

## 2004 Year-End Commentary

*“The sense of security more frequently springs from habit, rather than conviction. For this reason, it often subsists after such a change in the conditions that might have suggested alarm. The lapse of time during which a given event has not occurred, in this logic of habit, is frequently cited as a reason the event should not ever happen (i.e. if it hasn’t occurred yet, it won’t), when the lapse of time is precisely the added condition which could make the said event more imminent.”*

*(paraphrased from Silas Marner by George Eliot)*

Dear Friends & Clients:

After a year of relatively mild activity, the equity markets found some footing in November and ended the year modestly higher. While this was probably a relief to everyone, (especially institutional portfolio managers, whose jobs may hinge on such positive outcomes), it’s interesting to observe (in my view) that the brief rally we had at year-end was born more of emotional momentum than anything else, since economic and investing fundamental environments have not really changed during that time, nor have things changed all that much since then. One of the more difficult aspects of the past year was the relative scarcity of good value ideas, as finding stocks and other investments that were selling at bargain prices and fit our investing criteria were few and far between. Due to the relatively low volatility over 2004, the market did not offer up many opportunities to take advantage of emotionally-driven declines. This doesn’t mean that there aren’t good companies out there with growing earnings, it’s just that they aren’t currently priced at levels I felt (and still feel) warrant your investment to generate better-than-average returns over time. In fact, a recent survey published by AAI (American Assn of Individual Investors) revealed 70 companies they felt could weather rough economic climates. All of these had good consistent earnings growth over the past 5 years, yet were priced at premium levels above the general market. (You may like a certain brand of apple pie, but do you really want to pay \$25 for it?) At times like these, it is natural to question one’s methodology and perhaps second-guess the criteria used to select good investments. After pondering this at times, I still feel maintaining a certain discipline that has worked well in the past may require staying put when conditions aren’t favorable for buying, even if one risks looking foolish or out-of-touch (in the short-term) in doing so. Even now, we see slivers of past “irrationality” in the form of some popular technology stocks whose price multiples mirror those of our recent dot.com era. In my opinion, the justification for such investments could have more to do with social chatter and “greater fool” mentality than any fundamental business or value investing principals. It appears some investors never learned.

Looking forward to 2005, there appears to be a fair bit of optimism about our economy and financial markets in general. Consumer confidence seems to be high, many corporations are holding or generating large piles of cash to merge, buy back stock or increase dividends and the economy is expected to continue modest growth. So what’s not to like? There are some signs I feel could indicate a disturbingly lack of caution for one. Interest rate spreads (or differences) between US Treasuries and riskier junk bonds have narrowed considerably, perhaps indicating there is not enough of a “risk premium” being demanded of less-than investment-grade issues. Insider selling by corporate management of their own company’s stock has been garnering some attention. (Are these individuals seeing some storms clouds that the average Joe does not at the moment?) Finally, price levels compared to earnings for US stocks in general remain high by historical standards and as I mentioned, to me there does not seem to be much in the way of value-buying opportunities. This ‘lack of opportunity’ opinion, by the way, seems to be shared by various value-oriented institutional managers as well, some of whom are holding between 15-40% of their portfolio in cash. In fact, as I have told many of you already, some of these managers have also closed their doors to new investors to slow the flow of new cash, believing that if they cannot find adequate places to put new cash to work effectively, they would rather protect current shareholders rather than grow for growth’s sake. To me, this is an indication of sensible attitudes toward managing money and protecting shareholder interests. Sentiment among Wall Street forecasters, although generally positive, seems also somewhat

muted. From what I've read, most of the "bullish" crowd is even reluctant to talk about returns above 10% for the year.

The situation with our country's debt, on all levels, has not changed materially from my discussion at mid-point last year and is still troubling. As the saying goes, "you don't know what you don't know" and as I nor anyone else can predict how this debt situation will unfold, the growing elephant in the room that was once whispered about has now garnered more discussion and cautionary warnings, (ironically from those that argueably fostered the situation; Fed Chairman Alan Greenspan and members of Congress). As recently reported in Barron's, our national total credit market remains at 3x the level of our annual GDP output, a condition I may remind you, that is worse than a similar situation in the late 1920's. Though the Administration has pledged to cut the budget deficit in half over the next four years, implementing new pet Social Security measures may mean higher near-term debt financing, increasing our national and current account deficits even more by a few trillion or so. Foreign central banks and investors, (the chief purchasers of our Treasury debt securities), may start to get a little antsy holding all this debt, as evidenced by recent language about "diversifying currency reserves" and lowering their exposure to a declining US dollar. As I write, South Korea and Taiwan have been dropping hints about this very subject and financial markets reacted sharply downward, (which could be a wake-up call to further such reactions down the road). Derivative and leverage-based investing (meaning debt-financed investing), continues to grow as well, especially among the numerous so-called "hedge" investment groups forming over the past year, many of whom reside in our neighboring state of CT. (Apparently, the Mohegan and Foxwoods mentality is becoming more pervasive).

