Godsey & Gibb Associates Investment Watch

Issue No. 15 March 21, 2005

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Quote of the Quarter

"If you're an investor, you're looking on what the asset is going to do, if you're a speculator, you're commonly focusing on what the price of the object is going to do, and that's not our game."

**Warren E. Buffett, Chairman
Berkshire Hathaway, Inc.**

Godsey & Gibb Associates' - "LETTER TO INVESTORS"

2004

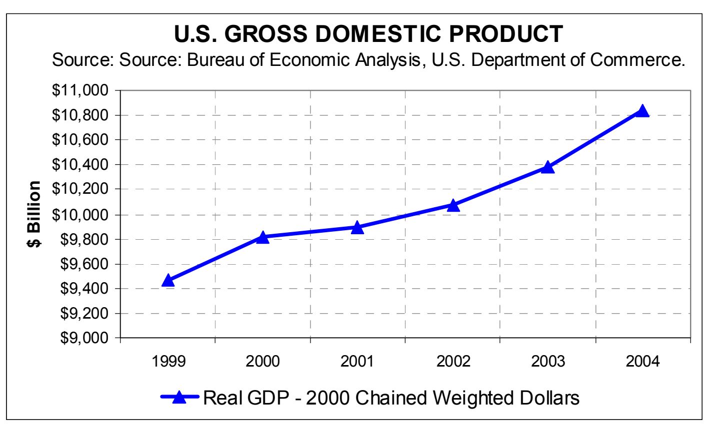
As fourth quarter and full year 2004 business reporting nears a close, we find that the "core" companies we currently own delivered another year of outstanding business performance. Collectively, the *net worth* (Book Value) per share of our companies grew by 14.0% in 2004, as you see in the chart below. The aggregated *cash flow, sales, dividends*, and *earnings* per share each grew by even higher growth rates. By comparison, the aggregated per share growth of our companies, materially exceeded the comparative growth of the S&P 500 Index. All aggregated calculations are based on an equal-weighted simple average. We will discuss these measures in greater detail later in this letter.

	Book Value	Cash Flow	Sales	Dividend	Earnings
G&G Aggregated Per Share Value	14.0%	19.2%	14.9%	32.4%	25.4%
S&P 500 Index Per Share Value	14.1%	11.4%	8.4%	11.8%	20.6%

In past issues of *Investment Watch*, we have primarily addressed our analysis of macro economic developments and provided our view of the investment marketplace. While we continue to monitor and measure our economic indicators, this issue of *Investment Watch* is devoted to a different and hopefully relevant subject matter; we wish to discuss our methodology of investing in businesses over **"The Complete Investment Cycle."** We broached this subject several times in 2004. Given that this month marks the 5-year anniversary of the peak in most equities markets, however, now may be the time to reiterate our investment philosophy and define our methodology in greater detail. We hope you will invest the additional time required to review our investment position and trust that your "return on investment" will be rewarding.

The First Five Years of Growth

The first five years of the "New Millennium" have passed. Growth was good, not great. The economy experienced growth nonetheless. As we enter the second half of the decade in this new century, we can look back with a sense of satisfaction over our economic achievements. U.S. Real Gross Domestic Product



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(GDP) grew from $9.5 trillion in 1999, to the current level of $10.8 trillion, an increase of 14.4%. Additionally, inflation (as measured by the GDP Deflator) only averaged 2.0%, as compared to an average inflation rate of 3.5% since 1947.

Gross Domestic Product (GDP) is the broadest measure of economic activity. Annualized quarterly percent changes in GDP reflect the growth rate of total economic output. The broad components of GDP are: consumption, investment, net exports, government purchases, and inventories. Consumption is by far the largest component, totaling roughly two-thirds of GDP.

Despite this economic strength, the past five years have been extremely challenging, as we all know. The period presented an economic slow-down in 2000, followed by recession in 2001, corporate scandals in 2002, war and deflation fears in 2003, and an elusive economic recovery that was slow to emerge with the strength of a typical recovery. Still, economic growth returned.

What About the Equity Markets?

Unfortunately, the equity markets have not delivered results commensurate with economic growth. Nevertheless, the investment markets have experienced a remarkable recovery from the market bottom of October 2002 after tumbling from a March 2000 peak. The S&P 500, S&P 100, and NASDAQ 100 have each registered impressive recovery gains of 57%, 38%, and 92%, respectively. Even with these gains, the S&P 500 remains 22% below its year 2000 record high, after declining by 51% during the market contraction. The S&P 100 is 32% below its 2000 price peak. The NASDAQ 100 Index, which represents the most ebullient stocks in the year 2000, still registers a 68% loss vs. its 2000 record high. During the market's downturn, the NASDAQ 100 experienced an 84% evaporation of its peak valuation.

