growth less than the so-called optimum rate of 3.5% is considered good for stocks, because the Federal Reserve is more accommodative to increased economic growth and not likely to raise interest rates significantly. **GDP receives a positive score -- 2 points.** The second chart shows the current unemployment rate of 5.7%. There is much debate about the trade-off between unemployment and inflation, but we believe that an unemployment rate above 5.0% keeps the inflation hawks calm. That being the case, we believe that any Fed rate increases in 2002 will likely be small and few. **Unemployment receives a positive score -- 2 points. The average score for the Economy as it relates to stocks is positive -- 2 points.**

Inflation

In the case of inflation, obviously, lower is better. The optimum level, however, is generally accepted to be 2.5% to 3.0%. We measure the total Consumer Price Index (CPI) on a year over year basis and CPI-Less Food and Energy, the so-called Core Rate of Inflation.

**Chart II
Inflation
CPI (left) and Core CPI (right)**



CPI, as shown on the chart on the left, is now running at just over 1.8% on a year over year basis. This is well below the 3.0% level where the bond markets begin to fret and send long interest rates higher (which would be bad for stocks). **CPI is positive for stocks — 2 points.** The Core CPI on the right is a bit of a different story. This measure of inflation is showing that after subtracting the volatile food and energy components from total CPI, we see a rising trend of inflation at 2.7%. While this has yet to reach the 3.0% threshold, the trend is not a pretty picture. **We rate CPI less food and energy as neutral for stocks—1 point. The overall Inflation element in the model receives a modestly positive average score of 1.5 points.**

Earnings

The score for corporate earnings in the model measures the trailing 12-month earnings growth and the projected growth rate for the next 12 months against the historic average annual growth. Unlike in our scoring of the economy, where very strong growth is considered a negative, in earnings it's the more the better. Over the past 75 years, corporate earnings, as measured by the companies in the S&P 500, have grown at an annual rate of 7.5%. Although the recession of 2001 will go down in history as very mild, with only one quarter of negative GDP growth, corporate profits took a beating. Trailing earnings for the stocks in the S&P 500 Index for the last 12 months fell by almost 20%. The term profit recession seems to be the legacy for which 2001 will be remembered. **Trailing earnings are negative for stocks—0 points.** Projected earnings growth for 2002 for the S&P is 14.8%. We believe corporate earnings will surprise on the upside of this number in 2002. We base this on continued strong consumer spending and a pick-up in manufacturing profits. **Earnings in the coming year will be a positive for stocks—2 points. With a negative rating for trailing**

earnings and a positive rating for forecasted earnings, the average score is neutral or 1 point.

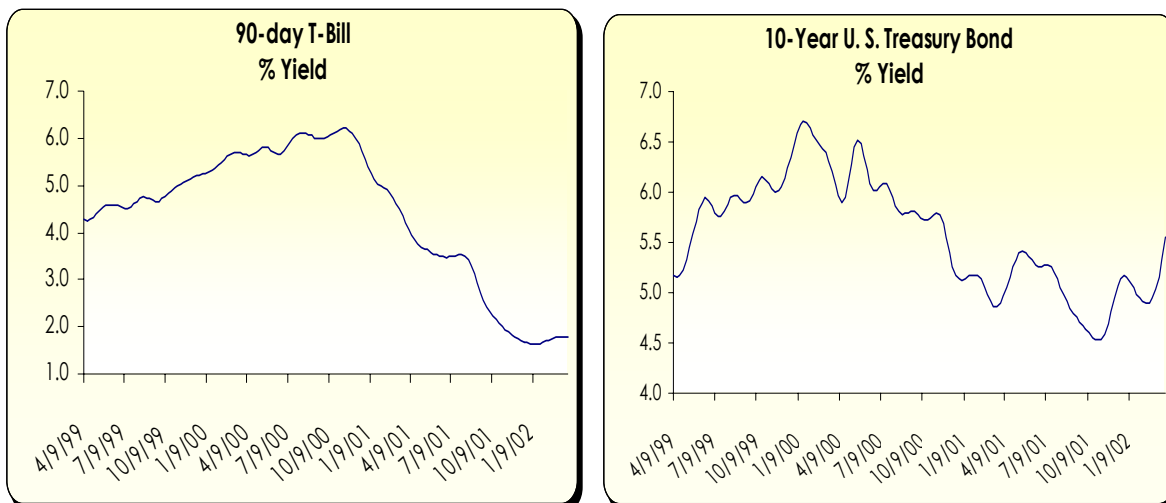
Increasingly in recent months, the market has responded with a show-me-the-money attitude toward companies that are reporting earnings under expectations. Two years ago a stock that missed its earnings estimate by 5% might expect to take a 5%-10% hit to its price. Recently, a 5% earnings miss might result in a 10%-20% sell off in the company's stock. As we have taken a closer look at this situation, we believe the big sell-offs are probably overdone. We believe this is a prime example of hot news overwhelming reason. It is quite natural for a turn in the economy and corporate earnings to be somewhat irregular and unpredictable. We are going to track a sampling of companies that miss earnings by at least 5% to see how their stock performance compares to the major indices through the rest of the year. We would not be at all surprised to find that some of the best performing stocks for 2002 might well have missed an earnings estimate earlier in the year. We will keep you informed as the year progresses on the result of our earnings tracking process.