As you may know, the so-called "China Phenomenon" has the financial and economic communities buzzing these days. China's economy has been startling, surpassing the growth and activity that I saw firsthand during a visit to Beijing and Shanghai back in 1997. According to many articles in Barron's and the Economist, despite government attempts to cool growth through interest rate hikes and other measures, business is still brisk in the Middle Kingdom. In fact, an interesting development has resulted from all this economic growth. Being the long-term thinkers and planners they are, many of China's state-run companies are out shopping to secure future supplies of natural resources, such as oil reserves in Canada and basic metal mines in South America, (a nice use for all those internationally-accepted US dollars that China has been accumulating). What is also fascinating (to me anyway) is the economic and strategic position China is assuming in Asia. Many neighbors are benefiting from China's economy, notably, Japan, Australia and South Korea. It is not inconceivable, judging by their past policies and history, that China could once again become the economic center of Asia and effectively exert significant influence in certainly Asian, if not world, economic and other international policy. It is also not hard to imagine China's position as similar to that of the USA during the 1900's, where our nation experienced great growth, wealth accumulation and world influence as Europe (and Britain particularly) relinquished some of their dominance. This is not to say that China will follow in our wake, as their political ideology and practice clearly differs markedly from ours, but it is clear the 'dragon giant' has awoken. With that thought, it seems the continued loss of US manufacturing jobs to China is inevitable. One example I read, "Can we really reasonably expect a US consumer to pay \$1000 for a US-made couch rather than an imported \$300 couch?" As anyone in business already knows, labor is generally the largest component of costs and it may be too much to ask many manufacturing businesses to compete with those that employ Chinese and other developing nation employees at a fraction of the cost of US labor. By the way, it's worth noting that although China has a big trade surplus with the US, it also has trade deficits with the countries it imports from to feed its economic engine.

It would seem then, that China may offer some potential investment opportunities, but some real caution should be exercised here. China is like a new teenage boy; lots of growth and appetite, all arms, legs and feet, feeling strong & ready to 'take on the world', but still developing strong structural support, maturity and experience. With all of its growth, China still lacks a strong network of banks, financial institutions

and financial market regulation, still ties its currency to the US dollar and may suffer some “growing pains” due to overbuilding and overcapacity, poor bank loans and other financial setbacks that could occur in the future. In addition, Chinese financial markets are notoriously volatile, so investing directly in China could be a minefield-kind of experience. In my view, if one were looking to direct a portion of their investments to this area, rather than invest directly in Chinese companies, it might be better and less risky to instead evaluate non-China based investments that supply or benefit from China’s growth, such natural resource or energy investments or in less risky companies that have significant business with China (as well as others in the world). If you are interested in discussing these notions for your own investments, feel free to give me a call.

A few clients who seem to be a little frustrated with moderate growth rates of their investments have been asking why they shouldn’t be putting more money in stocks, especially blue-chip large cap stocks recommended by Money, and (even better) Smart Money, magazines? Their argument is that these recommendations still have earnings growth and if others are buying, shouldn’t they be?

A fair question. The answer I give, along with some explanation, is rooted in those three most important words we all hold dear to our hearts, especially in this month of February. Of course, I am speaking of *Margin of Safety*. Yes, these recommendations you read about (and change with every issue, by the way) may well be good companies and/or investments, but if the aim is to exceed the return of the general market and be better than average, well, you might start with getting a better than average purchase price, meaning *buying it wholesale*, rather than retail. (Remember your price for apple pie). I totally agree, waiting for desired companies to “go on sale” or seeking bargains in this environment is very frustrating, but in my experience and those who have been at this much longer than me, having the patience to buy low could lead to better overall returns in the long run. This is where margin of safety is so important. Over the history of the markets, opportunities have arisen where it was possible to buy good companies selling for less than their worth and if you’ve been around long enough, you know this has been true with stocks, companies, real estate and Filene’s clothing. How successful would Antiques Roadshow be if things didn’t sell for much less than their true worth in the marketplace? The trick is, of course, recognizing that value, buying at a lower price and having the patience to wait for that value to be recognized.

Early in my past career in the seafood business, my employer and mentor explained this to me when I was training as a “grader” to buy giant bluefin tuna from fishermen for sale in the Japanese sushi markets. Though we were discussing fish, not stocks, the concept is the same: Recognizing value, and paying less than its worth somewhere else, is critical to business (and investment) success. I remember many occasions listening as he vehemently complained over prices I paid at times for various fish I bought for the company. He was right, of course, and a great part of his success in that business was thinking through his strategies, being patient, and not paying too much or buying fish just for the sake of staying busy. Many money managers fall victim to this tendency; they buy or sell holdings for the appearance of “doing something” even if the action makes little sense business-wise, which is why I see many portfolios with high “turnover” and the higher expenses that go along with all that activity. If we adhere to Ben Graham’s principle that “*investing is most intelligent when it is most business-like*” I think the financial world, and your own investments, would be far better off. Having that cushion of a margin of safety intertwined with your investments, as in your life, could make a fairly big difference in how your expectations and plans are met. This is why I have been emphasizing income, rather than capital appreciation, in many of your portfolios. Having a good amount of income coming in can be your “margin of safety” during this kind of environment.

As always, I want to thank you for your trust and business over this past year. If I haven’t been able to reach you as yet to discuss your investments or if there is anything else I could do for you, feel free to give me a call and let’s get together. Thanks again