So what explains the fact that the economy has experienced solid growth during the past five years, yet the equity market indices remain well beneath their 2000 pinnacles? To answer this question, we simply point to the extreme valuations that were created in the marketplace, especially for the most exhilarating stocks. At the peak of the investment cycle, it was difficult to keep up with investors' expectations if you did not own the largest market capitalization stocks - and they were not cheap. Not only were stock valuations excessive, so were investors' expectations! Consequently, the resulting conditions fed the fire of "irrational exuberance."

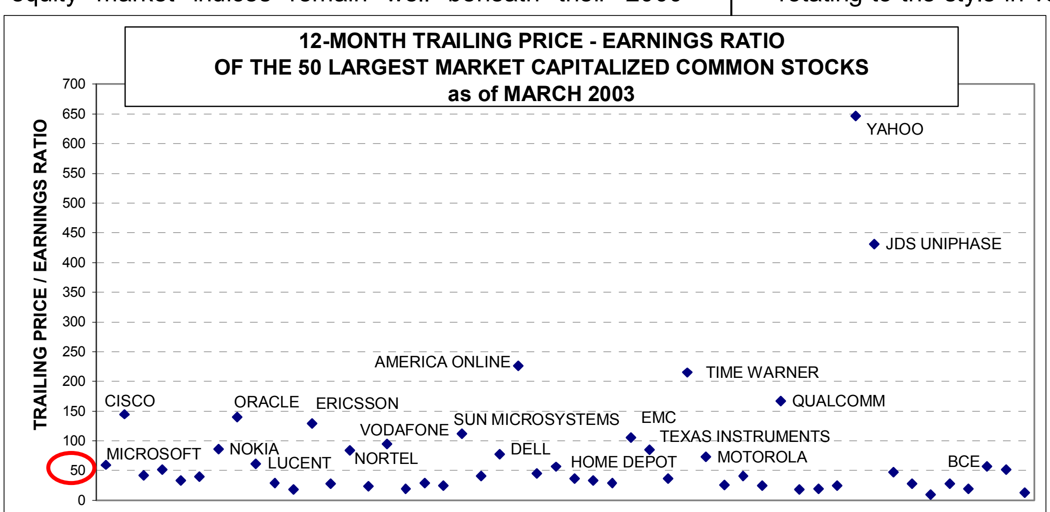
The bad news is that this 5-year period will be recorded with the likes of other sub-par periods of investment performance last seen in the mid-1970s, the early 1940s, and the 1930s. **The good news** is that the economy is growing, the year 2000 is five years in the past, and quality corporations have continued to expand their businesses and compound shareholder value every year.

The Cycles Within

When speaking of "The Complete Investment Cycle", a natural extension is to address *the cycles within* a longer-term investment cycle, which raises the subject of investment styles. There is an old adage that says, "Make hay when the sun shines," of course implying that every day doesn't always favor your choice of labors – make the best while you're able. And so goes investment style.

Investment styles are generally categorized as investing in large companies (large caps), mid-sized companies (mid caps), and small companies (small caps). Then there is a sub-categorization within each size, which is divided between what are known as growth investments (greater emphasis on consistent growth) or value investments (greater emphasis on low underlying "intrinsic" value). **Varying investment styles do not experience equal performance dominance over the same time period.** For a host of reasons, different styles exhibit uncommon strength and uncommon weakness during specific periods of time and with respect to specific economic conditions. While it may seem logical to simply shift from style to style, rotating to the style in vogue, history demonstrates that few investment managers have ever been able to successfully achieve such accomplishment. The overwhelming challenge is that the execution of varying investment styles often requires unique and contrasting skill sets.

In the early stages of an economic recovery, smaller, value-oriented stocks tend to gain attention. Many of these companies have been troubled businesses and have beaten-down stock prices. Often, they have been forced toward drastic cost-cutting measures and maybe even an extensive



reduction in employees, crudely referred to as "head-count reduction." When the recovery emerges, these companies have tremendous leverage based on reduced size and lower overhead expenses. This was the case during 2003 when very low-priced "salvage value" stocks provided the greatest market returns. Similarly, 2004 rewarded the value-oriented style.

