



ASSET MANAGEMENT COMPANY

THIRD QUARTER 2004

Current Considerations

As we go into the last inning of the election cycle, there is a lot to consider with respect to the economy and investing. The perception of risk has heightened under the daily barrage of news from the Middle East, and accordingly, many people have stayed pat with their holdings. Because of this, the market has been flat for the year without much movement in either direction. For 2004 so far, the S&P 500 is up 1.5 % and the Dow is down 3.6 %. Bonds are up slightly for the year despite the Fed's increasing short rates.

No matter who wins this election, the nation will most likely continue to operate with a budget deficit. While this is not a bad thing in and of itself, the size of the budget deficit relative to our productive output is somewhat concerning. It must also be acknowledged that the trade deficit continues to grow unabated. Because of the risk of inflation that these factors pose, we have purchased mostly short duration, high-quality bonds (some of them at variable rates). This mitigates much of the threat to principal. For stocks, we see new profit opportunities and continue to do our best to consider risks.

Risk Management Begets Reward

Benjamin Graham once said that there are two types of investors: those who make money in

the market and those who keep it. The investment industry mostly caters to the first group by promoting either a recent investment fad or some horribly complicated scheme, while the second group quietly realizes superior returns by carefully managing their costs and their risk.

Risk can come in many forms, but the best risk management technique is to simply avoid areas that can easily become problematic. The returns will come from areas that are likely to benefit, but where others' views are too pessimistic. Estimating the risks and payoffs can be difficult, but it's not *always* rocket science.

For example, Yahoo, Inc. is a fine company that has grown its revenues nicely since it started business in 1995. It has generated operating profits off and on for the last few years by essentially selling ad space (like many other businesses do). Last year it had a record year when it generated a 7% return on equity.

What Wall Street and the press don't talk about is the fact that Yahoo regularly grants its employees stock options that it doesn't report in earnings. The Chairman/CEO of Yahoo belongs to a group that lobbies aggressively to not have this expense disclosed in its income statement. In 2003, Yahoo granted \$216 million of stock options (most of which went to management) because it claims its key people need this much to get up and report to work. If we were to



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include this unreported expense, earnings for the most recent 12 months were in fact \$0.06/share as opposed to the \$0.22/share reported.

This makes Yahoo's actual P/E (price-to-earnings ratio) 567 instead of 154 times earnings (expensive to say the least). Other companies with a strong consumer franchise, such as Disney, currently trade with a P/E of around 20. Needless to say, we avoid investments like Yahoo because it is the financial equivalent of playing musical chairs — and it is impossible to know when the music will stop.

Opportunity Knocks

Mark Twain once said that history doesn't repeat itself, but it sure does rhyme a lot. Once again (after 30 years or so) there are plenty of opportunities to earn returns in commodity producers without the risk of tech stocks. The economic growth in both China and India has created huge demand for basic materials. It has been so long that the stocks of commodity producers have generated any returns worth noting that the industries have been significantly under-capitalized and now lack the capacity to meet demand. We believe that today's investors will be well rewarded by enabling new capacity. As a respected strategist recently noted, it is best not to invest in what Asia produces, but in what Asia needs.

This economic and financial recovery in the U.S. will continue to be atypical, because of the China (and India) factor. Doing what worked in the years after 1992 or 1982 won't work this time.

Your equity investments should begin with companies that benefit from the China story—oils, mines, papers, cements, steels, uraniums, fertilizers, agribusinesses, railways, truckers, airfreighters, and cargo ships.

If you believe that a change in strategy is needed in your portfolio either through a change in your personal finances, or if you believe you are not well-positioned to benefit from emerging trends, please contact our office at (970) 925-8747 to set up a *no obligation* review.