



ASSET MANAGEMENT COMPANY

THIRD QUARTER 2003

It's nice to have had a tailwind in the market for a change. Year to date through September 30<sup>th</sup>, the S&P 500 was up 14.7% and the Dow up 11.2%. During this period, our equity investments have performed well and continue to bear good prospects. Moreover, we believe that these investments pose less risk than the overall market. We must remember, however, that the market is likely to continue to be volatile. As J.P. Morgan summed it up: "Stocks fluctuate."

Our focus on valuation—as opposed to momentum—is a key element of our investment strategy. As Warren Buffett says, "In the short term the market is a voting machine, in the long run it's a weighing machine." At present, valuations are high and we are careful to avoid the expensive stocks because the rug can be pulled out quickly. Ultimately, it is economic profits—and not a string of promises or glossy annual reports—that count.

Apart from high valuations in the stock market, investment business scandals continue unabated as evidenced by Eliot Spitzer's upbraiding of certain mutual fund providers. This press seems to not have fazed individual investors so far, but to us, it is symptomatic of structural (mostly compensation) problems in the investment industry and is one that must be monitored carefully due to its potential impact on the investment landscape.

Lessons learned here are the importance of tough laws and a well-funded SEC (including the Enforcement Division), understanding how people are compensated and how that clouds their judgment, and the adage, *Caveat Emptor* ("buyer beware"). We like former President

Reagan's line used when negotiating with the Russians, "Trust but verify." As your investment manager, we work diligently to verify.

On the positive side, we see signs of legitimate growth in the economy. At least for now, inflation remains under control, interest rates are low and many consumers are spending again. Companies have trimmed back their resources to better match the current demand environment and profitability has improved nicely (in aggregate). Policy makers understand the impact of bear markets and are on the side of investors.

These positive factors are nice to see, but an important caveat is that stock returns and economic growth aren't necessarily tied together, nor is the current level of monetary and fiscal stimulus to propel the economy (without GDP growth). Some persistent factors that challenge the bond and equity markets are:

- High existing valuations across most asset classes
- The geopolitical scene
- Under-funded corporate pensions
- High energy and insurance costs
- The high level of consumer and corporate debt

While each of these factors in isolation may not mean much, all combined they may. This does not mean that there is a dearth of interesting opportunities, but it does warrant caution when making investments.

When evaluating an investment, we try to control risk by taking the time necessary to understand



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the business, how its cash flow is generated, the business risks we can identify, and also by becoming familiar with the people managing the organization, e.g., how they are compensated and if there are any conflicts with shareholders. This process can be somewhat time consuming, but we feel it is important in fulfilling our role as your advocate.

It is here where we make a clear distinction between investing and speculating and opt for the former. Successful investors closely estimate the value of the economic return of an asset over its life, and then negotiate (or wait for) a fair or low price for it. Speculators attempt to forecast asset price movements *independent* of the underlying economics/value of the asset. This latter effort we choose to avoid because it is more difficult to apply successfully over time.

With this in mind, we would characterize the current market environment as speculative. The table below shows that in this year's top performing stocks (the top 10% of returns), over half were by companies with negative earnings. In our opinion, this shows that once again there is little regard for valuations. The market seems to be driven by liquidity and hype.

<i>Return Decile</i>	Median Return	# of Companies	# with Negative Earnings	Ratio
Top 10%	<b>176.0</b>	<b>420</b>	<b>218</b>	<b>52%</b>
All Companies	23.8	4195	889	21%
Bottom 10%	-12.9	420	91	22%

*Source: Companies in Zacks research; Stocks priced over \$5 with reported prior 12 months earnings. Returns 12/31/02 - 9/28/03.*

Rather than chase these types of stocks, we prefer, for example, to make investments in companies like Acuity Brands, which generates around \$100 million in free cash flow per year and which the market values around 9 times free cash flow. Furthermore, the cash is generated by the profits in selling lighting hardware—an item everyone needs to replace periodically, no matter what the economy does. These elements make the investment attractive—a good company in a solid industry, with good/experienced people running it, and an attractive valuation.

We realize that in part we are judged by portfolio returns, but we would encourage you to not put too much weight on short-term performance. Returns alone do not necessarily reflect ability, especially over short periods of time. This goes for Obermeyer, hedge fund managers, mutual fund managers, or anyone else with discretion over your investments. Your best measure of manager compatibility is probably your understanding and agreement with their investment strategy, process and risks; the characteristics/merit of the investments within your portfolio; and whether these holdings are prudent for your situation and preferences. To this, we invite you to share with us any information that may help in evaluating your investments, any feedback on the qualities you deem important in an investment advisor, or best of all, ways that we can be of service to you.

For a no obligation review of your investments and/or strategy, please call our office at 925-8747, or (800) 337-0933 for an appointment.