



INVESTMENT STRATEGY UPDATE

June 26, 2002

A QUESTION OF CONFIDENCE

The stock market was very weak this quarter, with few stocks escaping the downdraft. Yet, the fundamental environment for stocks is actually fairly good. While not as rapid as some would like, the economic recovery appears to be on firm footing. Furthermore, interest rates are low, there is little inflationary pressure, and the Federal Reserve Board remains in a stimulative posture. In addition, the long-term demographic trends remain positive for financial assets.

We had thought there would be a timeout in the stock market advance from September's lows, to allow earnings to catch up with valuations, however the current weakness is more than we were expecting. Why? The most obvious explanation for the downtrend is the combination of troubling current events and the fact that the stock market is still somewhat expensive by historical standards. But we think there is more to it. What the market is experiencing, in our opinion, is a deterioration in investor confidence, the origins of which predate the weakening U.S. dollar, the recent escalation of troubles in the Middle East, and the rising tensions between India and Pakistan.

The slide in confidence started with the bursting of the great technology bubble and the realization that there was, in fact, no "new era" for stocks. Then came 9/11 and the threat of additional terrorist acts. Next there was Enron and the other accounting scandals, raising questions about whether Corporate America could be trusted. While only a handful of companies had been outright lying about their revenues and profits, it seems that numerous others were stretching the rules to more favorably show their earnings. More recently, there has been another revelation – Wall Street research is biased. To that we say, "Wasn't it obvious?"

Prognostications

So, what's next? Stock market fundamentals are subject to interpretation, but for the most part they are quantifiable. The concept of investor confidence, however, is more tenuous. Driven by greed and fear, investor psychology moves the market in great waves. While there is a central tendency of fair value, the swings can be very large, as witnessed during the recent technology-stock mania. Significant divergences from fair value inevitably reverse, but the reversals themselves can also overshoot. Sometimes, at the extremes, stock

market turns are marked by capitulation – an almost complete throwing in of the towel. Then, after almost all of the participants agree that either they “must be invested in stocks,” or “never want to own a stock again,” the trend reverses.

The current bear market in stocks is now more than two years old. The capitulation phase would seem near for those investors who concentrated in and still own the technology and telecommunication sectors. However, we are not yet sensing a lot of fear from the general investing public. There is concern, of course, and certainly aggravation, but not an overwhelming distaste for stocks. This time we do not believe that a full stock market capitulation is necessary for the downtrend to reverse. The stock market bubble was primarily technology and telecommunications based, and not all encompassing. Investors who chose to focus on less highly-valued sectors, never really participated in the great mania. We see little reason that they must give up on stocks before a final bottom can be reached. Nonetheless, we suspect the current weakness will continue for a few more months, albeit periodically interrupted by rallies.

Do we think there is a risk that events could worsen, escalating the current weakness into a more serious decline? Of course, there are myriad risks: war, terrorism, or even the unlikely collapse of the U.S. dollar. It is our job to be concerned, but stock market downturns driven by events tend to be sharp and relatively short. We do not believe the consequences would be long lasting.

In our mind there are two greater worries: consumer confidence and a deteriorating U.S. trade policy. The last recession was business led. The fact that the consumer continued to spend kept the recession from being more serious. Business is now improving, but the recovery is slow and we worry that continuing stock market weakness could negatively affect consumer confidence, leading to further economic weakness. But perhaps the bigger concern in our minds, is the current direction of U.S. trade policy. With the recent tariffs placed on foreign steel, the proposed tariffs on Canadian lumber, and farm subsidiaries on a variety of agricultural products, the Bush administration is sending the worst possible message to our global trading partners. It seems illogical? Is the U.S. not the bastion of open competition and free world trade? A reversal in the trend from freer world trade toward increasing protectionism would unquestionably lead to a permanent reduction in the rate of global economic growth.

Despite the risks, we remain optimistic about the next few years and continue to believe that the stock market will provide investors with very reasonable returns. When and at what level the current weakness will end is tough to call, but we think there is a good chance that this year will close on a more positive note.

