

January 12, 2004

Drilling Down

The past year was a good one for stocks with most of the major indices enjoying growth of over 20%, their best performances of this century. Of course, this was the first time since the turn of the twenty-first century that stocks have produced positive returns. Indeed, 2003's gains ended the longest losing streak for stocks since the 1930s, resulting in the question that is in many investors' minds: Was 2003 a rally within a longer-term bear market that is likely to fizzle out, or was 2003 the beginning of a new bull market? We discussed this question in our July 2003 letter, and we indicated then that, while we were very optimistic that a new bull was underway, there were two or three more indicators that needed to flash buy signals before we could give our final answer to the question: bull or no bull?

In our April 2003 quarterly letter entitled, "The Case for Optimism," which was written just as the statue of Saddam was being toppled, we cited nine economic and political issues that we believed were turning from negative to positive for stocks and would produce a rally of some significance. We offered a very simple reading from one of our Dow Jones 30 valuation models showing that the intrinsic value of the Dow was approximately 11,000, or about 25% higher than its 8300 level at the time. With the Dow ending the year at 10,470, and the surprising strength in the economy, we are confident the target price of 11,000 will be reached in the coming months. The question on the table, however, is not whether or not stocks can go higher, but do they offer good enough values, and is the world safe enough for a new bull market to take hold. In the remainder of this letter, please look over our shoulder as we drill down into the data and see where it takes us.

In the drill-down process, we will analyze four key areas: investor sentiment, valuation of the market, breadth of the market, and the market's technical condition.

Investor Sentiment

There are as many measures of investor sentiment as there are reality shows on television, and most of them are about as real as the hokum that is the current rage on the tube. One of the most well known measures of investor sentiment is the hemline indicator, which argues that when hemlines go up, stocks go up and vice versa. If this is the case, we are in for very bad times ahead because, judging from the aforementioned reality shows, if hemlines go any higher it will lead to another kind of line — a police line up. For our purposes here, we will use a straightforward measure of investor sentiment, the survey.

We find we seldom agree with Businessweek's conclusions on the economic or political issues of the day, but they do first-rate investor surveys, and thus, we are subscribers. The January 5, 2004 issue of the magazine offers a very good analysis of a survey that was conducted by the Businessweek/Harris Poll. The survey reveals that among respondents who own stock, 67% expect

stocks to rise in 2004. The article goes on to report that this is a sharp increase in the approval rating of stocks over last year, when only 47% of the participants expected stocks to rise. Furthermore, the good people at the magazine say that the 67% approval rating for stocks is near the highs reached in 1999. We do not see anything positive in this survey. In fact, as we have said many times in the past, we view investor sentiment as a contrary indicator. We were surprised that Businessweek did not acknowledge in the article that stocks had gone in the opposite direction of their survey in four of the last five years. Because this contra trend agrees with our long-held view that markets usually go in the opposite direction of what the majority of people think, we have to rank the important investor sentiment part of our study as NEGATIVE, and not supportive of a bull market call.

Valuation

Are stocks overvalued or undervalued; that is the eternal question, and, of course, if there were an easy answer, the question would be moot. By their very nature, a company's profits are uncertain over the long-term. Because of this, determining a finite value for any company is an educated guess. Mike Hull has coined the phrase "shadow of knowing." He means by this that we cannot know for sure what a particular stock is worth at any point in time, or even the markets in general, but we can know the shadow or range of where its valuation resides because we have years of historical relationships. In our work, we use two valuation models, or shadow makers: an inflation adjusted price/earnings model, and a traditional dividend discount model. For our purposes here, we will analyze the inflation adjusted price/earnings model. Of the two models, it is the easier to compute, and its recent readings are very similar to that of our dividend discount model.

