

C *Economic & Market* Commentary

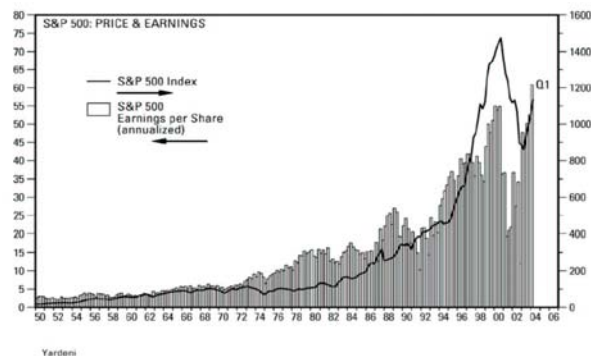
Earnings and Valuation

The economy has proceeded pretty much as we expected over the last 12 months. As corporate activity picked up, new orders increased, corporate revenue improved, capital spending increased and the employment situation improved. One might say we have recovered!

As a result, corporate earnings have come in at or above general expectations in many cases, but this quarter may mark the end of the “easy” revenue and earnings comparisons. The quarters immediately following a lull in economic activity typically show the largest growth rates. As economic activity extends beyond the recovery phase, we begin to estimate the sustainability of the new business cycle. On that front, barring any violent policy moves or global instability, the economy should be able to continue making progress.

The nagging question at this point does not seem to be about economic growth, or corporate earnings, but about how the market will value those earnings. Revisiting one of the graphs we have used over the years, Graph 1 shows the progression of earnings per share for the S&P 500 ratio (indicated by the bars) and the progression of the value for the S&P 500 stock index (indicated by the line). The relationship between the two indicates that earnings have led valuation most of the time. If history holds true, the rate of growth in corporate earnings might exceed the market’s rate of return for a period of time.

Another issue to be aware of is the history of the market. As Graph 2 indicates, periods of growth in the Dow Jones Industrial Average have been followed by periods of consolidation. A 26-year period of flatness beginning in the late 20’s was followed by 16 years of growth, which was followed by 16 years of flatness beginning in the late 60’s, which was followed by 16 years of growth, and (believe it or not) we look to be in the 6th year of flatness beginning in the late 90’s. The good news is that the flat periods have been getting shorter. One would expect the markets to move faster as information is disseminated to market



Graph 1

participants more accurately and at a faster rate. The days of the chalkboard, ticker tape, and hand calculated fundamental analysis have yielded to the Internet and spreadsheets. Data can be analyzed and acted upon much faster.

In viewing this situation, we believe that a modification in our long-term approach to investments in the stock market may be appropriate. During what may be extended flat periods in the market, there are shorter-term trends that allow managers to be more opportunistic with transactions that may improve portfolio rates of return. With that in mind, we are considering becoming a bit more active in harvesting profits in certain investments when appropriate. We believe that this approach, combined with the cash flow generated by our investments, will help us provide better risk-adjusted rates of return in the long run.

The much-anticipated initial move to increase interest rates by the Federal Reserve resulted in a 1/4 of 1% increase in the Federal Funds rate, which was announced at the June meeting. This decision came on the heels of a few

lackluster economic reports that helped many conclude that runaway inflation was not just around the corner, and that the Federal Reserve would indeed recapture the cuts made previously in a measured manner. If Alan Greenspan (Chairman of the Federal Reserve) can maintain a measured approach, it should not knock the economy off the tracks, as the primary intent at this point is not to reign in inflation, but to return rates to levels experienced before the economy needed a helping hand.



Graph 2

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July 2, 2004