April 2005

INVESTMENT PERSPECTIVES

Rome was Not Built in a Day

Successful investing requires a disciplined and consistent approach to making decisions for the long-term. It also requires a proper time frame for the investment to prove that it is worthwhile. In our opinion, it seldom takes less than four to five years for a new purchase to produce an attractive return (to double in value) for our clients.

As we read research reports each day, the overwhelming message is to buy a stock immediately so that we won't miss out on big gains. There is a great deal of short-term "hype" in these reports that encourages investors to buy now. Seldom do we read a report that identifies the rational steps that senior management is planning to take over a series of years to obtain specific goals.

There are many aspects of our lives that require long-term planning. These may include:

- Saving for your children or grandchildren's college education when he or she is just a toddler.
- Gifting to charities or relatives.
- Saving to buy a house.
- Remaining financially independent in retirement.

Investing in stocks and bonds is a way to achieve these long-term goals – investing is a means to an end, not an end in itself.

So, our approach to investing is strictly long-term. We want to find stocks that will hold up over time and will not disappear in a flash when investors unload their positions (does dot.com bubble sound familiar)? Our approach is first to determine, after its stock price has dropped in value significantly, whether or not a company is an appropriate investment opportunity. If the company meets our standards for quality, we next attempt to identify those steps that senior management is taking over the next five to ten years to bring the company back. We never approach a new investment idea with a focus on what

will happen to a company's earnings or stock price in the short term - meaning the next 3 to 6 months.

As we study the financials of a company, and talk with experts both on Wall Street and in the industry itself, it sometimes becomes clear that the management team is carefully doing the right things to correct the company's problems and to build a strong earnings stream. If we decide to take a new position in this company it is with the expectation that over the next four to five years this management team will make their company grow, and as it does, their stock will likely appreciate.

A common mistake that many investors make is to buy a company that has had a number of years of earnings growth and stock appreciation, without determining if this growth can and will continue. It is not uncommon for these investors to realize mediocre investment results because they bought the stock after it had appreciated significantly. One reason for this outcome is that a successful company often attracts real competition. If the company is not careful, the new competition will both take away some of their sales and impinge on future earnings growth.

Two popular areas, the Oil Industry and Emerging Markets, have attracted significant new money during the past 12 to 18 months. As discussed below, additional investments in these areas should be looked at very carefully before investing further.

The Oil Industry

Almost every business publication believes that energy prices will continue to increase. As recently as March 30th, Goldman Sachs analyst, Arun Murti, revised his forecast of oil prices to as high as $105 per barrel, stating that a "super spike period may be upon us."

While we don't agree with this prediction, it seems clear that emerging Asian economies are placing increasing pressure on demand. It is also clear that it is expensive to bring incremental supply on-line and that substantial investment is required to produce alternative fuels. Given these arguments it seems reasonable to predict that the days of $20 per barrel are behind us and that a new range will be established at a higher level.

Energy stock prices have historically moved in tandem with oil prices, regardless of the fundamentals of the underlying companies. History tells us that when oil prices fall, the major oil stocks will also tumble. According to Prudential, over the past 15 years there have been 31 times when oil has fallen 15% or more. During these periods the major oil stocks declined 60% of the time and under-performed the market 90% of the time.

Some conservation-minded individuals have already taken action to decrease their reliance on energy. Sales of SUVs have decreased, while sales of hybrid vehicles have increased. Enhancing public transportation has become a forefront issue for city and county politicians and planners. We expect to see a continued move to conservation as energy prices increase. Over the past two years, there has also been a significant increase

in investment funding targeted at increasing oil supply and at developing alternative fuels.

We believe that it is likely that energy prices will be higher than they were in the previous decade and we will be very selective in committing new money to this sector at current prices. We will gradually reduce holdings in portfolios that have more than normal exposure to this sector in order to realize some large long-term capital gains and to keep our clients' portfolios diversified. (As you know, preservation of capital is a primary investment objective for all of our clients.)

Emerging Markets

During the past two years the volatile emerging markets asset class benefited from solid global economic growth, low interest rates, and strong currency gains versus the dollar. Starting last September, mutual fund flows to international stock funds, particularly those dedicated to emerging markets, began increasing significantly. According to fund flow data from AMG (a firm that tracks mutual fund investments), international stock funds saw the largest inflows of any asset class in September and October. In February of this year, funds dedicated to emerging market stocks saw net inflows of cash of $4.6 billion - a record. It is our hunch that many people are new investors in this asset class and are unaware that this is one of the most volatile investment areas. Due to the very limited liquidity of the stocks in this sector, they do not know how quickly and severely this group can decline.

Recent concerns about the economy, including rising interest rates, increasing inflation and slowing corporate profit growth, have led investors (as events like this have many times before) to focus on higher quality investments and reduce exposure to riskier ones. The General Motors' earnings warning last month accelerated this flight away from risky assets classes and in recent weeks there have been large outflows from these emerging market funds. In fact, this asset class is now down for the year despite being up about 8% for the year in early March. Perhaps this drop will prove to be short-lived and emerging markets will deliver the high returns many strategists and hedge fund mangers expect, but we don't think so!

In our investment approach, the emphasis on downside risk and concern for preservation of capital, leads us to be inherently skeptical of volatile investments, such as emerging markets. We prefer to stick with high quality, industry leaders that some critics might characterize as "boring." We would argue that our disciplined, long-term investment focus helps us to avoid the allure of quick profits that frequently generates poor investment results.

In conclusion, we will continue (as always) to search for those companies that will produce attractive results over the long-term and that will help you to reach your goals. We will not take any "shortcuts" that could produce short-term gains but would negatively impact your portfolio returns over time. Our goal remains to protect your capital while realizing sound returns on that capital.