

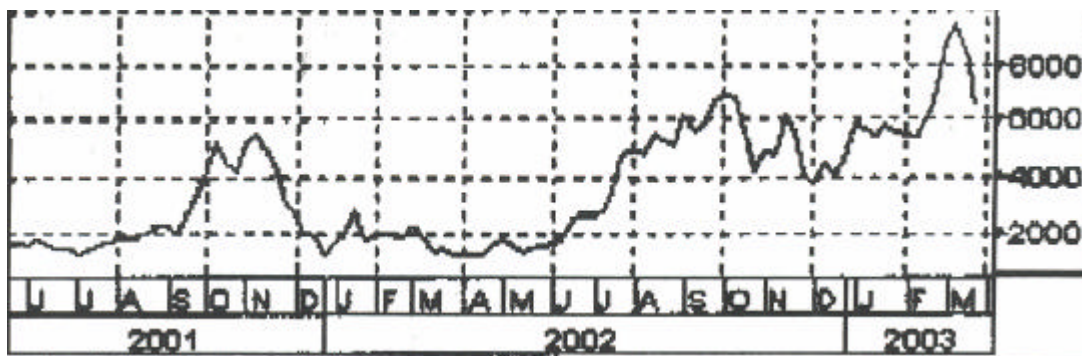
## Foundation Resource Management Quarterly Commentary 1<sup>st</sup> Quarter 2003

As the first quarter of 2003 came to a close, Operation Iraqi Freedom had the near total attention of the world and its security markets. The conflict has not only left a major imprint on the markets, but on the economy as well. Retail sales, auto sales and air travel are some of the areas of the economy that have been hurt by the consumer's focus on the war. The prosecution of the war seems to be progressing well for our side, after only two weeks at the time of this writing. It is apparent that we are going for the knockout punch in this war, having tried to get Saddam in the opening salvo, then heading straight to Baghdad once the invasion started. We don't pretend to have any idea of how long this war will take or what its cost will be. We do believe, though, that our leaders are determined and our forces will prevail. We also believe that it will be a long time before U.S. forces leave the country.

In the paragraphs that follow, we will examine first quarter market action and describe what we have been working on during that time. We will also discuss areas impacted by extremely low interest rates. Additionally, we describe the differences in the energy markets and related stocks between the 1991 war and the present one.

For most of the first quarter, stock and bond prices traded in opposite directions. Interest rates dropped to over forty year lows as a flight to U.S. Treasury bonds pushed bond prices higher. Government Sponsored Enterprises (GSE's) such as Fannie Mae and Freddie Mac were large buyers of U.S. Treasury securities. Low interest rates have set off a mortgage refinancing boom. The single hottest job market today is mortgage brokering, as the mortgage refinancing index reached all-time highs (see chart below). We forecast that this high level of refinancing activity will not likely be maintained in the near future.

### Mortgage Bankers Association Refinancing Index



Meanwhile, stock prices generally declined in reaction to the anticipation of war. The S&P 500 Index declined 3.15% for the quarter. Growth stocks outperformed value stocks by over four percentage points as technology stocks led the pack. We see more challenges ahead for

technology stocks, as it is likely that FASB (the Financial Accounting Standards Board) could issue a rule requiring U.S. companies to treat stock options as an expense starting in 2004. For the record, we are in favor of expensing stock options. A recent Merrill Lynch report found that earnings for technology companies in the S&P 500 Index would have been over 60% lower in 2002 if options had been treated as an expense. This contrasts with only a 10% earnings decline for the overall index.

The broader U.S. stock market has fallen to a level of slight over-valuation from the levels of extreme over-valuation of three years ago. Only when stock prices are compared to sky-high bond prices do they appear more reasonably valued. Stock market valuations are not yet near typical trough valuations seen at past bear market bottoms.

As you are aware, we spend our time searching for individual investment ideas (bottom up security analysis) rather than trying to guess (and that is all it would be) the direction of the economy and stock market. In the past quarter, we have researched various companies in several industries not currently represented in your portfolio. We have analyzed thirteen companies this past quarter in such diverse industries as pharmaceuticals, telecommunications, electric power generation, and retail. So far, **none** of these companies have the characteristics that completely meet our investment requirements. We are disciplined in our approach to produce an attractive return on your investment. By exercising price sensitivity, we attempt to invest in a stock that has a reduced risk of permanent loss and also possesses sizable appreciation potential.

This quarter, we have decided to do something different in this commentary. In the following two paragraphs, we thought we would give you a very brief description of two of our researched companies in which we have chosen **not** to invest. Our intent is to reinforce to you our investment discipline.

