Disciplined Growth Investors

The Way Wealth Is Built

WATCHING PAINT DRY

February 24, 2003

MORE FUN THAN WATCHING PAINT DRY: Jim Greif tends to his cornfield in Monticello, Iowa, under the watchful eye of digital cameras. CornCam, set up by Iowa Farmer Today newspaper, has proven inexplicably popular on the Internet.
CHARLIE NEIBERGALL/AP

In my search for an appropriate theme for this piece, I came across a website, www.Iowafarmer.com/corncam/corn.html. This is a popular website where interested persons can tune in and watch Iowa corn grow. As you can see from the accompanying photograph, watching corn grow is more fun than watching paint dry!

And so it is with this bear market. It is our forecast that over the next several years stocks will provide above-average returns in a manner akin to watching paint dry. While the headlines talk about terror and war, companies are healing themselves. Generally stocks are undervalued and should perform very well as investors slowly realize that corporate America is not only alive but making nice progress. One of the keys to investment success over the next few years is to remind oneself of the French proverb, "Patience is bitter but its fruit is sweet."

We are on the brink of war with Iraq. In a speech to the United Nations on September 12th of last year President Bush challenged that international body to deal with the Iraqi regime. On November 8th, the United Nations Security Council passed Resolution 1441, demanding that Iraq disarm voluntarily. Inspections to verify Iraqi compliance began shortly thereafter. Early this year the United States and England commenced a full-scale military buildup in the Mideast. Recently a dispute has arisen within the United Nations Security Council as to whether Iraq is sufficiently compliant with Resolution 1441. There is a major controversy within NATO regarding the defense of Turkey. The FBI and the CIA have issued warnings of another domestic terrorist attack.

Since President Bush's speech to the United Nations last September the markets have exhibited increasing concerns over a likely war. From September 13th (the day after Bush's U.N. speech) until February 24th of this year, gold prices have increased by 11%, crude oil prices by 26% and natural gas spot prices by 93%. Short-term interest rates, reflected by Treasury Bills, collapsed further, from 1.66% to 1.16%. The U.S. dollar has fallen 11% versus the German Mark and the Swiss Franc, 10% versus the Eurodollar, 2% versus the British Pound, and 4% versus the Japanese Yen.

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Since September 13th, a dichotomy has emerged between commodity prices and stock prices. The table below compares the performance of various commodity-related industry stock groups from September 13th through February 24th with the underlying commodity. As you can readily see, the related stock price groups have fallen in the face of rising commodity prices. Since rising commodity prices foretell rising profits the divergence between the commodities and the stocks most likely reflects investor skepticism about the sustainability of commodity price increases.

Price Changes (09/13/02-02/24/03)

Commodity	Stock Price
Steel Scrap Prices +6%	S&P 500 Steel Stock Index -22%
Crude Oil +26%	S&P 500 Oil/Gas Integrated Stock Index -4%
Natural Gas Futures +93%	S&P 500 Oil/Gas Exploration Stock Index +3%
Gold Prices +11%	S&P 500 Gold Mining Stock Index -6%

The Iraqi Conflict

While we cannot forecast the likely course of the looming invasion of Iraq (and we hope Iraq will disarm without further bloodshed), we believe it is now possible to place that conflict in context.

- **First**, the Iraqi conflict is likely to be the defining moment in the war on terror. Whereas the liberation of Afghanistan was precipitated by the Al-Qaeda attack on the U.S., the Iraqi strike would be pre-emptive. Regardless of the outcome of the war, this conflict is already realigning the world. Even if the French and Germans were to experience an about-face and wholeheartedly support a U.S. led invasion of Iraq, the NATO alliance will become different.
- **Second**, an invasion of Iraq will raise the chances of a terrorist attack in the United States. It is prudent for investors to understand that the chances of another terrorist attack are uncomfortably high.
- **Third**, if the U.S. leads an invasion into Iraq, the effort must be well-executed and sustained. With the decision to invade, the U.S. is committing itself to the initiation of democratic rule in a distant country in an area of the world beset by turmoil.
- **Fourth**, while no one can identify all of the risks, we believe the Bush administration understands the breadth and length of the challenge associated with a military invasion of Iraq.
- **Fifth**, we are also resisting the temptation to evaluate the effects of the Iraqi war on the U.S. and world economies; there are too many possible outcomes to support a reasonable forecast.

Source: http://www.locked.de/en/tanks/abrams_m1a1/abram4.jpg.html

Against the backdrop of the probable Iraqi invasion, what is the condition of the stock market today?

1.) **The stock market offers highly competitive returns against realistic alternatives.** Over the last few years we have used General Electric as a proxy for the large-cap stock market. The company is large, well-managed and highly diversified. General Electric grew its earnings and dividends 15% per year from 1990-2000; we believe a prudent estimate of GE's earnings and dividend growth is 7% per year from 2000-2010. According to our valuation framework, GE should sell at 19-23x earnings. In the aftermath of the terrorist attack in 2001 GE sold at $38 per share. At that time we estimated GE was worth about $23-27 per share (19-23x normalized earnings of 1.20 per share). Today, GE is earning about $1.40-1.50 per share, so the stock is worth about $27-33 per share. We believe GE stock will be worth about $40-45 per share in 2009. Today GE common stock sells for slightly less than $24 per share. The stock has a current dividend yield of 3.4%. If the stock sells at its $40-45 estimated value in 2009, investors today will receive price appreciation of about 77%, or 10% per year. Investors will also receive an initial dividend yield of 3.2% with dividends growing at 7% per year.