Conversely, in the later stages of an economic recovery, larger, growth-oriented companies tend to excel – the leverage of smaller, value-oriented stocks tends to have run its course, thus the market's emphasis shifts toward companies with the ability to sustain longer-term growth. One of the greatest examples of this phenomenon is noted by the incredible stock performance delivered by the largest companies in the back half of the 1990s. This was also the case in the early 1970s when the largest dominant performers were known as the "Nifty-Fifty."

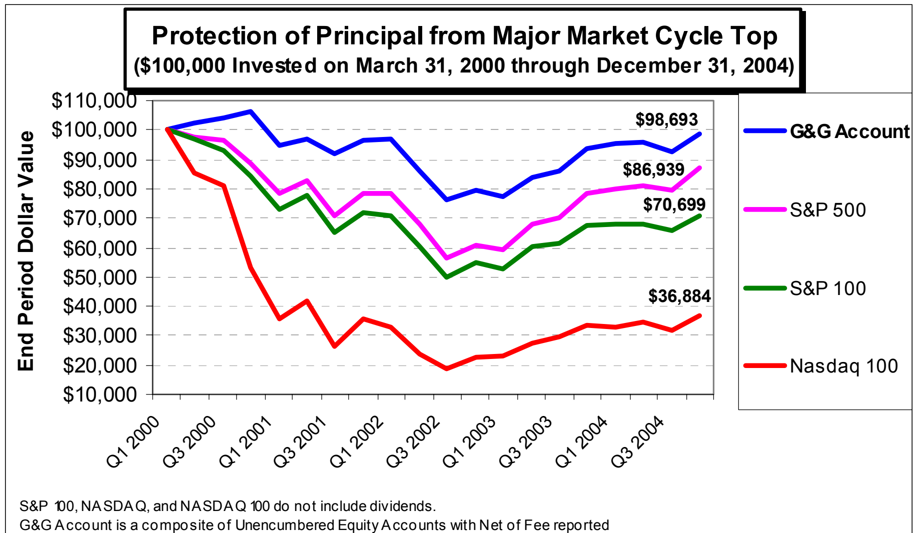
	Large Cap Growth	Large Cap Value	Mid Cap Growth	Mid Cap Value	Small Cap Growth	Small Cap Value
1990	-0.30%	-8.10%	-5.10%	-16.10%	-17.40%	-21.80%
1991	41.20%	24.60%	47.00%	37.90%	51.20%	41.70%
1992	5.00%	13.80%	8.70%	21.70%	7.80%	29.20%
1993	2.90%	18.10%	11.20%	15.60%	13.40%	23.90%
1994	2.70%	-2.00%	-2.20%	-2.10%	-2.40%	-1.60%
1995	37.20%	38.40%	34.00%	34.90%	31.00%	25.80%
1996	23.10%	21.60%	17.50%	20.30%	11.30%	21.40%
1997	30.50%	35.20%	22.50%	34.40%	13.00%	31.80%
1998	38.70%	15.60%	17.90%	5.10%	1.20%	-6.50%
1999	33.20%	7.40%	51.30%	-0.10%	43.10%	-1.50%
2000	-22.40%	7.00%	-11.80%	19.20%	-22.40%	22.80%
2001	-20.40%	-5.60%	-20.20%	2.30%	-9.20%	14.00%
2002	-27.90%	15.50%	-27.40%	-9.70%	-30.40%	-11.40%
2003	29.80%	30.00%	42.70%	38.10%	48.50%	46.00%
2004	-2.60%	5.50%	1.40%	9.00%	-0.70%	8.00%

Note: 2004 Index returns are through September 30, 2004
Source: Russell Mellon Analytical Services

Much time has been allocated to studies on this matter. We believe any meaningful risk-adjusted advantage gained by a specific style, over time, is a result of the shift in the beginning and ending point of the measurement period. Therefore, a blended approach of growth and value characteristics within a universe of large-caps and mid-caps becomes our risk-adjusted style of choice – Growth at a Reasonable Price, if you will, over **"The Complete Investment Cycle."**

There's Something about Protection of Principal

As stewards of individuals' accumulated wealth, our investment mission has always stated that our first objective is protection of principal, and second, growth of investment capital. Without question, our investment performance has not