During the last 50 years, the price/earnings multiple of the 30 stocks in the Dow Jones Industrial Average has averaged approximately 15. During this same time, inflation has averaged 4%. Our formula transposes the more familiar P/E into E/P, or earnings yield, to provide an apples to apples comparison with inflation, which is quoted as a percent. This simple transposition shows that stocks have traded at an average earnings yield of 6.7% ($1 \div 15$). The E/P yield is simply computing the rate of return investors would have earned had all of the earnings of the DJ 30 stocks been paid out to them. The tables below complete the computation.

Average Earnings Yield	6.70%
<u>Minus: Average Inflation rate</u>	<u>4.00%</u>
Average Real Earnings Yield	2.70%

Next, we add the average real earnings yield to the current inflation rate to find the appropriate earnings yield for today's market.

Average Real Earnings Yield	2.70%
<u>Plus: Current Inflation Rate</u>	<u>2.00%</u>
Projected Current Earnings Yield	4.70%

Finally, we convert the projected current earnings yield back to the more familiar price/earnings ratio.

$$1 \div .047 = 21.3X$$

Equipped with the projected price to earnings ratio of 21.3, we can now make the final calculation to determine the projected value of the Dow Jones 30 Industrials at the end of the coming year. To do so, we simply multiply the projected price/earnings ratio by the projected cumulative earnings for the 30 companies in the Dow Jones Industrial Average for 2004. We are using Value-Line Investment Survey's earnings projection of \$583 for 2004.

Projected DJ 30 Earnings for 2004	\$583
Times: Projected P/E Ratio	21.3
Projected DJ 30 Closing Price 12/2004	\$12,418

A Dow Jones of \$12,418 would represent a gain of almost 20% from today's levels. Of course, this rate of return is dependent on inflation staying in the 2.0% range and earnings reaching \$583, but in our judgment, these are very reasonable targets. This forward-looking estimate forms one edge of our valuation shadow. We determine the other edge by valuing the DJ 30 using its trailing twelve-month's earnings.

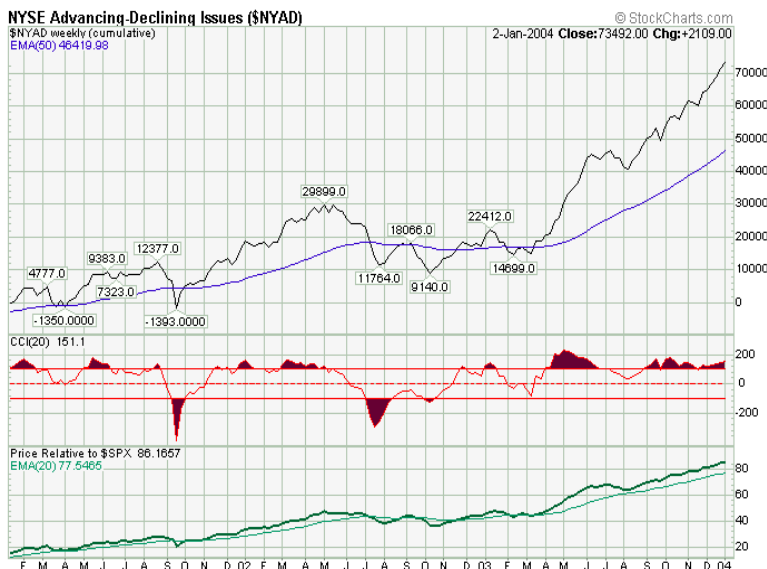
$$\text{Trailing DJ 30 Earnings } (\$518) \times \text{Projected P/E Ratio } (21.3) = \$11,033$$

Markets are always looking ahead, or discounting, so we believe the forward-looking valuation is the most appropriate, but computing the valuation using the trailing data is useful and gives us a baseline estimate of what we might expect in the coming year as well as defining the other edge of our valuation shadow. The midpoint of the DJ 30's valuation shadow in the coming year is 11,725, which would represent approximately a 12% return.

From a valuation perspective, we believe the market is undervalued and is very likely to move higher. We rate Valuation as POSITIVE.

