



**Quarterly Commentary**  
**1<sup>st</sup> Quarter 2004**

We have said many times that our firm is a bottom-up value investor. In a nutshell, that means that our time is better served searching for individual securities of companies that are mispriced to their true value rather than trying to anticipate the direction of the world's economies, interest rates, commodity prices, currencies, and stock markets. Although we believe that these macro topics are important, we have low confidence in our ability to produce good compounding rates of return for you with these as our primary focus. Therefore, our typical workday (if there is such a thing) is principally spent studying financial reports of companies. This is what we believe that we do well. We know that it is this work that has allowed us to grow our clients' capital over long periods of time.

At the end of every quarter, we convene to crystallize our thoughts on the securities markets and put them in writing, which our clients can simultaneously digest. The importance of performing this task is that each of our clients observes the consistent application of our investment strategy in different types of market environments.

In this commentary, we will discuss a few of the investment topics that we find important and that we are attempting to understand from a macro perspective. The first subject is interest rates and inflation. We use the phrase "attempting to understand" because the bond market and interest rates currently display no connection to fundamental reality, in our opinion. It probably will feel like we are spending an inordinate amount of space discussing the bond market, but we believe it has major implications for investors in stocks, commodities, and real estate. The second topic is a follow-up on last quarter's discussion of an historical perspective of the commodity markets and recent news on oil reserves. Last, but probably most importantly, we will discuss our actions and reasoning on three particular stocks in your portfolios this past quarter.

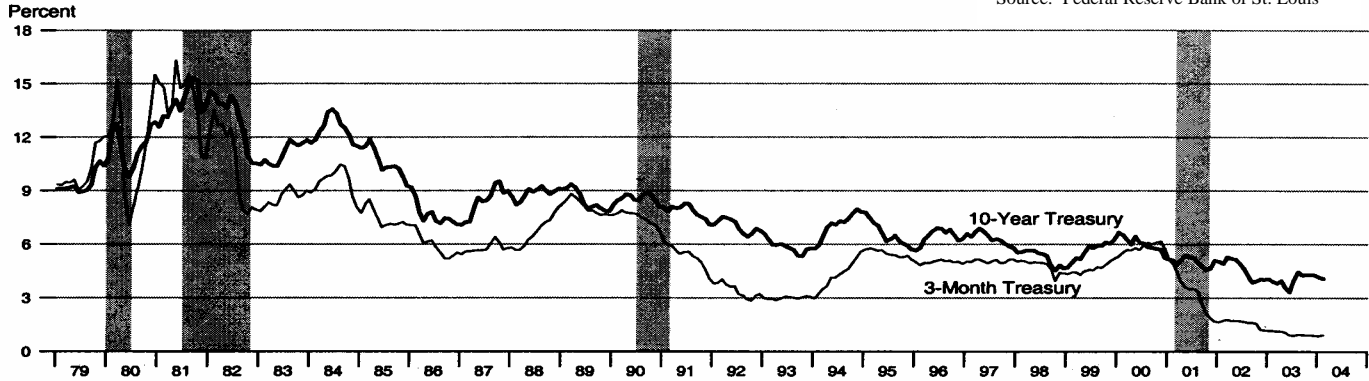
**INTEREST RATES AND INFLATION**

**"WHAT IS HE THINKING!"** could be heard reverberating through our office on the morning of 2/24/04 as we read the headline, **"Greenspan Says ARMs Might Be Better Deal."** The article went on to say, "He (Greenspan) said a Fed study suggested many homeowners could have saved tens of thousands of dollars in the last decade if they had ARMs." In this case, ARM stands for adjustable rate mortgages, the type of mortgage that benefits the holder if interest rates decline. The fact that the chairman of the Federal Reserve

would, after 23 years of declining interest rates to 45 year lows, choose now to begin to advise borrowers to mortgage their homes using adjustable rates appears reckless.