**Bristol-Myers Squibb (BMY)** – It is not often that one of the major drug companies' stocks declines 75% from its all time high, but that is the case with BMY. When that happens, we get interested, because we love to buy growth stocks at value prices. The opportunity just does not present itself very often. Anyway, we found a myriad of problems within this company. The company has leveraged its balance sheet much higher than the norm for the quality companies in the industry. This was done to finance an acquisition binge in the past several years. Most of these acquisitions appeared to be cases of management overpaying with resulting poor returns on investment. Added on to this is the fact that the company has had their patent expire on some of their best sellers, including BuSpar (anxiety), Taxol (cancer), and unless granted an extension, Glucophage (diabetes). To give the appearance that some of these problems were being offset, management deployed various improper accounting methods and also gave wholesalers huge incentives to take delivery of several medicines, creating a giant backlog. The company has had to re-state their financial statements twice in the last year. Given that management is prone to deceit, we decided that this stock was going to have to get a lot cheaper before we would commit, despite a very attractive 5% dividend yield.

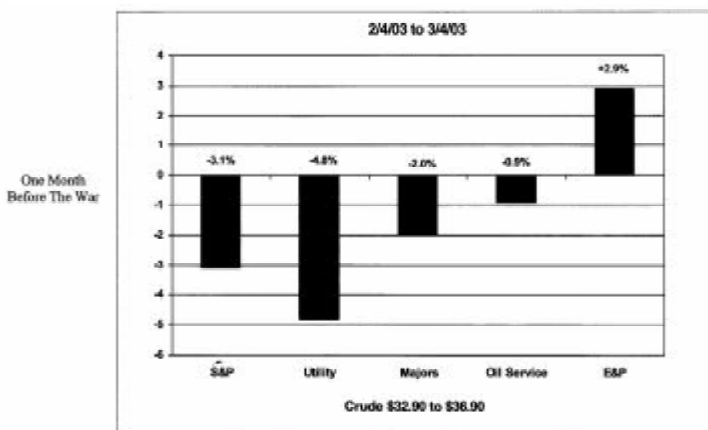
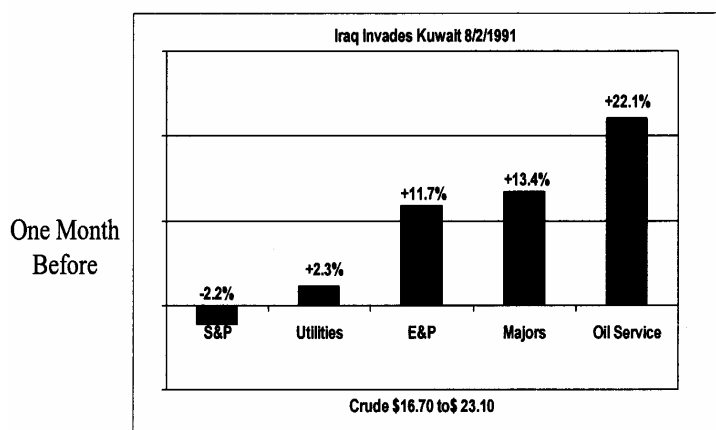
**Duke Energy (DUK)** - We began to analyze this formerly high-quality mainstay of the electric utility market along with several others in its industry as its stock was pummeled due to problems it was experiencing in its trading and wholesale power businesses. We have a natural bias against heavily regulated industries, but it was DUK's non-regulated businesses that were creating their challenges. The company, along with others, was implicated as contriving the California energy crisis of 2001. The resulting contingency weighed heavily on the stock, though it is our view that this event had more to do with market forces than market manipulation. Our balance sheet analysis identified that DUK had over \$7 billion of debt maturing in the next five years which could become problematic. A potential dividend cut and lack of confidence in management's non-regulated businesses indicated that fundamentals likely would deteriorate before improving, and we decided we should look elsewhere for the time being.

With margin borrowing still at very cheap levels, speculation in the stock market continues, albeit in a different form than occurred during the late 1990's. The speculators chasing a quick buck have shifted from telecommunications and technology stocks to shorting stocks (selling stocks not owned in the hope of buying back at a cheaper price), thereby positioning themselves to profit from a bear market. The vehicle of choice for such activity is to invest with a hedge fund. We feel that speculation of this nature is having a dampening effect on the stock market in general and a couple of our stocks in particular. **Fairfax Financial** has a short interest representing 17.7% of the total shares outstanding. **Goodyear Tire** similarly has a 16.4% short interest outstanding. We believe that the shorts provide future demand for these two downtrodden issues.