Breadth

Breadth measures the action of the average stock. Most of the major stock market indices are market capitalization weighted, which give greater influence in the index to the larger companies and can be misleading. Rising markets that have good breadth, meaning stocks regardless of size are moving higher, are the most trustworthy and are deserving of the designation of bull market. The chart below shows the cumulative advances versus declines of all stocks on the New York Stock Exchange. The chart has three parts; the top part is a chart of the cumulative net advancing stocks minus declining stocks over the past three years. The middle part of the chart is a momentum indicator, which tracks how fast the index is moving in one direction or the other. This momentum indicator identifies when sharp moves in the market have reached overbought or oversold levels that



in the past have lead to reversals. The lower part of the chart is the relative strength line, which measures how the index is doing compared to the S&P 500. Our analysis of the Advance-Decline chart is simple—it is the picture of classic bull market action. In this case, the two key parts of the chart are the top and bottom. The top chart shows that stocks of all sizes are moving higher. The rising trend of the bottom part shows that the average stock is actually stronger than the S&P 500 Index. This means that smaller companies are outperforming larger companies, which is precisely as it should be for the early stages of a bull market. There is one caution flag waving. That is the momentum indicator in the middle. It

is significantly overbought; meaning the current rate of ascent is unsustainable. This is a negative, but we suspect it may mean that the leadership in the market may soon be shifting to larger companies. Perhaps the single most important message from the chart as it relates to whether or not we are in a new bull market, is the fact that the average stock started higher on March 12,

2003, a week before the invasion of Iraq. That was a time when the hand wringing concerning the looming Iraqi war was at its highest. For stocks big and small to have begun their ascent in the face of all the uncertainties is a strong argument that a new bull market has begun. We rate the breadth of the market as POSITIVE.

Technical Condition of the Market

Wall Street strategists segregate the 500 stocks in the Standard and Poors into nine industry sectors. Each of these sectors contains companies who are in similar businesses, which allows for easier comparisons among the companies. In addition, we further reduce the nine sectors into three "sensitivity" sectors based on what we believe is the prime driver of the companies in the sector. The three sensitivity sectors are: (1) Economically Sensitive, meaning the main determinant of their price is the strength of the economy; (2) Interest Rate Sensitive, meaning the stocks react most acutely to the direction of interest rates; and (3) Insensitive or sometimes called Defensive, meaning the prices of the stocks are reasonably unaffected by either the economy or interest rates, but are driven by their own results. Obviously, all sectors are impacted by the economy and interest rates at some level, but in our experience, each sector has a different reaction time and leverage to changes in economic and interest rate activity. Below is a table showing the sectors and our alignment of each into one of the three sensitivity sectors.

1. Economically Sensitive

Basic Industries
 Industrials
 Technology
 Consumer Cyclicals

2. Interest Rate Sensitive

Financials
 Utilities

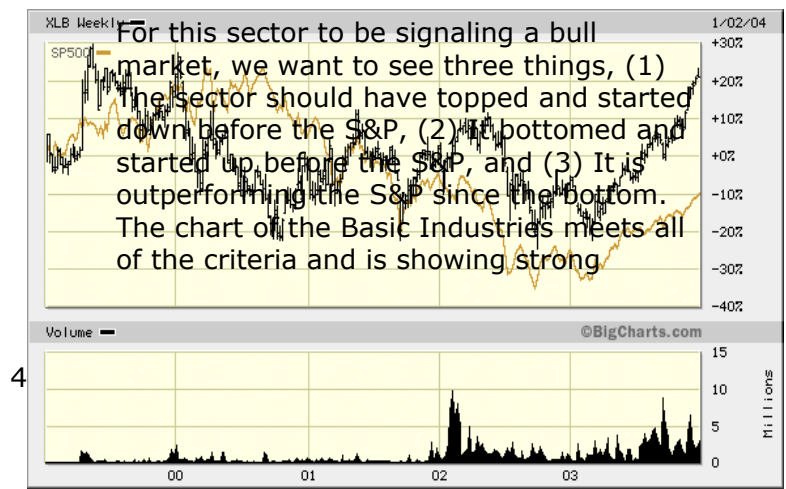
3. Insensitive or Defensive

Consumer Staples
 Health-Care
 Energy

We have found that the prices of the sectors move well in advance of their fundamentals, and they do so in a sort of wavelike motion. In a rising market, the order and magnitude of these waves are key to early detection of a true bull market. In this regard, we are like surfers. There are waves all around us, but we are looking for waves that have the correct makeup to carry us for the longest ride.

