



Quarterly Commentary 3rd Quarter 2004

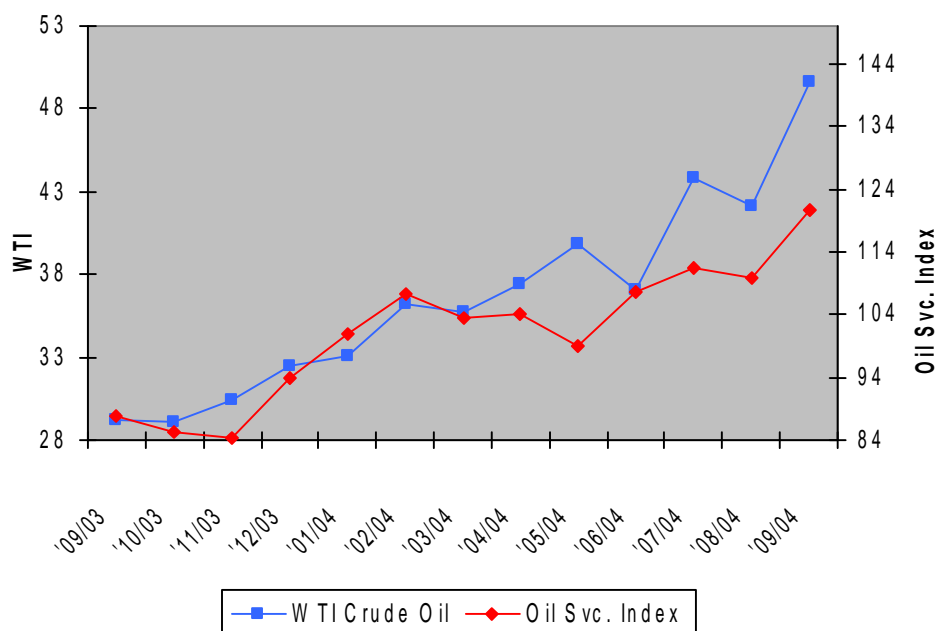
In our quarterly ruminations, we attempt to highlight those events that we believe are having or will have an impact on our ability to compound our clients' portfolios at an attractive rate. Our desire is to identify those few critical factors that can create or destroy value over long time periods. We spend very little time focused on news. On the subject of news, Joe Granville, a well-known market forecaster, eloquently is quoted to say, "Investors get into more trouble and make more expensive wrong decisions by following news than for any other reason. So heavily influenced by the news, the majority get lost in the maze, unable to see what the smart money is doing. It misleads more often than it guides. It creates mistimed fears which provoke selling at the wrong time and raises hopes, which encourage the buying of stocks at the wrong time." We desire to be selective in our pursuit of uncovering value. We will highlight a few of the things that we believe are of prime importance.

\$50 Per Barrel Oil – Just like the four-minute mile in track and field or the one hundred mile per hour pitch in baseball, the world loves to witness the breaking of milestones. There is something about nice round numbers that stand out in people's minds as an official target that begs to be broken. Fifty dollar per barrel oil was just such a barrier whose time to fall occurred at the end of the third quarter of 2004. Officially, it was October 1st before oil actually closed above \$50 per barrel. The significance of the event is probably overstated by the creators of headlines in the national media. We have said before that on an inflation-adjusted basis, the price of oil today actually remains low compared to 1980.

Our clients' portfolios are heavily influenced by what is going on in the energy markets. Currently our average equity portfolio weightings in the energy markets exceed 25%, and when some of the peripheral holdings in energy-related securities are also included, roughly a third of our clients' assets are affected by the market's opinion in the energy world. However, we have been invested in many fine energy companies since long before the world saw \$50 per barrel oil. For our longer tenured clients, most of our energy stock positions were initiated several years ago when oil and natural gas prices were only 30–50% of current levels, bargains in real and absolute terms.

Two quarters ago, we attempted to make the point that, even though most commodity prices had risen in the last several years, on an inflation-adjusted basis, they were coming off 80 year lows. This was definitely the case regarding oil and natural gas. Only recently have the stocks in this industry begun to act as if higher energy prices are here to stay (See **Chart 1** on the next page).

Oil Prices Versus Oil Stocks



Actually, the futures market for oil is amazingly complacent about future oil prices. West Texas Intermediate crude oil to be delivered in December of 2009, roughly five years hence, is selling for approximately \$35 per barrel, a \$15 per barrel discount from current spot prices. This describes what is referred to as backwardation in the futures market, a period when futures prices are actually lower than spot prices. Backwardation is relatively rare in the commodities market. This situation tells us that today's buyers and sellers of oil believe that oil prices will decline significantly over the next several years.

How can we measure the stock market's appreciation for such events? We have included **Chart 2**, as a separate page, from Crandall, Pierce & Company that we believe displays convincing proof. In 1980, the last time oil prices were at similar levels, the energy sector of the S&P 500 Index represented 27.1% of the index. At that time, the energy sector was far and away the largest sector, almost double the number two sector, basic industry, representing 13.7% of the index. In 1999, a time when we were identifying tremendous buying opportunities in oil and gas stocks, the energy sector only represented 5.3% of the S&P 500 index, a multi-decade low. Interestingly, it was technology in 1999, a sector that we identified as highly speculative and fortunately avoided, that topped all sectors with a weight of 28.2%. Today, even after the recent out-performance of energy stocks, the energy sector only represents approximately 6.2% of the S&P 500 Index. We believe many energy stocks still represent good value today.