An anomaly which we are observing and acting upon is the discrepancy between the bond market and commodity prices. It is highly irregular that interest rates have trended down to forty year lows simultaneously with a rapid and broad based increase in commodity prices. This divergence cannot continue indefinitely. Our instincts tell us that rising commodity prices are beginning to be reflected in the Consumer Price Index. The weakness in the dollar should only exacerbate this situation. This should eventually lead to rising interest rates. Not only is the bond market ignoring this event, but also the stock market has not acknowledged that stocks of commodity producers are unusually cheap. This is where we differ from most investors. The Federal Reserve's position today is that strong measures must be taken to avoid a Japanese style deflation. As noted Forbes columnist, James Grant, says, "Nothing succeeds at causing inflation like a good whiff of deflation." We have said many times that inflation is a monetary phenomenon. Currently, U.S. credit is growing faster than the real and nominal economic growth rate. This is the Fed's attempt to do all in its power to avoid deflation. If there is one thing that Greenspan has been successful at it is creating money, and lots of it.

In the first quarter, oil and gas prices began to appreciate swiftly, but it was the clear consensus that they would recede as soon as the first missiles were fired in Iraq. This in fact has occurred. The difference between Gulf War I and Gulf War II is that the stock market has acted very differently. Twelve years ago, the stocks representing these commodities (natural gas utilities,

exploration and production companies, major integrated oil companies, and oil service companies) moved in tandem with the commodities themselves (see charts below). Wall Street had gotten religion and was not going to fall for that trick again. We identified very different industry circumstances, particularly in the oil markets that we believed were being overlooked. The last invasion of Iraq was in 1991. The price of crude oil was \$32 per barrel. This time oil prices reached a high of \$39.99 on February 27<sup>th</sup>. In January '91 U.S. crude oil inventories were 323 million barrels (270 million barrels today). U.S. imports were 6 million barrels per day (now 9 million) – 3.4 million from OPEC (now 4 million). Demand was 17 million barrels per day (today it is almost 20 million). OPEC excess capacity was approximately 5 million barrels per day compared to probably less than 1 million barrels today. We believe that oil and gas fundamentals are much improved from twelve years ago. Meanwhile, political circumstances in Venezuela and Nigeria, two of the world's largest oil producers, have raised the awareness of the existing shortages. Natural gas markets have an even stronger bull case. This is the reason why we own such energy related stocks as **Conoco Phillips, Halliburton, Encana, and Teekay Shipping**.



One area of analysis we are more thoroughly reviewing is corporate debt structure. It is clear to us that a growing number of companies are financing long term assets with short term debt or by using a derivative security called an interest rate swap to accomplish the same result. This is troubling to us. The reason for this herd mentality is found in the shape of the yield curve. Currently, short term interest rates are distinctly lower than long term interest rates. Because of the pressures on managements to maximize short term profits, many have opted to shift their indebtedness to short term obligations in order to reduce their interest rate tab. This is a dangerous idea, just ask anyone in the savings & loan industry. We are looking closely at existing and prospective holdings to see that long term assets are financed with long term indebtedness wherever possible.

Another observation on the subject of debt is corporate debt buybacks. With interest rates at 43 year lows, it seems to us that this would be as good a time as any for a company to take on long term indebtedness. Money is cheap. In general, however, that is not happening. As business confidence has waned, corporations are more reticent to expand their businesses. This re-direction of cash flows towards debt repayment and away from capital expenditures is having an adverse

economic effect. Several years ago, many corporations were issuing debt at much higher interest rates to buy back stock at much higher prices. This is just another example of how herd mentality can affect even the most sophisticated corporations.

Since this time of year tends to be our busiest proxy voting season, we are reviewing annual reports, 10-k's, and proxy statements of your portfolio holdings in order to properly exercise our authority to vote proxies on your behalf as a shareholder. We have always taken this job very seriously, since good corporate governance is imperative in representing our interests as shareholders. Foundation Resource Management has written policies and procedures as to how we vote proxies on various subjects. If you would like a copy of our written policies on proxy voting, please contact us and we will be happy to send you one.

We would like to announce the newest addition to the Foundation Resource Management family. Madeline Rose McKelvy was born on March 9<sup>th</sup>, and both she and her mother, Abby, are doing well. Damon is learning about sleep deprivation and diaper changing. As anxious as we are for Abby's return, we believe Madeline may need her mom even more than we do for now.