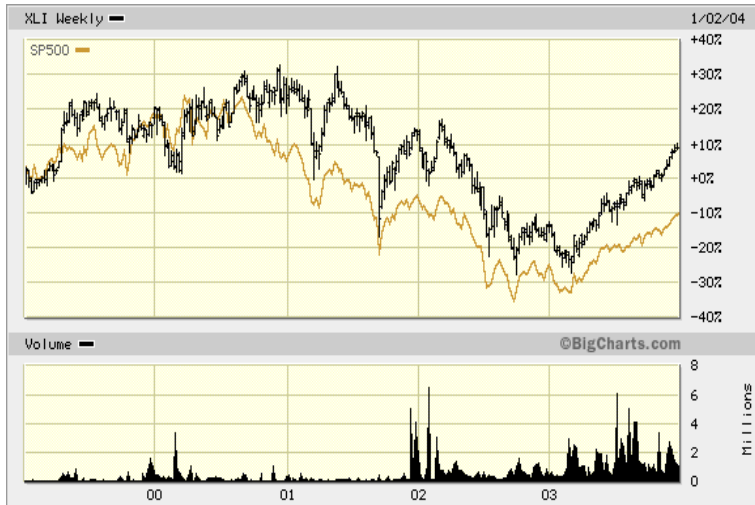
The classic patterns that we look for are as follows: The economically sensitive sectors turn up first and lead the market's advance. Next come the interest sensitive sectors, which usually turn higher a little later than the first group and ascend at a slower early pace. Finally, come the defensive stocks, whose most defining characteristics are that they are the last to enter a bear market, and under-perform the other two sectors during the early stages of an upturn. The charts below cover the last five years of price action of each of the sectors. In addition, each chart is compared to the Standard and Poors 500 Index over the same period.

Economically Sensitive - Basic Industries Sector



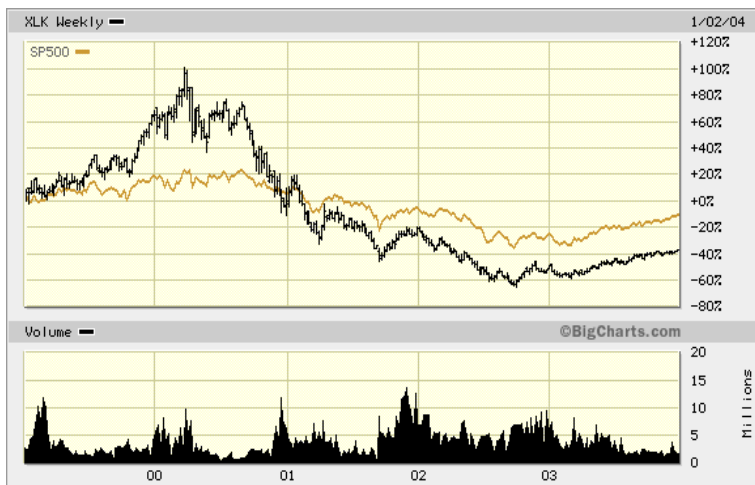
earnings improvement as a bonus. The sector has formed a classic bottom and executed a powerful upturn. Take a moment to study the chart, including the bear market action from 2000 through 2003. It will be instructive as we look at the other sectors.

Economically Sensitive - Industrials Sector



The Industrial Sector, which includes GE, United Technologies, Emerson Electric, and Illinois Tool Works, also has made a strong bottom and is outperforming the S&P 500. Earnings are improving, but so far at a slower pace than we had expected. The odd thing about this chart is that the Industrials outperformed the S&P throughout the recent bear market, as well as during the current upturn. We think this sector could show leadership for a long time.

