Godsey & Gibb Associates
Investment Watch

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Quote of the Quarter

"Bull markets are born on pessimism, grow on skepticism, mature on optimism, and die on euphoria."

Sir John Templeton

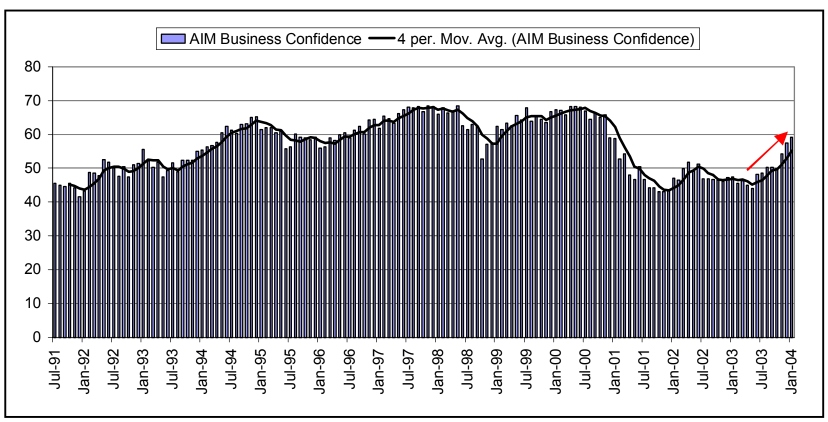
THINGS CHANGED!

Since we last put pen to paper in December of 2003, reporting of economic measures has continued at a robust pace. Initial reporting of the Real Gross Domestic Product (Real GDP) for the 4th Quarter of 2003 shows a solid 4.1% advance, with a year-over-year gain for all of 2003 at 4.3%. Last quarter's gain was less than the surging 8.2% of the 3rd Quarter, but very healthy given that long-term Real GDP growth averages 3.5%. During his recent testimony before Congress, Federal Reserve Chairman Alan Greenspan said,

> *``The U.S. economy appears to have made the transition from a period of sub-par growth to one of more vigorous expansion. The most recent indicators suggest that the economy is off to a strong start in 2004 and prospects for sustaining the expansion in the period ahead are good.''*

Economic measures buttress his views. Already this year, Industrial Production has risen, Capacity Utilization edged forward, Inventories started to rise as the Inventory-to-Sales Ratio established a new low level, and Construction Spending increased. Productivity gains outpaced economic growth for the 3rd straight year, averaging 3.7% since 2001, and continues its above average growth, while the Index of Leading Economic Indicators reported a ninth consecutive increase, representing the longest string of increases since 1983. Needless to say, the Consumer Confidence Index firmly increased from the March 2003 War-Torn low.

More importantly, Business Confidence measures its highest level since dropping off a cliff in the year 2000. Clearly, the "hot topic" in the U.S. is the jobs report, Payroll Employment. Historically, Payroll growth lags a recovery, and only after Business Confidence improves does job growth have a chance of expanding.



Source: Bloomberg L.P.

> *``As those opportunities to enhance efficiency become scarcer and as managers become more confident in the durability of the expansion, firms will surely once again add to their payrolls,''* Greenspan said.

Without a doubt, Payroll growth is sub-par to any other recovery on record, and second to the 1991 recovery. When "The Wall" came down in 1989 and the U.S.S.R. divided in the early 90s, *THINGS CHANGED*! *Globalization and Democratization* throughout the world continues to affect the way business is executed. Often we hear

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the call for restrictions and limits on job exportation. What is seldom reported is the FACT that EVERY MAJOR INDUSTRIALIZED COUNTRY IN THE WORLD is experiencing the same force and transition in its Labor Force. While the subject is difficult and complex, improving Business Confidence and Corporate Spending is a meaningful beginning.

JUST WHEN YOU LEAST EXPECTED

So now it's universally accepted in the financial community that an economic recovery has arrived. Without a doubt the *Synchronized Global Recovery* is under way, as demonstrated by solid improving growth in the U.S., but also in Japan, Canada, the United Kingdom, China, and Southeast Asia. While showing improvement, the Euro Zone has demonstrated a much more muted recovery, but growth all the same.

And then it happened! Just when you least expected? Our composite Economic Indicator Analysis ROLLED OVER. Not a lot, but down nonetheless. Remember, this is the same composite of economic indicators that bottomed in early 2001 and measured a slow but "gradual" improvement throughout 2002 and 2003. This is the same composite that measured improvement when fear was its greatest. Now when most everyone is gaining complacency, this elusive measure zigzags. How can that be?