As we have often said, there is opportunity in adversity. With the general weakness, many stocks have reached or are approaching levels at which their two- to three-year returns should be quite positive. Therefore, as investors, we are willing to own them. Can stocks go still lower before they inevitably rise again? Of course, but our goal is to provide our clients with investment returns *over time*. And of that, we are confident.

The Brokerage Industry, Wall Street Research, and BTR

The media expressed surprise at learning that Wall Street's securities analysts are biased. But let's look at the brokerage/investment banking companies these analysts work for, and consider the pressures that drive them. These are shareholder- or partner-owned businesses whose purpose is profit. They are primarily marketing organizations, whose employees compete for compensation and recognition. Success at every level, whether it be in retail sales, institutional sales, or corporate finance, is measured by revenues and profits. Those who produce the most are paid the most and, typically, they are the ones promoted for their revenue-generating prowess.

All of this is not to say that these brokerage/investment banking companies are inherently immoral, or that all of those who work in the industry are greedy and corrupt. In fact, we think that most of the industry's employees believe they are operating in their clients' best interests. But their organizational cultures make it easy for them to believe in those products that also happen to be the most profitable. Furthermore, it is easiest to sell what is currently most popular. And what is currently most popular has probably already risen to unfavorable levels of valuation.

Investment banking is, by far, the most profitable arm of the brokerage industry. An investment banker wishing to participate in a company's investment banking related activities needs to demonstrate that his or her firm is willing and able to show that company in a favorable light. Pre-existing research coverage by a well-regarded securities analyst and a highly complimentary research report can help a lot. A less-than-enthusiastic report or, even worse, a sell recommendation would be devastating to the relationship. Research analysts who help to bring in or maintain investment banking relationships have typically received a portion of the fees generated from the relationship. And, investment banking-based remuneration is often the largest part of an analyst's pay. Are the majority of Wall Street's analysts biased? You bet they are, consciously so or not.

Recently, regulators and politicians have taken an increased interest in research analyst/investment banking conflicts of interest. As a result of one inquiry by the state of New York, Merrill Lynch has paid a \$100 million fine and agreed to changes in the working relationship between analysts and investment bankers. Other firms are following suit. But while these changes may serve to remove the most obvious abuses, we doubt they will entirely do away with the pressure on securities analysts to help their firms generate revenues. We will follow the developments.

So, how does BTR utilize Wall Street research? Judiciously. But actually, we find this research to be valuable in a number of ways. Wall Street's securities analysts typically follow one or two industries in depth. As such, they can be great sources of sector knowledge and can help us to understand how a particular company compares and fits within its industry. Also, following relatively few companies, these analysts typically have a good sense of the raw numbers. And sometimes we are able to make

use of their individual company financial models, adjusting them for a variety of scenarios utilizing our own conservative assumptions.

Whether we choose to give weight to a Wall Street analyst's opinion regarding the attractiveness of a particular stock depends upon our knowledge of and personal experience with that analyst, over time. Certainly we pay less attention to the recommendations made by those analysts involved with the investment banking activities of a given company. Typically, when considering a potential investment, we seek out the opinion of a not-so-positive analyst, in order to help us understand the risks.

In addition, we find value in measuring the collective opinion of the majority of the securities analysts following a given industry or company. If too many agree on the positive outlook of a particular company's stock, chances are they have already convinced a majority of the potential purchasers who view their work to own the stock. If that is so, then who is left to turn positive, thereby creating the additional fuel to drive the stock still higher?

So yes, Wall Street's analysts are biased and we do not expect that to change. But once that bias is understood, Wall Street research can be a very useful source of information – one resource among many.

Postscript

As this *Investment Strategy Update* goes to press, another major accounting fraud has been made public, Worldcom. Nonetheless, we continue to believe that investors who are willing to own good companies at good prices will be well rewarded in coming years.

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