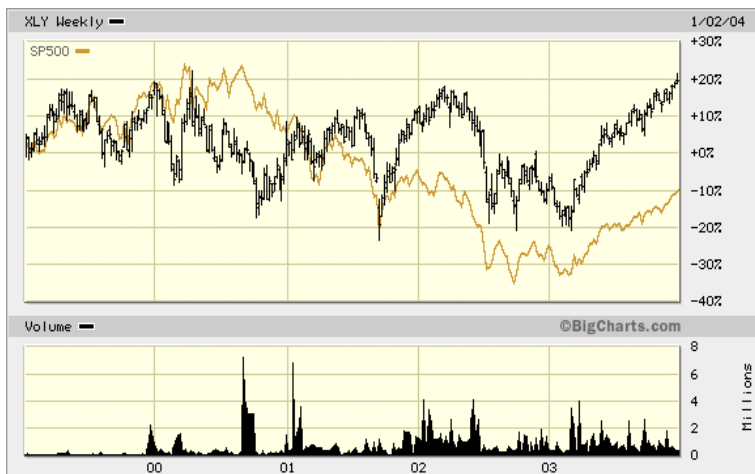
Economically Sensitive - Technology Sector



It's hard to believe that the Techs are still 40% below where they were 4 years ago. However, they have formed a massive bottom and, even though the chart does not show it, have outperformed the S&P since the bottom in February 2003. Tech earnings are now heading north, albeit from very low levels. The biggest problem we see with the Techs is that they rose nearly 50% last year, while earnings grew by only about 25%. The chart vividly shows the Tech mania of 1999 and 2000, and the ugly bear market since then. The bottoming action is very impressive, but the odds are not great that we will revisit the old highs

anytime soon.

Economically Sensitive - Consumer Cyclical Sectors

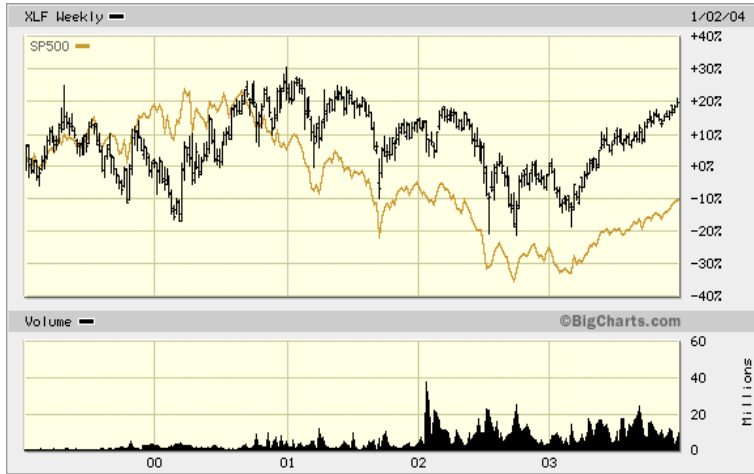


The Consumer Cycles have been a star performer. Remarkably, the consumer cyclicals have outperformed the S&P since 9/11, attesting to the resiliency of consumers. The bottom was powerful, the acceleration has been impressive, and the earnings have been strong throughout. This sector, which includes Wal-Mart, Home

Depot, Lowes, and the autos, is up nearly 20% over its 1999 level and recently broke to a new all-time high. We still like this sector, but it has had a long run and may be due for a pause.