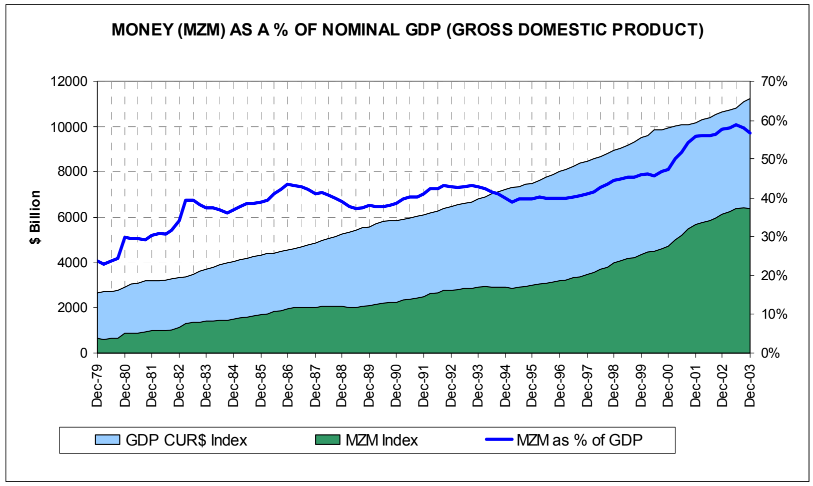
We believe the lag in our indicators is a direct result of the changing leadership within the components propelling economic growth. As of our last writing, we stated our belief that Consumer Spending had "passed the baton", thus charging Corporate Spending with the responsibility of generating economic growth. Year-to-date, this case has been strengthened. Albeit from a historically high level, Housing is showing signs of a slowdown in growth. The key emphasis here is on the growth rate slowing, NOT a collapse in the housing market. Also, auto sales growth has been far from robust. As Paul Ballew, chief sales analyst at General Motors Corp. said, *"February was 'not a great month' for U.S. vehicle sales, but it wasn't all bad either."* Clearly, housing and autos are waning as Corporate Spending gains ground.

> *"With real short-term interest rates close to zero, monetary policy remains highly accommodative,'"* Greenspan said.

While emotions of exuberance may have once again driven expectations astray, we remain comfortable with our "steady but gradual" expectations for growth. Aiding our confidence is the fact that the "Mountain of Money" in money market funds represents 57% of Nominal GDP, a near record high. Thus, ample liquidity remains available. Be that as it may, we continue to measure for changing implications. (To view our Economic Review & Perspective Charts, visit www.godseyandgibb.com)

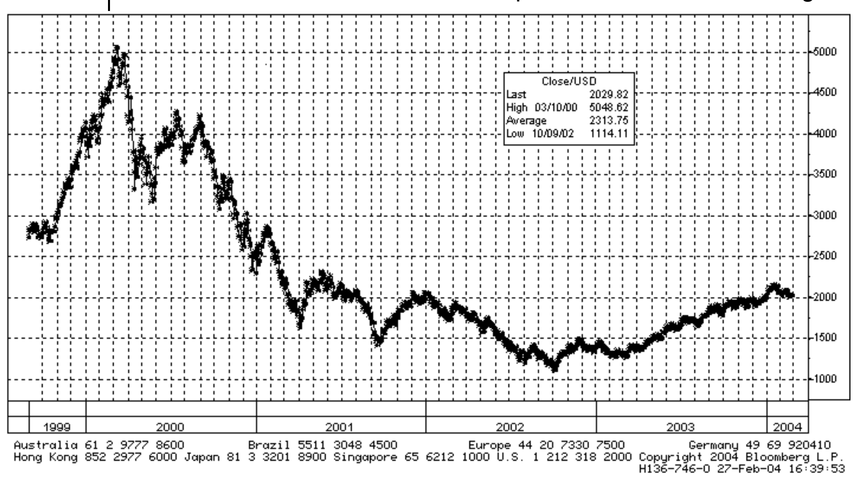
CHAOS

Likely the best confirmation of improving global economic conditions is the strength in the world's stock markets. Over the past twelve months ended February 24th, 2004, the



Source: Bloomberg L.P.

average market gain of thirty major world markets is 56.8%. The greatest gain was the Brazilian Bovespa, with 108%, and the least return was the Sidney All Ordinaries, with 17.9%, as the NYSE Composite returned 41.4%. So the "rampant" bull market is back… Right? Time to throw caution to the wind? Before we draw our conclusions we may wish to collect our thoughts from the reality of the NASDAQ chart below. Yes, the NASDAQ has risen 51.7% in the past twelve months… though



it remains 60% below its 2000 high. Much value and wealth have been destroyed, some forever.

