Saybrook Capital
Investment Outook

December 31, 2004

At the close of 2003 we wrote to you with our 'laundry list' of forecasts and wisdom for the upcoming year. While the end result for the year was right at our target, the arrow took a circuitous route to the proverbial bull's-eye. We made an argument for positive single digit equity returns, driven by steady earnings gains with no multiple changes and an eventual rise in interest rates. Instead we saw earnings for companies in the S&P 500 index surge +22%, while the market returned less than half of that amount, due to a concurrent decrease in valuations. This occurred in a context of surging energy prices, continued geopolitical uncertainty, a contentious national election, and sustained low interest rates. 2004 has been characterized as a year of low volatility for the 'average stock', but many companies, especially in the mega-cap arena, witnessed billions of dollars in wealth destruction.

While we would like to predict that 2005 will be a 'normal' year for the market, the truth is there is no such thing. We can't predict the future, but there are several developments that we see persisting in the coming year. A worthwhile exercise is to overlay the economic trends we envision with our disciplined valuation framework. This process seeks to ignore the near-term emotions and 'noise' of the markets in order to determine a predictable range for equities in 2005 and a long-term outlook for our clients' portfolios.

The first step in our model is economic (GDP) growth. We retain our confidence in the self-sustaining nature of the domestic economy. In the three years since the end of the 2001 recession, US real GDP has grown an average of 3.5% per quarter, higher than the rate for the 1990s. While the 'accelerating' stage of this cycle is over, we believe that the economy can continue to grow at a reasonable pace (3-3.5%) for the next few years. Some variability in these numbers is inevitable, on the downside from the delayed effect of higher energy prices and probably from higher interest rates, and on the upside from a potential weak-dollar export surge.

Secondly, we analyze how economic growth translates into corporate profits. In 2004 earnings surpassed all expectations not due to stronger GDP (although +4% was above most economists' forecast ranges), but because companies benefited from significantly higher margins. Historically, as the economy continues to grow, companies cannot rely only on productivity gains and eventually must accelerate hiring and other investments. While this stimulates and sustains the economy (as mentioned in the previous paragraph), it also signals the end of the powerful operating leverage that enables profits to grow so much faster than the overall economy. We do not envision major earnings disappointments, such as seen in 2001 and 2002. Instead, we expect the end of margin growth to cause profits to grow more in line with revenues and the US economy (real GDP + inflation) for the next couple years. Depending on the level of inflation and new rules for options-expensing, S & P 500 earnings growth should range between 6 - 7% for 2005 and 2006.

Following the first two steps of our three-part model, we have not forecasted a lot of variability in economic growth or earnings. Determining what investors will pay for the resulting earnings is a formidable challenge. The multiple, or 'price/earnings ratio', that measures how much investors value each dollar of earnings is impacted by a number of different quantitative and qualitative factors. Some of these include:

- **INTEREST RATES:** At this juncture, still historically low interest rates argue for higher multiples (a 4.3% 10-yr treasury yield means that bond investors are paying 23 times 'earnings'). Yet the anticipation of potentially higher inflation and interest rates, which could lower the current value of future earnings, has held valuations near 17 times, already reflecting a yield increase to nearly 6%.

- **RISK PREMIUM:** The premium that investors require in order to justify owning equities rather than risk-free investments also remains elevated in the post-9/11 era. Just as certain heightened geo-political threats could wane, other fears and shocks could develop, causing investors to question the certainty of future earnings. These shifts are impossible to predict, but we are confident that the miniscule risk premia of the late 1990s (resulting in mid-20s market multiples) will not return.

- **CASH DEPLOYMENT:** As mentioned in our 3rd Quarter Investment Outlook, companies are at a critical stage where they are determining how to deploy the record levels of cash on their balance sheets. While reckless acquisitions and option-generated stock repurchases represent inefficient use of capital, we think the market will reward companies that invest in their infrastructure and distribute excess cash to their shareholders. If an investment is worth the discounted present value of all future cash flow, then a continuation of the trend toward initiating or raising quarterly dividends should result in a willingness by investors to pay incrementally more for a company's earnings.

- **LOWER TAXES:** One must continue to consider the effect of the landmark 2003 tax law. In addition to encouraging more resourceful allocation of corporate capital, these changes enable equities to provide a higher after-tax return from both dividends and capital gains. This potential should increase the value of equities.

- **SUPPLY AND DEMAND:** Another dynamic impacting the valuation of stocks is their desirability versus other asset classes. Current levels of long and short-term interest rates decrease the attractiveness of bonds and cash equivalents. At the same time, real estate and commodities are winning the attention of investors' dollars. The long-term upward trend in equity valuations has been partly attributed to the dramatic increase in the breadth of equity ownership over the last 30 years, resulting primarily from the introduction of IRA and 401(k) plans for individuals. Proposals to allow private Social Security investment accounts could accelerate this trend, amounting to as much as an additional $100 billion per year by some estimates. Such changes to the U.S. retirement system are by no means a certainty, but even possibilities of a bill passing may increase equity multiples, as investors anticipate the new flow of funds into equity ownership.

We continue to believe that a valuation of 15.5-19 times the S&P 500 forward twelve months earnings is a fair range that allows for the fluctuation caused by the variables discussed above. At 17 times our 2005 earnings forecast at the end of 2004, stocks are fairly priced (in the middle of our expected range). Applying these multiples to our relatively narrow range of earnings for 2006 (upon which stocks will be valued in twelve months), results in a total market return for 2005 of 8-9%, with volatility within our multiple range stretching from slightly negative to a return in the high teens.

Three factors could impact this investment outlook. First, it is the 'unforecastable' events and changes that force market multiples outside of this rational range. A geopolitical, currency, or inflation crisis (or resolution) is the type of market 'event' that causes the spikes or crashes outside of the more predictable range. Secondly, there is legitimate concern that the markets' 10%+ year-end rally has 'borrowed' from this year's returns. We have generated a reasonable forecast for the end of 2005, but much of this optimism has already materialized in the form of November and December's enthusiasm. Finally, Saybrook Capital's long-term record has demonstrated that our 'undervalued growth' strategy can generate excess returns with less risk than our benchmark indices. We have identified growth companies, in a wide range of sectors, which are under-appreciated by the investment community. Over a 3-5 year holding period, we are confident these investments will generate strong total returns.