Improved Accounting Quality – After many of the high-profile accounting debacles like Enron, Tyco, Worldcom, and Adelphia came to light, we began to reflect on the future impact those occurrences would have on the quality of earnings and conservative accounting practices. Our observation was that reactions to such events usually cause a swinging of the pendulum from one extreme to the other. Prior to these incidents, we had been rather guarded against certain liberties being taken in the areas of aggressive accounting practices in the corporate world. Although we have been able to avoid the high-profile versions of the crook of the month club, we have not gone unscathed. **Goodyear**, one of our senior positions, has had a major multi-year re-statement of financial results.

We have begun to notice a pattern that we have only half-jokingly started to call the “SAP Effect”. SAP is a German computer software company that is a market leader in providing an accounting package that gives companies access to highly detailed financial reporting. Several companies that have purchased the SAP system have subsequently announced a re-statement of past earnings. Quite often, a sharp stock price decline is soon to follow. We are convinced that companies are becoming more attuned to the accuracy of their financial reporting. We believe in the past, many of these publicly disclosed accounting occurrences would have gone unnoticed in the public’s eye and would have been treated as an item that would “flow through”, known only to managements and their auditors. What we perceive as eventually beneficial to long-term shareholders, more accurate financial reporting, is now being treated negatively within the stock market. Herein lies what we believe may give rise to opportunities.

Interest Rates – Based on its recognition of the evidence that the U.S. economy is gaining strength and that deflation no longer appears to be a threat, the Federal Reserve began to raise short-term interest rates on June 30 of this year. Subsequently, the Fed has raised the Fed Funds rate twice more in the third quarter. The total increase has taken the Fed Funds rate from 1% to 1.75%. To us, the most surprising fact is that the bond market remains complacent about rising interest rates. It is quite common that financial crises (see table below) have occurred at times when the Fed has been in tightening mode. As

The Fed's trail of victims
 Fed tightening campaigns have triggered financial crises in the past few decades

Victim	Year
Franklin National Bank	1974
Penn Square Bank	1982
Continental Illinois	1984
U.S. stock market	1987
Savings & loan industry, real estate	1989
Mexico, Orange County, Kidder Peabody, Askin Capital	1994
Asia, Russia, Long Term Capital Management	1998
Nasdaq stock bubble	2000

Source: Merrill Lynch

can be witnessed by the table on page 5, longer-term interest rates have actually declined while the short-term interest rates controlled by the Fed have risen. We believe that it is noteworthy that short-term interest rates, after adjusting for inflation, remain negative. It is a very rare occurrence that short-term borrowers can pay back less to their lender than they borrowed after the adjustment for inflation. Accordingly, the Fed remains in a highly stimulative mode even though it has begun to raise short-term rates. Likewise, the bond carry trade, which is being

Fed's Effect on Certain Interest Rates

	<u>6/29/04</u>	<u>9/30/04</u>	<u>Difference</u>
Fed Funds Target Rate	1.00%	1.75%	+.75%
Two-Year Treasuries	2.82	2.61	-.21
Five-Year Treasuries	3.90	3.37	-.53
Ten-Year Treasuries	4.69	4.12	-.57
Thirty-Year Treasuries	5.36	4.89	-.47

exacerbated by hedge funds and foreign investors, appears to be alive and well. Unexpectedly, the bond market had a very strong 3rd quarter. This followed a very weak 2nd quarter for bonds. We believe that some of the strength in bonds has resulted from a flight to quality.

Residential Real Estate – If you had an opportunity to read our article written last quarter entitled, “It’s Time to Bust up Fannie and Freddie”, you know that we believe the nationwide residential real estate market is exhibiting bubble-like characteristics. It now appears that our thoughts are becoming more broadly accepted as it recently was made public that Fannie Mae’s chief regulator, the Office of Federal Housing Enterprise Oversight (OFHEO), has found Fannie to be under-reserved and the subject of manipulative accounting practices. While OFHEO would agree with our expressed concern for Fannie Mae’s excessive financial leverage calling for an increase in their equity capital, they do not go far enough, in our opinion, in addressing the need for broader private competition. The Justice Department and the SEC have also announced formal investigations of the company.

Why should this matter to you since we do not own Fannie Mae stock? We consider that a very important part of our job as your investment advisor is to guard your capital against excessive market speculation. You might have noticed in **Chart 2** that the financial services sector is the new leader in equity market capitalization today. We believe much of this activity results from the fact that excessive lending in the residential real estate markets is inflating the balance sheets of many financial institutions. Real estate lending is the fastest growing segment of the banking industry. Typically, it is a sign of financial speculation when lending institutions are rapidly increasing their lending toward a particular asset type. We are amazed at the capacity of key GSE (Government Sponsored Enterprises such as Fannie Mae and Freddie Mac) lenders to issue seemingly endless quantities of new liabilities with little to no impact on the market’s perception of these securities’ AAA quality status. Today GSE and Wall Street’s security issuance has replaced the government’s printing press as the primary source of monetary inflation. Total combined GSE assets along with outstanding mortgages and asset-backed securities have expanded 126% to \$7.46 trillion over the last seven years. These conditions warrant a cautious investment position regarding residential real estate and the financial institutions exposed to this very real threat.