Interestingly, the lapsed twelve-month time frame originates from a point in time of extreme fear and pessimism. At that time, we wrote of "Climbing the Wall of Worry" and "a millennium's worth of worries". All the while, our measurements continued to improve, evidenced by five consecutive quarters of improving corporate profits, growing Nominal GDP, and extraordinary money growth and liquidity. However, the world was truly full of *Chaos*.

Year-end 2002 delivered the third consecutive yearly decline in the U.S. equity markets, the first such occasion since the 1939 - 1941 period. U.S. Stock Fund Net Redemptions (the net result of mutual fund purchases and redemptions) is one indicator that we follow that measures the flow of money, or *Market Liquidity*, in or out of public stock positions. The 2000 -

2002 downturn that bottomed in late 2002 created an environment where many investors panicked and liquidated equity investments. As such, 2002 experienced U.S. Stock Fund Net Redemptions, or more money flowing out of stock funds than money flowing into stock funds. This condition continued throughout early 2003, ironically ending in April with a slight bias toward Net Purchasing. Heavy stock fund Redemptions continued averaging near $500 million in outflow per month throughout the remainder of the year. The last such occasion of Net Redemptions in U.S. Stock Funds was in 1988, *after* the '87 market crash. Not so surprisingly, the markets were surrounded by *Chaos*.

LET CHAOS REIGN

Precisely one year ago the investment markets closed the month of February with another monthly loss, which had the S&P 500 down 7.0% year-to-date. Entering the month of March brought more *Chaos* as War in Iraq was clear and evident. Talk emerged of a fourth negative year in the equity markets, a condition not seen since the Great Depression. All the while the fundamentals of the economy were improving. Monetary and Fiscal stimulus was provided. As we stated a year ago, we believed the elements for an expanding economy were in place. Consumers spent, Profits accelerated, Corporate Spending grew, and the U.S. equity markets advanced every month, going forth to deliver the catalyst for a remarkable synchronized global advance.

Somewhere under the clouds of pessimism the cry, *"Let Chaos Reign"* must have reverberated. Because it certainly did! Turning on a dime, the same market that earlier liquidated stocks at market lows, avoiding risk at any cost, suddenly pivoted, then accepted risk of the greatest magnitude. Frankly, this is not surprising. At the point of inflection in stock market bottoms the highest risk stocks, normally those beaten down the most, rise rapidly and for unapparent reasons. This is clearly evident in our chart, which demonstrates a negative correlation between share price before the market advance and stock performance at year-end. This phenomenon is not unusual; in fact, it is quite normal. At its peak, the market had many stocks *priced for perfection*. At its trough, the market had many of these same stocks *priced for extinction*. While sounding rather simple, acting on this can be very complex, especially depending on one's investment discipline.

> As an example: A well-established communications equipment company had its stock peak at a high of $262 in March of 2000. By 2002, the stock price was $4. As of February 26, 2004, this company's stock has risen to $28.97, an increase of 624%. While the given company may be a fine company and employer, and will likely be an ongoing growing concern in the telephone equipment business, let us focus on shareholder value creation. From 2000 - 2003, Sales declined by 50%. GAAP (Generally Accepted Accounting Principles) Reported Earnings per share went from $2.80 in 2000 to… well, it has had a loss in each year since. Long-term Debt nearly doubled and Shareholder Equity declined. But, earnings are expected to rise in 2004.

In no uncertain words, this is NOT a depiction of our investment approach or philosophy. We are not declaring others as wrong. We ARE simply defining our investment discipline with a focus on investing over a complete investment cycle. This example is a very clear reminder of the post-1987 crash, in which the stock of General Motors doubled in less than a year's time. GM stock was over-sold and was deemed "cheap". However, in the ensuing years GM stock has been far from a stellar performer, even though General Motors remains an outstanding company in its field. *Chaos Reigns*, but not forever.