### Interest Rates

Source: Federal Reserve Bank of St. Louis

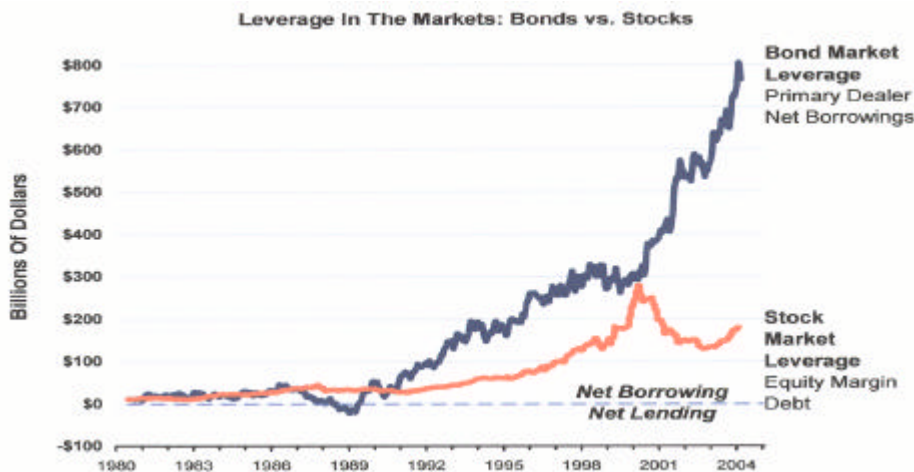


We have said for longer than we would like to admit that the bond market has, in our opinion, abandoned any fundamental logic and is exhibiting bubble characteristics. Interest rates have gone lower than we would have ever dreamed given current economic characteristics. We have heard that being early and being wrong look the same 95% of the time. Today, we frankly look wrong in the bond market. We hope that tomorrow we will be proven to have been early. We believe that bonds today represent a high risk-low return asset class and would stress caution particularly for maturity risk but also for credit risk. From a positive perspective, we can not wait for the day that we can invest when interest rates are much higher, fully reflecting all bond market risks. Recently, we have told our clients that investing in bonds today must feel very much like investing in internet stocks in late 1999. We, and probably our clients, are grateful to be able to say that we really do not know what investing in internet stocks felt like in 1999. However, ignoring the warning signs will likely lead to one's detriment. We believe there are three reasons for the strength in today's bond market, none of which are permanent. They are as follows:

**I. CURRENCY INTERVENTION** We have used the term "race to the bottom" in describing most of the world's major central banks' policies toward their own currency. Their purpose is to improve domestic economic activity through exports at the expense of their own currency. The most obvious example is Japan. Last year, the Bank of Japan spent \$188 billion, an annual record, on U. S. Treasuries and other bonds denominated in U.S. dollars trying to prop up the dollar against their currency. The dollar fell 10% against the yen anyway. In the first three months of 2004, the pace of U. S. debt purchases by the Japanese incredibly tripled over the record pace last year. The Bank of Japan intervention, which began in earnest last September, has left Japan with paper trading losses of approximately \$80 billion. So what happens if the Japanese begin to sell our U.S. Treasury bonds? We may soon find out. On March 29<sup>th</sup>, Bank of Japan sources declared an immediate end to their currency intervention policy. Japan's economy has begun to accelerate. Last quarter's real growth rate for Japan was 7% (the fastest pace in 13 years). For the first time in 10 years, Japan is now running a

trade surplus with China. Since foreigners now own 36% of U.S. Treasury debt, we may witness rising interest rates if foreigners ever decide to be sellers instead of buyers of our debt.

**II. BOND CARRY TRADE** This term is used to describe the process of bond speculators borrowing cheap short-term money and investing the proceeds by buying long-term bonds. This tactic typically surfaces when interest rates are low and when short-term rates are proportionately lower than long-term rates, a condition that perfectly describes today's interest rate environment. It is hard to quantify the magnitude of the bond carry trade epidemic, so when we recently found the chart below on a Google search, we were astounded. We had already reported to you the resurgence in margin debt for stock purchases, but were frankly unaware of the magnitude of leveraged speculation in the bond market. Certainly, hedge funds are a major factor in this speculation. It does not take much of a move against an investor leveraged 20 to 1 or higher to cause a complete wipeout. Just ask Long Term Capital Management, a hedge fund that suffered that fate in 1998. It is for these reasons that we have said we believe when interest rates inevitably begin to rise, they will likely do so quickly.