Interest Rates

The direction of interest rates is the catalyst that either propels the economy to higher growth and profits or a slowdown. We all know what interest rates are, but most people do not understand how interest rates affect the stock market. The first way is obvious. Most companies have debt. Thus, when interest rates are rising, interest expenses increase and profits are squeezed unless other costs can be reduced. The opposite effect occurs when rates are falling. Rising and falling interest rates also affect corporate sales because the total cost of products purchased on credit also goes up and down with interest rates, which impacts final demand.

The part of interest rates that most people miss is that interest rates are not monolithic. There are many different interest rates and, to a greater or lesser degree, each moves in its own unique way. We score interest rates by analyzing the trends of the yields of the 10-year US Treasury bond and the 90-day T-bill. The level and direction of 10-year Treasury bond yields have a direct effect on home mortgage rates and corporate bond interest rates. The rates of very short T-bills impact the prime rate of interest that banks charge and home equity lines of credit for consumers. Simply put, if short and long-term interest rates rise sharply in 2002, the stock market is not going anywhere, even if earnings do rise strongly. We, however, do not believe that rates are destined to move dramatically higher. In fact, we think short rates may still be under 3% by the end of the year and that long rates may be only modestly higher than their current levels.

Chart III
Interest Rates
90-Day T-bills (left) and 10-Year Treasury Yield (right)



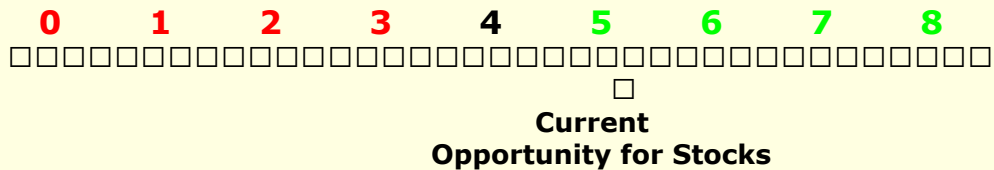
The T-Bills chart on the left is most revealing. The time span of the chart is three years and begins roughly where the Federal Reserve initiated their string of rate hikes in mid-1999. In this case think of T-Bills as a proxy for Fed Funds, which the Federal Reserve directly controls. The Fed pushed rates gradually higher until the third quarter of 2000. If you remember it was in the third quarter of 2000 when the rate hikes finally bit and the economy began to slow. Chart I on page 2 shows that the economy had grown at over a 5.0% annual rate in the second quarter of 2000. The T-Bill chart shows the rapid series of rate cuts the Fed initiated beginning in January of 2001 as the economy continued to lose momentum. Finally, the chart shows the second series of sharp rate cuts that occurred after 9/11. The rating for T-Bills is based on their current level versus a year ago, and the slope of their most recent rise or fall. T-Bill rates are appreciably below year ago levels and the recent uptick is very muted. **T-Bills receive a positive score for year-ahead stock performance—2 points.**

Rating the 10-year Treasury bond is a much tougher task. Rates are approximately where they were a year ago, but the sharp upward trend since early December is troubling. Indeed, while the Enron/Arthur Andersen debacle and the Israeli/Palestinian conflict have dominated the news, the sharp jump in rates of 10-year Treasury bonds is the main reason that the stock market has cooled since the first of the year. The rise in 10-year bond yields is the result of strong evidence that first quarter GDP growth will be much higher than originally thought. As we said earlier, first quarter GDP has not yet been reported, but preliminary estimates have steadily risen from 1.0% growth three months ago to almost 4.0%, as we ended the quarter. This surprising pick-up in economic activity is resulting from the very low interest rates available to corporations and consumers; higher tax refunds as a result of President Bush's tax cuts; a milder than normal winter that spurred construction spending; and a restocking of inventories that were drawn down during the past year. The cumulative effect of all these forces has probably produced economic growth above the worry level of 3.5% that we discussed earlier. We won't know the final growth rate for some time, but we do know that many of the forces that came together to produce higher than expected growth in the first quarter are fading. For this reason, we expect second quarter GDP to dip below the 3.5% rate. At first this may seem like bad news, but the way the markets react to inflation fears, slower, steady economic growth is the best recipe for stock prices. **Even though we think long-term interest rates will fall, based on their current level and their rapid ascent in recent months, we rate 10-year Treasury bonds negative—0 points. The average score for Interest Rates is Neutral—1 point.**