REIN IN CHAOS

In Andy Grove's (Chairman, Intel Corporation) recent book, *Only The Paranoid Survive*, he titles Chapter 8 as, *"Rein in Chaos"*. He goes on to write:

> *"Clarity of direction, which includes describing what we are going after as well as describing what we will not be going after is exceedingly important at the late stage of a strategic transformation."*

If we may assume that being the steward of the lifetime wealth of many, qualifies as "the late stage of a strategic transformation", then defining clarity of direction is paramount. As we proceed in defining the clarity of our direction, *Investing for the Complete Investment Cycle* becomes a major theme. As such, we must first briefly discuss an "unthinkable" topic: P/E ratios. Normally, we would never speak with such focus on P/Es; however, now may be the appropriate time.

The subject of P/Es is very simple, yet complex. P/E is simply a ratio, comparing the price of a stock to the company's annualized earning per share. (Example: If a stock trades at $40 and has $2.00 in annual earnings, the P/E ratio is 20.) Simply put, a P/E ratio becomes a multiplier or capitalization rate, which establishes a price valuation measure. Complexity arises with P/Es because the "multiplier" constantly varies for many reasons. Let's say we have a new car, and a specific value is established as a purchase price. Now let's say this same new car is in an accident, and has a bent fender with two flat tires. The price we are willing to pay is dramatically reduced. On the other hand, our new car is in pristine condition, with many luxury accessories added; as such, the price required for purchase would be dramatically elevated. In basic terms, establishing valuation parameters has a lot to do with quality… quality of a car, quality of a business, quality of earnings and earnings growth. And so goes the subject of P/Es, and this is only one of the many valuation metrics utilized in stock valuation methodology.

The point of our P/E discussion centers on interest rates, inflation, earnings and the P/E multiples paid for stocks over time. In general terms, these are the major factors, along with emotions of fear and euphoria, which affect established levels of P/Es. As inflation falls and interest rates decline, P/Es (the multiplier times earnings that we are willing to pay for a stock) expand, and vice versa. Over time there is an inverse relationship, and this relationship tends to expand or contract exponentially, not linearly. Now let's focus on these factors over a complete investment cycle.

Beginning in the early 1980s, inflation measured near 15%, the 10-year U.S. Treasury topped at nearly 16%, and the price multiple paid for the S&P 500 Index was close to 6 times. Fast-forward twenty-plus years and inflation has been near

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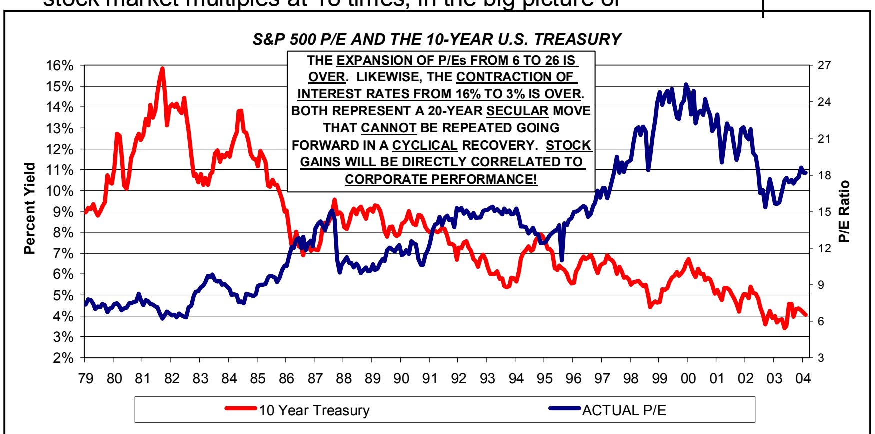
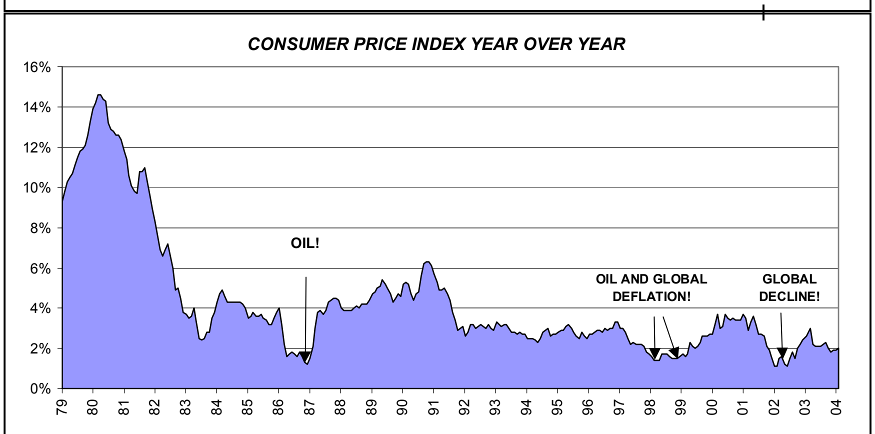
1%, Treasury rates have fallen to a low of 3.11%, and P/Es expanded to a high of 25 times forward earnings and currently scales at 18.2 times forward earnings estimates. Looking back over time it is clear that more money has been made in stocks by the expansion of a willingness to pay higher prices than money made by rising earnings. In fact, if today's S&P 500 Index traded at a paltry 6.2 times, as it did in 1981, the S&P 500 would only be 388, substantially less than the S&P 500 Index of 1,137 that we know. The differential of 749 Index points is directly attributable to P/E multiple expansion.