What is the alternative to GE today? The most obvious choice is Treasury Notes and Bonds. The yield-to-maturity for 5-year Treasury Notes is 2.77% and the yield for 10-year Notes is 3.81%. GE common stock offers a comparable current cash yield to Treasury fixed obligations today. Further, GE holders are likely to experience substantial price appreciation over the next six years while Treasury debt holders will receive little or no appreciation. In total, a GE common shareholder is likely to receive over 13% per year return while the investor in a 10-year U.S. Treasury Note will receive less than 4% per year.

2.) **Corporate America is healing itself.** There are two areas in which nearly all corporations have begun to substantially improve:

- **Cost Control.** The 9/11 terrorist attack may have an ironic effect on the economy. It is possible, even probable, that the terrorist attack caused corporations to accelerate cost cutting in anticipation of a recession. Just as the average U.S. citizen was horrified by the terror attacks, so too were corporate CEOs. As a result, in 2002 capital spending and inventories declined by the greatest percentage in over 30 years. This level of extreme caution by corporations usually occurs only after a serious recession. Today companies are much leaner in preparation for a possible double-dip recession which has so far failed to materialize. If the economy continues to recover through next year corporate profits will be much better than forecasted.

- **Corporate Governance.** Corporate governance is improving. The Enron and Worldcom scandals focused attention on the conflict of interest between the auditing and consulting businesses of the major accounting firms. The scandals also highlighted the correlation of favorable ratings by Wall Street analysts on selected large clients paying large investment banking fees. (It should be noted that Wall Street analysts have always favored well-heeled investment banking clients in my opinion; although it seems the practice becomes an epidemic during bull markets.) As a result of the collapse of Enron and Worldcom, the chairmen of board audit committees of public companies have become better educated and more diligent. Last August the SEC instituted a regulation requiring CEO's and CFO's to personally certify financial results. Companies are providing more information. Executive pay is coming under more scrutiny. Today, corporate books are probably as clean as any time ever.

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3.) The telecomm sector appears to be slowly rationalizing itself after a long period of chaos and many bankruptcies. The FCC seems to be coming out of its long hibernation. The telecomm stocks appear to have bottomed last October. This is critically important for the U.S. economy. The telecomm sector is very large and must be able to build out the information superhighway if the U.S. is to be competitive with low-wage countries like China. We expect the rebound in the telecomm sector to begin slowly at first and then take hold at a faster pace, probably next year or in 2005.

4.) **George Bush is doing better.** In the presidential election of 2000, George Bush lost the popular vote and won on a technicality. In the Congressional election of 2002, he put his prestige on the line and his party won control of both houses of Congress. Since then he has proposed an ambitious tax plan, including a sweeping and long-overdue elimination of the double taxation of dividends. The Bush tax proposal is very, very well done and offers neutral tax treatment of interest expenses, dividends, and capital gains. His proposal would begin to reduce the effects of unequal taxation on corporate balance sheets. While his policy to preemptively strike Iraq is deservedly controversial he has pursued the war on terrorism steadfastly. The recent emergence of strong presidential leadership is good for the stock market.

5.) The technology revolution continues to unfold. A recent study indicated that broadband had reached 15-20% of the U.S. households. It is probable that broadband adoption is at or near critical mass in the U.S. This means that the convenience of high-speed web access will elevate this service to the "must have" category. At the same time, companies such as Ebay and Yahoo are beginning to demonstrate that it is possible to develop a highly profitable company via the web. The coming widespread adoption of broadband will require more equipment and a host of new services.

6.) Investor behavior is showing signs of panic and despair. During the past month investor behavior is showing signs of panic and despair similar to the market activity during the one month period after the 9/11 terrorist attack, the Worldcom bankruptcy last June, and the Bush speech to the U.N. last September, respectively. During each of these times various measures of investment activity showed very high levels of anxiety. In each of these times the market has responded to a specific threat to prosperity. We believe the effects of each successive market panic are cumulative; that is, the stock market is becoming increasingly oversold on a secular basis.

Summary

While stocks offer very attractive prospects versus competing instruments such as Treasury Bills and Notes, it is critically important to note that the world stock markets have been involved in a secular bear market. Bear markets of this severity only occur once in a generation. All investors must view forecasts of how this bear market will end with a skeptical mind. Further, the year 2003 begins with several major factors likely to sway stock prices. These factors include the war in Iraq, Bush's tax plan, business confidence, consumer confidence, and continued repair of the telecomm sector. It is our view that the high implied return from stocks today will inevitably pull stocks up. It is also our view that the end of this bear market may resemble the end of the war on terror. We may not know for a long period of time that the war on terror is over; we may also not know when this bear market ends. This is not a reason to avoid stocks; it is a reason for maintaining an ironclad investment discipline and endless patience.

In closing we would like to leave you with some data suggesting a reason for optimism this year. Since September 13th of last year through February 24th of this year, while the S&P 500 has declined 6% along with oil and gold stocks, the emerging web franchise stocks have been standout performers. Yahoo stock has risen 88%, Adobe 37%, Ebay 34%, and Amazon 31%. The ability of these stocks to rise in the face of war trauma may reflect the simultaneous emergence of the web and companies able to build a sustained profit model around the web.