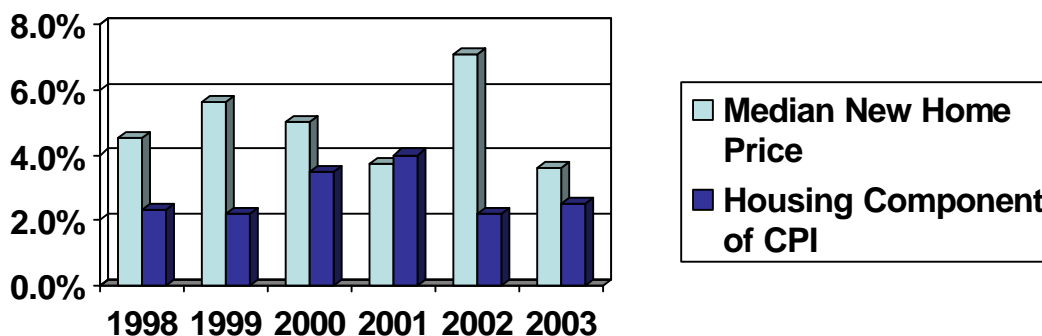
Source: Bianco Research & ING

**III. INFLATION MISINFORMATION** Most investors have been brainwashed into believing that rising prices **cause** inflation. Watch most mainstream financial news programs, and whenever inflation is discussed, the implicit assumption is almost always made that as long as consumer prices are not rising, then there is no inflation. Who has been the leader in this misinformed way of thinking? You can thank your government. When central banks around the world throw discipline to the wind and create fiat currencies at rates exceeding the growth rate of their own economies, inflation is the inevitable result. Inflation is uniquely a monetary phenomenon caused by relatively more fiat dollars chasing relatively fewer goods and services in an economy.

We believe the Consumer Price Index (CPI) is understating inflation in many ways but the most important variable is housing. At 40%, housing is the heaviest-weighted component in the CPI. Your government calculates housing not by home prices, not by real estate taxes, not

by homeowner’s insurance, but by something called “rental equivalency.” The problem with “rental equivalency” is that approximately 70% of Americans **own** their homes, not rent. Not only is the rental market in a decline today because of the increase in trends toward home ownership, but also the “rental equivalency” is dampened by record low interest rates. As interest rates have fallen and mortgage holders have refinanced, monthly house payments have fallen, thus reducing the CPI measure of housing inflation. Look at the chart below to see the discrepancy between actual home price increases and the level of the housing component of CPI for the last six years.

