



INVESTMENT STRATEGY UPDATE

September 30, 2004

EXPECTATIONS – LOOKING BEYOND THE BUMPS

The baby boomers are concerned. Their retirement years are coming ever closer but, thus far this decade, their investment portfolios have shown little growth, if any. So questions abound. Will the investment environment improve? Will their retirement savings be sufficient to provide the standard of living they desire? What kind of returns can they expect from the markets, going forward? To the latter we say, it's a question of time horizon. Looking beyond the short-term bumps, we have a fair degree of conviction about stock and bond market returns over the next five years or so. What we are less confident of, however, is the manner in which we get there from here.

Simply put, there are three components of stock market return – earnings growth, dividend yield, and changes in valuation. Earnings are the underlying determinant of value for a stock or stock market. Thus as earnings grow, so too does value. Historically, corporate earnings have grown in line with nominal GDP, or about 7% per year. But over the next few years, we are looking for a somewhat lower-than-average 5 to 6% earnings growth due to the top-line pricing pressures of a low inflation, increasingly competitive global- business environment. As for dividends, the current yield of the Standard & Poor's 500 Stock Market Average is slightly less than 2%. So excluding changes in valuation and ignoring the interim fluctuations, we can look forward to 7 or 8% stock market returns, longer term.

And what about valuation? The long-term average price/earnings ratio of the S&P 500 is 15.4 on trailing earnings. Currently, P/Es are somewhat higher with the S&P valued at 16.8 times this year's forecast earnings and 15.8 times next year's expected earnings. But stock market valuations have usually been higher during periods of low interest rates and mild inflation, such as we are currently experiencing.

Inflation	Average Trailing P/E	Peak Trailing P/E	Minimum Trailing P/E
< 2 %	19.0	27.8	13.7
2 - 3 %	19.9	28.4	14.5
3 - 4 %	16.2	23.5	11.8
4 - 5 %	15.6	21.6	10.1
5 - 6 %	14.8	18.0	10.8
6 - 7 %	10.6	12.0	8.7
> 7 %	8.5	11.3	7.3

Source: Morgan Stanley Research, S&P - 1956 to present

In fact, according to Morgan Stanley Research, over the last fifty years the average trailing price/earnings ratio was 19.9 during periods when the inflation rate was in the 2 to 3% range. And even with a somewhat higher rate of inflation, 3 to 4%, the average P/E was still an above average 16.2. So from an interest rate/inflation standpoint, the current stock market valuation is actually lower than would seem justified historically, but that is probably a reflection of the uncertainties associated with terrorism, Iraq, oil prices, and the upcoming presidential election. Valuation slippage may also be a continuing function of the aftermath of the stock market bubble. Following previous such bubbles, valuations have sometimes taken years to fully unwind. Nonetheless, we anticipate favorable business conditions in coming years and relatively mild inflation. So while stock market valuations could trend somewhat lower, history would suggest that a meaningful valuation decline is not in the cards.

Our bottom line expectation is 6 to 8% stock market returns over the next five years or so. And we think those returns will compare quite favorably to the rate of inflation as well as to the returns produced by most stock market alternatives. The returns available on cash and cash equivalents, for instance, remain below the rate of inflation. Commercial real estate appears to us to be quite richly valued currently. And we continue to view the bond market as unattractive at this point in time.

Regarding bonds, we have been expecting interest rates to rise. While the process is taking longer than we had originally anticipated, partially due to high oil prices, we believe the current economic soft patch will soon pass. So rising interest rates are highly likely over the next year or two. The probable result, in our opinion, will be falling bond-market valuations and near-zero fixed income returns. Following the projected bond-market weakness, we would expect two or three years of relatively steady interest rates. There will be a time to invest in fixed income, but that time is not yet at hand.

In the Interim

Under the normal four-year cycle, the presidential election year is usually a positive period for stocks. So, too, is the second year of a bear market recovery, which we are now in. Additional favorable factors have included robust corporate earnings and an economy that continues to expand. Yet stock market progress has been hard to come by in 2004. So what about next year? Under the normal four-year cycle, 2005 could be expected to be a difficult year for stocks, but that is not our belief.

The economy reacts to stimulation or tightening with a lag. So most typically in the presidential-election cycle, the administration in power stimulates the economy well in advance of the next presidential election, attempting to yield favorable economic conditions at the time voters go to the polls. The hyperstimulative moves taken two years ago were not unique to the Bush administration.

But the presidential cycle often has a backside as well. It has not been unusual for incoming or re-elected administrations to inherit an overheated economy with a multiplicity of excesses in need of being purged – a result of the sometimes-excessive previous stimulation. Thus, it has also been relatively common for new administrations to take restrictive actions early in the cycle, in order to slow the economy. That, in turn, has often led to weaker stock markets in the first and, sometimes, second years of the four-year presidential cycle.

The difference with this cycle, in our opinion, is that there are very few serious current excesses. The economy has slowed, interest rates are low and steady, inflation is moderate, capacity utilization is low, and Corporate America is flush with liquidity. No doubt, there are some excesses. Housing prices have been soaring and consumer debt is quite high, however much of that debt is in fixed-rate mortgages at affordably low rates of interest. And the federal budget deficit is certainly too high, so depending on the election outcome, there may be some pressure to raise taxes. But with the relatively soft financial markets, and a less than ebullient current economy, we see very little reason for the incoming administration to take any significant action to slow the economy. Therefore, we are not expecting the normal post-election pressure on stocks in 2005.

And what about the risks of war, terrorism, or other events? Significant events, such as acts of terrorism, would certainly affect the stock market, as they would the attitude with which most investors approach the markets. But while such events may cause major dislocations, historically they have been transitory in their effect on the markets (i.e. the 1987 stock market crash). In fact, it is our contention that the 2000-2002 secular bear market would have approximated the same magnitude, even had the 9/11 attacks not occurred. The ferociousness of the bear market was primarily a function of the size of the preceding bubble – the great overextension that had occurred in the technology sectors of the stock market and economy. We believe the events of 9/11 changed the shape of the bear market, but not necessarily the size.

Events are likely to occur, and neither we nor anyone else can successfully predict their timing, magnitude, or effect. But when all is said and done, the fallout from those events will pass. Thus our belief is that we are highly likely to look back from some point in the future (five years or so) having earned positive stock market returns, which were generally in line with earnings growth and dividend yield.

As mentioned in previous *Investment Strategy Updates*, we are anticipating a stock market environment much like that which occurred during the second half of the 1970s. It was a period during which total-return investors and capable stock pickers were able to meaningfully add to general stock market returns. Although our market return expectations may seem modest, we think the coming environment will be one which rewards savvy investors with better-than-average investment returns. Thus, we believe that a disciplined, conservative, long-term, total-return approach to stock market investing makes great sense at this point in time.

A Side Note

On an interesting side note, equity and fixed income investors seem to be telling very different stories about the health of Corporate America. On the fixed income side, yields are quite low, overall. And since junk bond yield spreads over the Treasury note are near the lowest levels seen in many years, lower quality corporate bonds seem particularly expensive. So fixed income investors appear quite confident that companies have more than ample cash flow to meet their obligations. But at the same time the stock market can be judged as somewhat cheap, measured relative to inflation and interest rates. So by the numbers, stock market investors appear to be taking a much dimmer view of Corporate America's health and outlook. Historically, such significant discrepancies between the equity and fixed income markets have not persisted for very long. Thus, it is not unreasonable to expect that one or both markets will soon adjust. Either corporate bond investors will become less optimistic about the outlook by requiring high interest rates, or equity investors will reconsider their pessimism, thereby resulting in better-than-expected stock market performance, going forward.

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