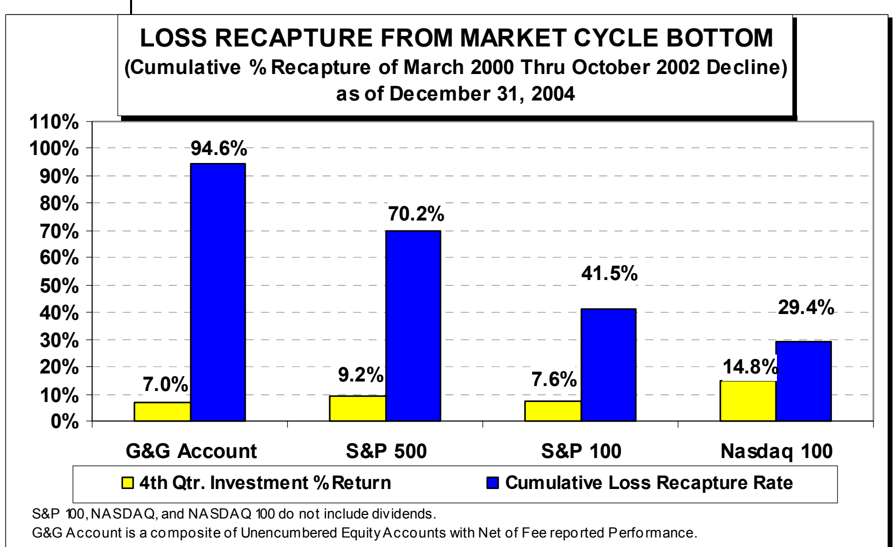
Protection of Principal from Major Market Cycle Top
($100,000 Invested on March 31, 2000 through December 31, 2004)

S&P 100, NASDAQ, and NASDAQ 100 do not include dividends.
G&G Account is a composite of Unencumbered Equity Accounts with Net of Fee reported

equaled the leveraged recovery gains of the S&P 500 and NASDAQ markets in the past two years. We have materially participated in the market's recovery from its lows. Many of the "core" businesses that we strive to own for the benefit of long-term investors simply lack the *economic recovery leverage* to catapult them to the top of the markets. To possess the required leverage, often the business had to have been broken or at least impaired. We do not acquire broken or impaired companies.

Our mission has always been directed toward owning companies that operate in sound and growing businesses, have low debt, impeccable financial qualities, and typically, are leaders of their respective industry. As we monitored the development of the economic recovery, we made re-balancing shifts, emphasizing the more economically sensitive businesses that benefit as the economy emerged from recession.

While our strategy may not serve the short-term desires of speculators or traders, it certainly proved its worth during the market downturn of 2000-2002. The net results



LOSS RECAPTURE FROM MARKET CYCLE BOTTOM
(Cumulative % Recapture of March 2000 Thru October 2002 Decline)
as of December 31, 2004

S&P 100, NASDAQ, and NASDAQ 100 do not include dividends.
G&G Account is a composite of Unencumbered Equity Accounts with Net of Fee reported Performance.

provided *Protection of Principal,* while also providing a greater foundation of invested capital from which to compound as markets improved. Consequently, our loss recovery has been much greater than that of the market indexes.

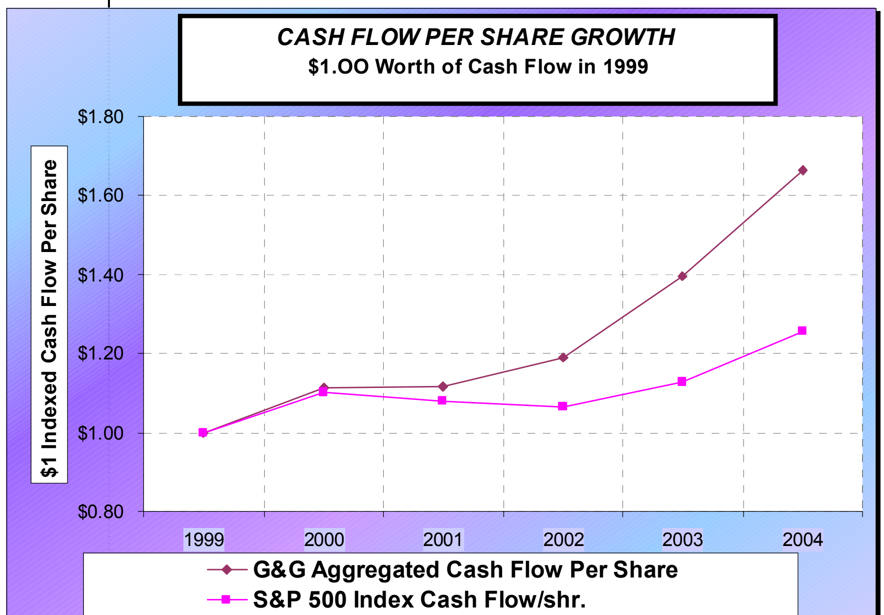
Additionally, as investors, we usually do not experience the added transaction expense of accelerated investment turnover along with the added replacement risks and the resulting tax consequences. Most research points to a low-turnover style as having the best opportunity for long-term wealth creation.