Opportunity

Rating each of these indicators individually helps remove our own biases and emotions from the process of evaluating the current environment for stocks. Regardless of what we "feel," adding the more factual elements together brings us to **a current rating of the Opportunity for Stocks to Modestly Positive – 5.5 out of a possible 8 points.**

E I E I = O Stock Model		
<u>Element</u>	<u>Rating</u>	<u>Average Score</u> <u>(0 to 2)</u>
Economy	Positive	+2.0
Inflation	Modestly Positive	+1.5
Earnings	Neutral	1.0
Interest Rates	Neutral	1.0
Opportunity	Modestly Positive	+5.5



Our experience has shown that a modestly positive rating should translate into a rate of return for stocks of between 7% and 15%. Even though the media continues to highlight a lot of negative events, our model and its components indicate an environment in which stocks will likely move higher. While “hot” and negative news will create volatility in the stock market, the forces that dictate longer run market movement – economic growth, inflation, corporate earnings, and interest rates – are signaling a favorable climate.

The Wall of Worry

Even in times when everything seems to be working in favor of stocks, stock prices can sit idle. How can that be? The old stock market adage that explains this phenomenon says that the market needs to climb a “wall of worry.” If all investors agree that the environment is right for corporate earnings to continue growing and that interest rates will make investing in stocks attractive, there will be very few buyers remaining on the sidelines to push stocks higher. When there are worries in the air, it pushes money to the sidelines. As each successive worry moves from front page news to back page news, additional money will be pulled back into the market and drive prices higher. So, even in the face of a Mid-East conflict, an Enron scandal, and companies warning that their first quarter earnings may not match the market’s expectations, the market can find room to move higher. As we have shown above, the reason that stocks eventually will begin to move higher lies behind the news where the real economic environment in which corporations operate is now improving dramatically. Mark our words on this, within the next thirty days, first quarter GDP growth will be released. It will be surprisingly strong. And, it will be lucky if it makes the front page news because the media is constantly in a fit of publishing negative news.

As last year’s recession worsened, many companies tightened their belts by laying off workers and shrinking their inventories. This, plus lower interest rates and a decade of reengineering and productivity enhancements, has set the stage for solid profit growth as the economy gets back on track. In an environment like we saw through E I E I = O, increasing corporate profits will lead to increasing stock prices.

As we have stated here, hot news will always sell better than mundane economic statistics, but hot news is very seldom something that we as investors can use for profitable decision-making. We have no idea what events of worldly proportion will occur in the rest of this year, nor do we know how the media will treat those events. It is clear to us, however, that the economic dynamics are building a positive environment for the stock market.

Investors today are facing two challenges – one old and one new. The one that investors have had to fight forever is that emotional decisions are likely to be unprofitable decisions. The newer challenge is the exponential growth in the vendors of hot news, which assaults us from websites, newspapers, radio, and television. Regardless of what those sources say, the laws of economics are still in force, and through our E I E I = O model, our reading of those laws is for solid improvement in the year ahead.

A Final Note

The Enron accounting scam has left many investors worried about the integrity of American business. Since we at Donaldson Capital Management are part of that landscape, you may consider our views biased. Whether that is the case or not, we research and analyze hundreds of companies every year. That experience tells us there are some untrustworthy characters running some

businesses. But, the vast majority of publicly traded companies are run by decent, honest people building their businesses with hard work, integrity, and factually reporting the results. If anything, the consequences being felt at Enron and Arthur Andersen will cause the managers of publicly traded companies to look even more closely at their practices than they have in the past and bring forth squeaky clean financial reports. If that is the case, even this most recent scandal will prove to be a benefit to the future of the financial markets.

Blessings,

Greg Donaldson

Mike Hull

p.s. Each year, the Securities and Exchange Commission requires us to update a document called the "Uniform Application for Investment Adviser Registration" (ADV) that is on file with them. The ADV contains detailed information about Donaldson Capital Management and how we operate. We have just updated it for 2002. If you would like a copy, please call our office; we will gladly send it to you.