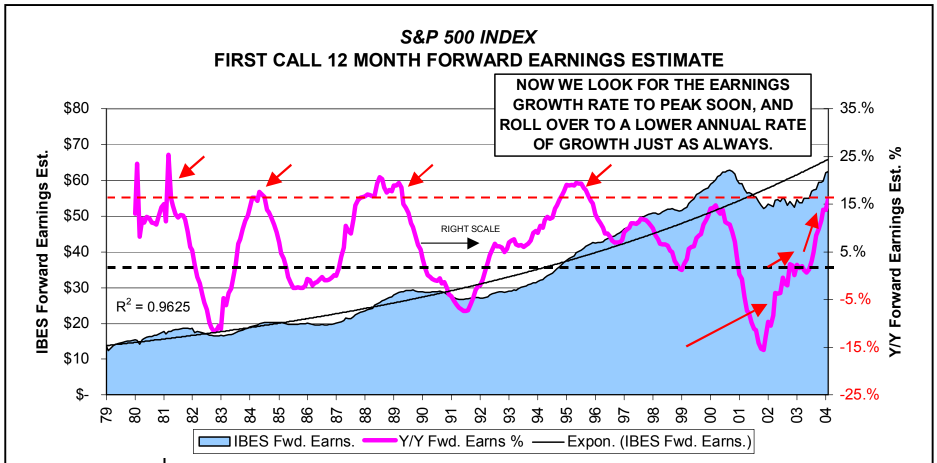
Of course this exercise is ridiculous! In 1981 the market was oversold, rates and inflation declined, and earnings increased, thus, expanding multiples were justified. However, the exercise guides us to the next material question. When inflation is 1 and interest rates are 4, and with stock market multiples at 18 times, in the big picture of





Source: Bloomberg L.P.

The Complete Investment Cycle, what is the probability of expanding P/E multiples in the coming 10 or 20 years? We believe the best we could look for is a very slim probability. With respect to rates? We believe the secular downtrend is nearly over.



Source: First Call

How about earnings trends? For several years we have accentuated the point that earnings trends were improving, after collapsing in 2000. Additionally, after-tax corporate profit margins have recently gone to all-time record highs. Currently this is commonly known, as earnings revisions have been catapulting upward. But just as complacency gains footing, our work points in the direction of moderating growth rates on the market as a whole. With year-over-year earnings compounding over 16%, what is the probability of another 16% on top of last year? Such compounding is easier when coming off a weak year, but how about the encore? Earnings should be okay, even good, but the compounding comparisons quickly rise in level of difficulty.

Gloom and Doom? Not at all! We believe the forces of *Globalization and Democratization* remain in place, which should allow the opportunity of moderately low inflation, a low interest rate environment, and sustainable growth (albeit with intense competition). However, given the absence of expectations of expanding price multiples, we believe the marketplace is left with two alternatives: shorter term trading or investing for growth over a complete investment cycle. With respect to *Reining In Chaos* and *providing clarity of direction*, as fiduciaries of the hard-earned wealth of our clients, *we choose to go after* capturing growth through the quality compounding of earnings with companies and businesses that exhibit demonstrated value creation. And though it may be perfectly acceptable for others, *we choose not to go after* a trading environment of capturing oversold stocks of companies and businesses that are value destroyers. So as we journey through this *late stage of transformation* together, our *direction has clarity*, *purpose*, and *definition* with respect to *what we are going after*.

(For greater detail on our investment philosophy and approach, visit www.godseyandgibb.com.)