### Median New Home Price Versus Housing Component of CPI



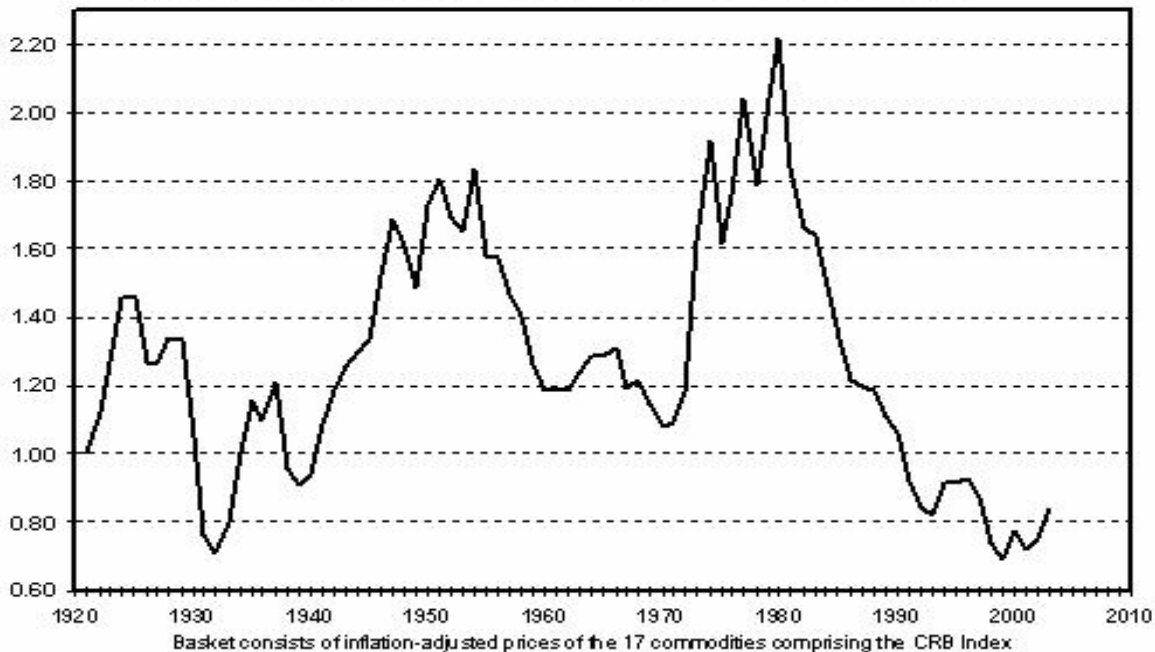
Source: US Housing Bureau, Bureau of Labor Statistics

Likewise, our government’s approach to calculating inflation does not consider inflation in prices of assets such as real estate, stocks, or bonds. Maybe we should begin doing what the Bank of England is doing and not just take into account consumer prices but asset prices as well. We believe at some point the investment community will begin to catch on to this government misinformation and send interest rates higher.

### **COMMODITY PRICES – HIGH OR LOW?**

This is the single most important question that we continue to ask ourselves and are asked by our clients. After all, commodity prices are up approximately 50% in the last two years in terms of U.S. dollars. The following chart visually answers that question on a real (inflation-adjusted) basis. Although commodities are up recently, we must consider that they have come from extremely low levels three or four years ago. In fact, after a 20 year bear market, commodity prices in 2000 were at the lowest real levels in the last 80 years. Our desire is to avoid any possibility of speculation when it comes to managing your assets. That is why we feel that it is so important to be able to conservatively analyze your commodity-related security holdings, which represent a large part of your portfolios.

## Commodities Near All-time Low



Source: ditomassogroup.com

Surprisingly, there has not been a commodity price boom in terms of foreign currencies. That is why we are not witnessing worldwide growth in production capacity for many commodities. Accordingly, we believe commodity prices have a long way to go to reach excessive levels.

### NEWS ON OIL RESERVES

On 1/9/04, Royal Dutch/Shell shocked the energy markets by announcing a write-down of proven crude and natural gas reserves on the magnitude of 20%. This was quickly followed by similar announcements by Forest Oil, Nexen, Husky Energy, El Paso, Vintage Petroleum, and Western Gas Resources. Thankfully, we do not own any of these securities in our clients' portfolios, although we do have a large investment in energy stocks. What made these disclosures so surprising was that they were made at a time of rising oil and gas prices. Recently, Business Week cited Matt Simmons, head of an investment banking firm specializing in energy, as vocalizing his belief that the Saudi Arabian oil production "miracle" was nearing an end. Our assertion for a heavy investment in oil- and gas-related securities rests on two premises. First, worldwide demand for energy is growing faster than our ability to produce it, which should continue to lead to strong energy fundamentals. Second, the securities markets appear utterly blind to this reality, which is why energy-related stocks are currently valued as if energy prices are going down, not up. We believe that these recent news events, while considered temporarily negative for those making the announcements of reserve reductions, will likely be viewed positively for the long term by investors.