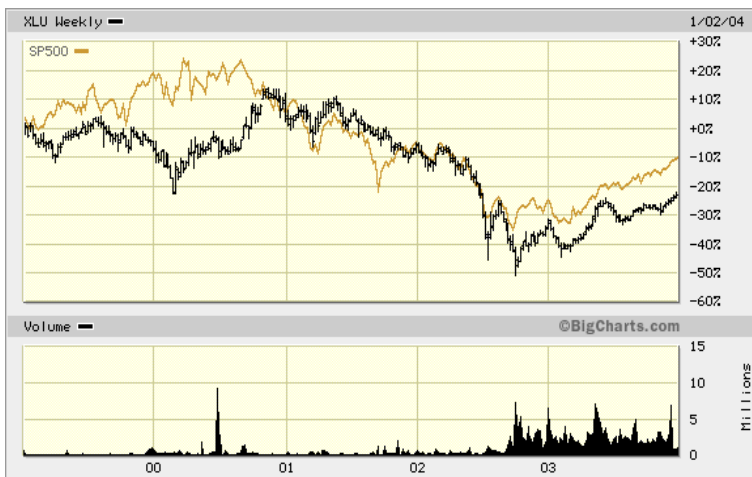
In our judgment, the Economically Sensitive Sector is showing almost all of the classic bull market attributes that we look for and makes a strong case that a new bull market is underway.

Interest Sensitive - Financial Sector



If there is a mother of all surprises among these charts, it is the price action of the Financials. Typically, the Financials do not do well in the early stages of an economic recovery because loan losses and write-offs hamper earnings well into the recovery. In this case, the Financials have actually been a leader, particularly since 9/11. The shallow recession kept loan losses low, and the sector's generous dividends cushioned their fall and gave them an early lift. Earnings have been very strong, and we believe they will continue.

Interest Sensitive - Utilities Sector

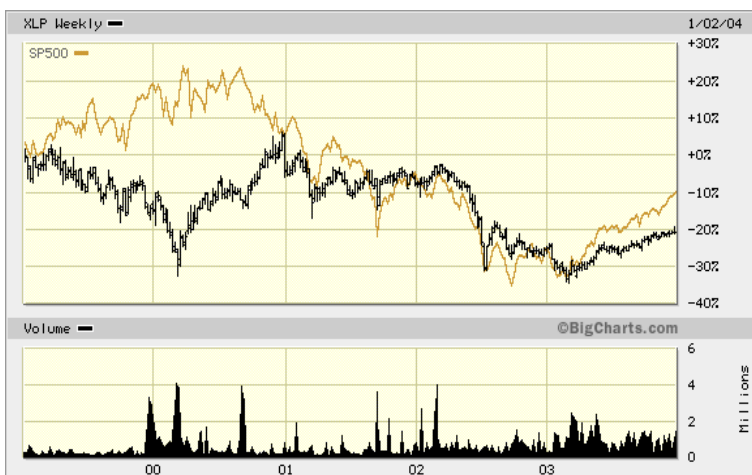


As surprisingly strong as the Financials have been, the Utilities have been just as weak. We will get right to the point here. Utilities are not what they used to be. They are no longer bond substitutes. In fact, we are not sure how to think of them going forward, but we are sure that their risk profile has changed. This sector has become a much more risky crowd both because of added debt and also because of more competition.

Even though neither of the Interest Sensitive Sectors has acted as we might have expected, we believe there are good reasons for their divergence. The strong

action of the Financials, however, is powerful medicine for a bullish call on the market.