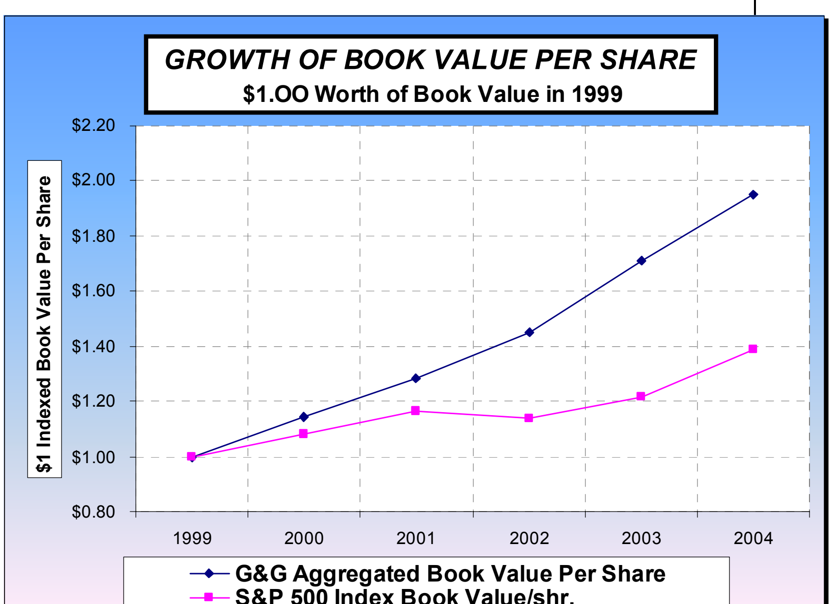
Measurements Beyond Mr. Market

In our introduction, we sighted a number of quantifiable measures that demonstrated the value-added benefits of shareholder ownership over the past year. At the close of 2004, the five-year simple average aggregation of the "core" companies that we currently own reveals a meaningful, steady, and persistent upward trajectory of shareholder wealth creation. These results occurred in spite of the challenges cast upon the economy and the marketplace. The following measures provide the perfect illustration of the meaning of a “durable” business franchise, as well as the purpose behind owning leading businesses.

Book Value (Net Worth)

Since 1999, the aggregated *net worth* per share of the companies we currently own grew by a compounded average growth rate (CAGR) of 14.3%, while the S&P 500 Index *net worth* compounded by only 6.8%. We point out that it is difficult, if not impossible, to reliably translate per share *book value* into per share business value. However, the tracking of the rate of change in *book value* should provide guidance to the underlying growth rate of the business’ intrinsic value and the underlying shareholder wealth created. Picture a private business owner/operator who systematically grows a business year after year, consistently building wealth. Then one day a stranger walks into the business and makes a ridiculously low offer to acquire the business. Does that mean that the owner’s wealth in the business suddenly declined? Of course not. Now picture the next day, when no one makes an offer for the business at all.





