

AUGUST 2000

## More Rational ... Still Exuberant

*For the first time in years, we are witnessing broad-based "rationality" in the stock market. While the longest economic expansion in history is providing global companies the ability to increase earnings, the stock market is once again valuing the vast majority of shares reasonably. Taking advantage of the recent market action, new equity positions in world-class companies have been initiated. These new holdings are being purchased at prices well off their highs and, more importantly, at valuations which we believe are justified by future earnings.*

For a perspective on this issue, we examined key market statistics from the decade of the 1990's. Using the 500 largest companies as a proxy (S&P 500), we note that the stock market rewarded 13% annual corporate earnings growth during the 90's with an "outsized" 18% annual return on underlying shares. We use the term "outsized" because stocks normally appreciate at a rate equal to their earnings growth. These exuberant historical returns were largely justified by improving world growth prospects, low interest rates and shareholder friendly managements. All of this good news was readily embraced by a portion of the public which was ready to buy.

And buy they did ... until this year when Alan Greenspan and his colleagues at the Federal Reserve stepped in. The recent downturn in the major market averages has been fairly significant. Compared to their highs during the last year, the NASDAQ market has been down 46%, the Dow Jones 16% and the S&P 500 18%. Significantly,

many traditionally strong market performers (i.e., Microsoft and AT&T) are down 30%-40% this year.

We view the market's recent "pause" as a golden opportunity. The global economy is still growing, interest rates remain less than half of what they were in the 1980's and large companies are embracing technologies that allow them to be more profitable than ever. Demographics remain strong, while mergers and acquisitions continue at a torrid pace.

As evidence of these strong fundamentals, the majority of our Quality Core Buy List holdings reported stellar earnings growth in the most recent quarter. General Electric (+20%), Colgate-Palmolive (+15%), Texas Instruments (+40%) and Merck (+16%) to name a few. Inescapably, a few companies disappointed and have either been sold or are being evaluated as to whether they face short-term hurdles or long-term challenges.

As previously mentioned, the current market “pause” has allowed us to purchase new positions in quality companies which are trading well off their highs. New names to our Quality Core Buy List, followed by the percentage to which we bought the stocks below their high for the last year, are shown below:

<i>New Quality Core Holdings</i>	<i>Business</i>	<i>% Trading Off High When Purchased</i>
<b>Sysco Corp.</b>	Food Distribution	22%
<b>Wal-Mart Stores</b>	Global Retailing	31%
<b>Lowes Cos.</b>	Home Furnishings Retailing	30%
<b>Motorola</b>	Wireless Technology	44%
<b>Alltel Corp.</b>	Wireless Communications	30%
<b>Goldman Sachs</b>	Global Finance	12%
<b>Computer Sciences</b>	Computer Services	26%
<b>Honeywell International</b>	Diversified Manufacturing	45%

Although citing the degree to which a stock trades off its high is interesting, the more important issue is the degree to which these companies meet our stringent standards for management quality, growth and financial strength. They must also trade at prices that are reasonable relative to their growth prospects.

As for an overall market view, we remain mindful that the “long-term” is nothing more than a series of “short terms” linked together. We envision the coming decades as having strong global growth resulting in increased employment and consumer spending, while experiencing new technological developments. In addition, massive mergers and acquisitions will continue to create global juggernauts that will dominate their industries. It remains our job to find the best managed, most predictable companies and buy them for our clients when they are priced appropriately.

Our long-term exuberant view notwithstanding, we see continued short term volatility due to rising interest rates, higher oil prices, select overvalued technology companies correcting and intermediate disruptions in old economy business models. There is much good news surrounding the fact that inflation remains in check because wages and productivity are both increasing at roughly the same rates. However, some old economy businesses can't offset higher wages with more productivity and are suffering the consequences, as exhibited by their severe price declines, (i.e., J.C. Penney, Albertson's, etc.). Over the coming years, many business models will prove to be unsuccessful in the new economy. We will do our best to steer clear of these situations.

We have never felt better about the growth prospects and fair valuations of our Quality Core companies. As Alan Greenspan never said, “we must attack this exuberance as rationally as possible”.

Important Disclosure: “It should not be assumed that recommendations made in the future will be profitable or will equal the performance of the securities discussed in this newsletter.”

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