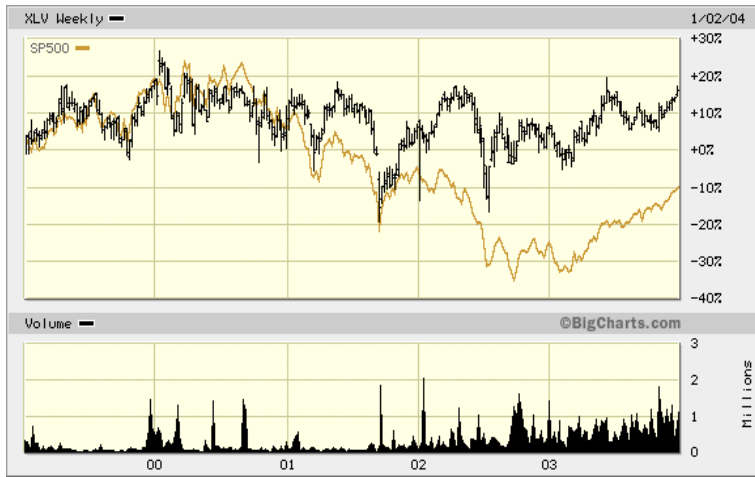
Defensive - Consumer Staples Sector



The collapses of the Consumer Staples in early 2000 and again in early 2003 were surprises. We would not have expected Coca Cola, PepsiCo, Procter and Gamble, Clorox and the rest of the Consumer Staples to have fared so poorly. All of these companies have strong brands, and we use their products everyday, so we do not know what to make of their weakness in the recent bear market. The recent under-

performance since the bottom is as expected, but we believe these stocks will start perking up once the Fed starts pushing up rates, which we believe will occur in the coming year.

Defensive – Health-Care Sector



This chart is really showing the power that is in this sector. About 1/7th of the US economy is spent in Health-Care so there are always opportunities here, as well, as the creative destruction of new technologies replacing old ones. The sector has outperformed the S&P almost continuously over the past 5 years, and it did so with the drug stocks under siege. This is just a very eye-opening chart and suggests that there really are new dynamics at work in health-care. Lots of opportunity here, including the drug stocks.

Defensive – Energy Sector



There was a time when the Energy sector was driven primarily by oil prices. As the oil companies have put more and more capital into the retail side of the business, their business has become more defensive and less dependent on oil prices. Miles driven appear to be the metric with the best correlation to stock prices. Miles driven by consumers doesn't change much, but corporate miles driven track the economy. The recent uptick in this sector is most likely a function of the improving economy and not crude oil prices or threats of terrorism.

The technical condition of the market shows all the classic signs of a bull market. We would worry about this precision if the fundamentals of the sectors were not mirroring what we are seeing in the price trends. The technicals show strong support for the case that a new bull market is underway.

The Envelope Please

Investor Sentiment	Bearish for stocks
Valuation	Bullish for stocks
Breadth	Bullish for stocks
Technical Condition	Bullish for stocks

We completed this letter on Friday January 9th and were preparing to mail your quarterly reports. At the last moment, we decided to wait until Monday to mail the packets. The reason for this was we wanted to sleep on the implications of our findings. If you have been keeping count, you realize our model is projecting a bull market in a landslide. Valuation, Breadth, and Technical Condition are all giving near perfect scores, with only Investor Sentiment offering a dissenting vote. The question

that entered our debate at the last minute was: Are we overlooking something on the international scene? Terrorism is an obvious wildcard; perhaps a trade dispute with China; or a crisis of the dollar. Maybe we're being too optimistic on DJ 30 earnings. Maybe the uptick in earnings this year was an inventory bounce. We are in the business of trying to call things right, not right now, so we decided we would sleep on it over the weekend. It was at that moment that serendipity entered the room. Well, actually, Rick Roop, one of our portfolio managers, stuck his head in to ask if we had seen his email. Standard and Poor's had just reported on dividend increases during 2003 by the 500 companies in their index.

"A total of 229 companies boosted their dividends by an average of 26%, with at least 14 doubling their payout and 33 companies increasing their dividends more than once. Twenty-one companies, including the likes of Microsoft Corp. and Best Buy Co., started paying dividends for the first time, the biggest number of new payers in at least 24 years, according to S&P."

The dividend tax cut of 2003 has not received much attention lately from the press, but corporate America is responding with dividend increases not seen in 20 years. We have been saying for years that dividends are real, not a function of accounting machinations, and we believe corporations will increasingly use them as a signal about the company's prospects for the future. Corporations, in determining dividend payouts, have to consider the same list of worries that we have identified here. Their confidence about the future, which manifests itself in a cash payout that they are not obligated to make, is a powerful message that things are getting better.

We believe in dividends, we have preached dividends for a long time, and Friday evening, dividends cast the final vote. It's a bull market!

Blessings,

Greg Donaldson

Mike Hull