

JANUARY 2004

Happy Last Year

The stock market responded well in 2003. Broad averages were up over 25% in response to growing corporate earnings and low interest rates. We quote our mildly bullish February 2003 newsletter... "There exists approximately \$2-\$3 trillion in cash on the sidelines, waiting to buy stocks once the market moves higher..." Well, that is exactly what happened as the market improved significantly, with much of that cash still available for investment in stocks or bonds.

Both the domestic and global economies are growing more rapidly than we predicted and well-managed corporations are "over-delivering" on the earnings they once projected. We are pleased to report that the 35 Quality Core holdings which comprise our Buy List have all met or exceeded their earnings estimates. As a group, the companies have also reported sizable dividend increases.

As always, risks remain. A partial list would include:

MIDDLE EAST

Problems like this take time to fix. We sense that the worst may be behind us and that many countries in the Middle East may reform now that Iraq is somewhat neutralized. From a "big picture" standpoint, we believe that the economic benefits from a modicum of peace with both Russia and China far outweigh the ongoing complications in the Middle East.

VALUATIONS

It is hard to believe that it is happening again.

Many small, unprofitable and poor quality stocks performed well last year. Some research shows that stocks priced less than \$10 (a proxy for poor quality) were up 90%-100%. Many large technology stocks have returned to unjustifiable valuations and we are avoiding them. It amazes us how quickly investors forget fundamentals and invest in spurious stories. Thankfully, we made some good purchases during the market doldrums (e.g., Intel) and, therefore, participated in some of the speculation of late.

DUAL DEFICITS AND INTEREST RATES

A big risk to the markets right now relates to interest rates. Longer term bonds with interest coupons of 4% or so are not great investments, especially when investors see that some "A" rated Blue Chip stocks pay 2-3% dividend rates (and may increase those dividends annually).

We believe there is a risk that interest rates will increase. The U.S. government's budget and trade deficits are around \$500 billion each. These defi-

cits almost have to cause interest rates to rise. Our government's issuance of new debt (possibly trillions of it on the next four years alone) may crowd out other investments. For the time being, however, foreign investors have gobbled up America's debt as they now own roughly 36% of our debt as compared to just 20% in 1980. If foreign investors decide to either sell our debt, or simply stop buying so much, higher interest rates would probably follow.

We remind clients with balanced accounts that if we are wrong, and interest rates remain low, we expect continued solid equity performance on stock holdings. We do not want our balanced portfolios to be in a position where both bonds and stocks lose value. Accordingly, fixed income portfolios remain invested with average maturities at the shorter end of 3-5 years.

CHINA

There is the possibility that China will stumble. Admittedly, watching 1.2 billion communists convert to capitalists is probably a lot prettier than watching the reverse. "Fits and starts", however, should be expected. For example, war with Taiwan is an "on again, off again" proposition and the Chinese banking system is suspected to be approximately \$400 billion under water. Even so, the overall trend is positive and let's hope the mainland's prideful anticipation of hosting the 2008 Beijing Olympics encourages good behavior.

Growth in China is a major investment theme of ours, but it is only logical to expect bumps along the way to long term prosperity. We believe these will only be "bumps", and not trend reversals. Important to note as well is that our Global Core Blue Chip stocks are invested in a myriad of growth themes, including demographic trends in America and the growth in global consumerism well beyond China.

In summary, roughly \$2.0 trillion of investors' cash remains on the sidelines. Our balanced portfolios (typically 60% equities) and equity accounts were up smartly last year. Investment performance can never be guaranteed, but we remain encouraged by corporate earnings prospects. Our bond portfolios are short and our long positions in the equity market have justifiable valuations. So, Happy Last Year and Happy New Year.

Your comments and questions are always welcomed.

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."

Hamilton Point Investment Advisors, LLC is a fee-based investment advisory firm which manages portfolios for individuals, not-for-profits, retirement plans and corporations. We welcome comments or questions and can be reached at (877) 636-3765, or e-mail us at aburns@hamilton-point.com.

Our newsletter is circulated for general information only. Investors should seek financial advice regarding the appropriateness of any investments discussed and statements about future prospects may not be realized.