Cash Flow

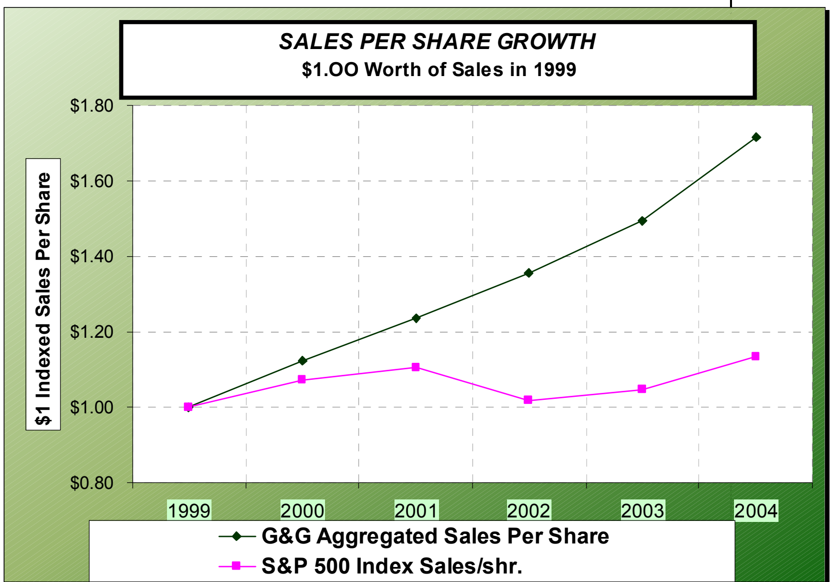
Simply put, *cash flow* represents the underlying strength of earnings generated by a business before subtracting depreciation and amortization charges. Since 1999, the aggregated *cash flow* per share of the companies we currently own grew by a compound average growth rate of 10.7%, outpacing the S&P 500 Index CAGR of 4.7%.

Sales

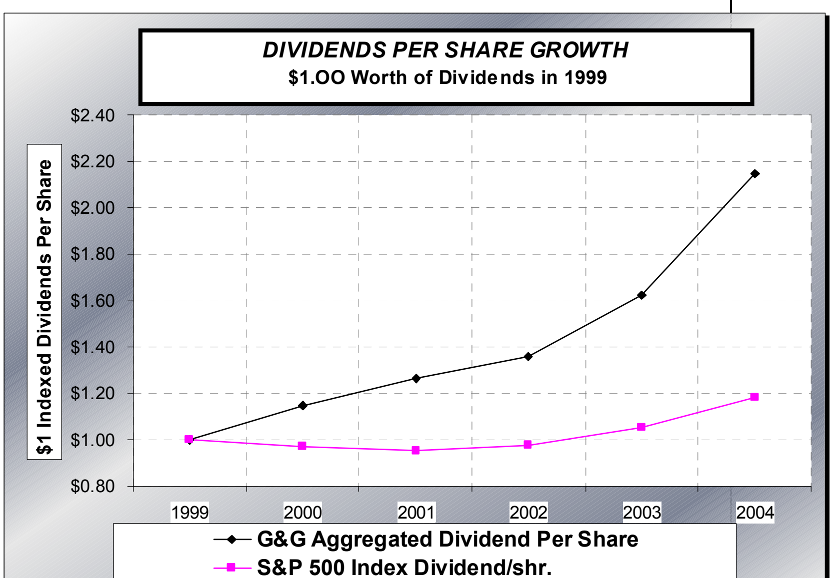
Without *sales* growth, a business is left with nothing more than cost reductions as a growth strategy, which will work to increase earnings for a while, but only for a while. Businesses usually work better when *sales* are growing. Since 1999, the aggregated *sales* per share of the companies we currently own grew by a CAGR of 11.4%, blasting the S&P 500 Index CAGR of 2.6%.

Dividends

Common stock cash *dividend* payments to shareholders have once again returned as a prominent issue in the marketplace, and reasonably so. Historically, *dividend* payments have provided a 42% contribution to long-term common stock total return performance, according to Ibbotson Associates. The market’s current *dividend* yield is approximately 1.6%, vs. an historic average yield of 4.3%. This does not bode well for long-term expectations of common stock total return… unless *dividend* growth quickly compounds. Since 1999, the aggregated *dividends* per share of the companies we currently own compounded at an annual rate of 16.5%, swamping the paltry *dividend* growth of the S&P 500 Index of only 3.4%.



We could go on to talk about the strength of the earnings per share measure, but we trust we have already made a convincing case. It is crystal clear that the businesses we own have been performing well. On the other hand, if and



when we determine that one of our companies suffers a long or lasting deterioration of business performance, we will promptly upgrade it with a more vibrant and dynamic business.

NEVER have we implied that we are immune to the emotional distress of Mr. Market. Our emotions are challenged daily, along with most everyone else. It is only by a conscious and continuous restraint that we refrain from allowing ourselves to be driven by the short-term affects of Mr. Market, as opposed to the long-term guiding principles of our conviction. As long-term investors, these principles guide us to be driven by the performance of the collection of businesses we own and not by the excitement of the moment. We will make mistakes, that is a given. As Charles Ellis, noted global investor, teacher, and author of *Winning the Loser's Game*, said, *"Investing is a loser's game, in which the winner is often the investor who makes the fewest errors."*

So, Who is Mr. Market Anyway?

In closing this *Investment Watch*, we'd like to provide excerpts and guidance from Warren Buffett's "Chairman's Letter" to the shareholders of Berkshire Hathaway, Inc. He defines the essence of "Mr. Market;" a character conjured up by his mentor, Benjamin Graham. Warren Buffett is noted as one of, if not the most, successful investor of all time, and is one of the wealthiest men in the world. Benjamin Graham, "The Father of Modern Security Analysis", teacher, investor, and author of such noted books as *Security Analysis* and *The Intelligent Investor*, has influenced the teachings of security analysis over the past eighty years. My memories of first reading this letter some seventeen years ago remain fresh, and more importantly, its implications remain as true today as when it was first written only months after the stock market "Crash of '87."

"Ben Graham, my friend and teacher, long ago described the mental attitude toward market fluctuations that I believe to be most conducive to investment success. He said that you should imagine market quotations as coming from a remarkably accommodating fellow named Mr. Market who is your partner in a private business. Without fail, Mr. Market appears daily and names a price at which he will either buy your interest or sell you his.

Even though the business that the two of you own may have economic characteristics that are stable, Mr. Market's quotations will be anything but. For, sad to say, the poor fellow has incurable emotional problems. At times he feels euphoric and can see only the favorable factors affecting the business. When in that mood, he names a very high buy-sell price because he fears that you will snap up his interest and rob him of imminent gains. At other times he is depressed and can see nothing but trouble ahead for both the business and the world. On these occasions he will name a very low price, since he is terrified that you will unload your interest on him.

Mr. Market has another endearing characteristic: He doesn't mind being ignored. If his quotation is uninteresting to you today, he will be back with a *new one tomorrow. Transactions are strictly at your option. Under these conditions, the more manic-depressive his behavior, the better for you.*

But, like Cinderella at the ball, you must heed one warning or everything will turn into pumpkins and mice: Mr. Market is there to serve you, not to guide you. It is his pocketbook, not his wisdom, that you will find useful. If he shows up some day in a particularly foolish mood, you are free to either ignore him or to take advantage of him, but it will be disastrous if you fall under his influence. Indeed, if you aren't certain that you understand and can value your business far better than Mr. Market, you don't belong in the game. As they say in poker, "If you've been in the game 30 minutes and you don't know who the patsy is, you're the patsy."

Ben's Mr. Market allegory may seem out-of-date in today's investment world, in which most professionals and academicians talk of efficient markets, dynamic hedging and betas. Their interest in such matters is understandable, since techniques shrouded in mystery clearly have value to the purveyor of investment advice. After all, what witch doctor has ever achieved fame and fortune by simply advising "Take two aspirins"?

The value of a market esoteric to the consumer of investment advice is a different story. In my opinion, investment success will not be produced by arcane formulae, computer programs or signals flashed by the price behavior of stocks and markets. Rather an investor will succeed by coupling good business judgment with an ability to insulate his thoughts and behavior from the super-contagious emotions that swirl about the marketplace. In my own efforts to stay insulated, I have found it highly useful to keep Ben's Mr. Market concept firmly in mind.

Following Ben's teachings, Charlie and I let our marketable equities tell us by their operating results - not by their daily, or even yearly, price quotations - whether our investments are successful. The market may ignore business success for a while, but eventually will confirm it. As Ben said: "In the short run, the market is a voting machine but in the long run it is a weighing machine." The speed at which a business's success is recognized, furthermore, is not that important as long as the company's intrinsic value is increasing at a satisfactory rate. In fact, delayed recognition can be an advantage: It may give us the chance to buy more of a good thing at a bargain price.

Sometimes, of course, the market may judge a business to be more valuable than the underlying facts would indicate it is. In such a case, we will sell our holdings. Sometimes, also, we will sell a security that is fairly valued or even undervalued because we require funds for a still more undervalued investment or one we believe we understand better."

Warren E. Buffett

We hope that through this letter you have gained a greater knowledge of our investment philosophy, methodology, and approach and have gained a greater appreciation for our continued use of the phrase **"The Complete Investment Cycle."**

For greater detail on our investment philosophy, methodology, and approach, visit www.godseyandgibb.com or contact us directly.

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Disclosure Statement