Saybrook Capital
Investment Outook

March 31, 2005

Wall of Worry

Recent media coverage of current events impacting the US economy, whether in the financial or popular press, has ranged from merely dire to apocalyptic. The litany of concerns are too long to list, but legitimate ones include: high energy prices, weak dollar, rising inflation, increasing interest rates, "twin deficits" (trade and budget), corporate malfeasance, high consumer debt (and low savings), and a "real estate bubble". Both the length and breadth of this list are too significant to ignore, as each issue can impact economic output, corporate earnings, and stock returns. A weak stock market in April suggests growing concern. However, the long history of market trends indicates that when such apprehensions become well known and thoroughly discussed (even appearing on magazine covers), they are likely already reflected in stock prices. Hence, as investors adjust to concerns like these and begin to foresee their potential resolution (or, in some cases, learn that they were not as calamitous as originally thought), equity markets frequently begin to recover. Investing jargon terms this "climbing a wall of worry".

While neither market psychologists nor technical analysts, we strongly believe in the value of taking a contrarian position to the consensus thinking among investors. There has been no shortage of market and economic anxieties since the end of the bull market in 2000, but the collective trepidation of market forecasters and media pundits has reached an extreme in early 2005. The S&P 500 is trading at approximately 17x 2004 operating earnings and less than 16x the next 12 months' earnings consensus. Interest rates and inflation continue at comparatively modest levels, albeit above the 2002-03 period. If you believe, as we do, that markets are efficient discounting mechanisms of the shared information and knowledge in the investment community, then the moderate level of multiples on forward stock earnings means that equity valuations have already adjusted to the potential for either higher inflation and interest rates or decelerating economic growth. We are unlikely to see both sets of negative conditions. The surprisingly low level of interest rates may be reflecting the future softness in the economy. Both low stock valuations and moderate interest rates suggest that markets are extremely proficient at discounting future concerns, such as those listed above. In reality, it is the unforeseen occurrences (i.e. continued steady growth or

an unexpected economy-shattering event) that cause stock prices to rise above or fall below their expected ranges.

Specifically, we do not foresee a recession for at least the next year or two. The spike in fuel prices is an event that could qualify as devastating enough to trigger an economic decline. However, energy costs represent a significantly smaller portion of overall business and consumer spending than they did in the 1970s, the last downturn triggered by oil prices. Unquestionably, certain industries suffer (e.g. airlines), but we believe that economic output as a whole is decelerating, not declining, as a result of energy prices.

In recent decades the US economy has experienced longer expansion periods between recessions, with the last downturn in 2001 capping 10-11 years of growth. The long-term shift in our economy away from industrial production towards the less cyclical service and information sectors has driven this phenomenon. International trade, particularly with developing regions, has also helped to sustain business activity. Specifically in 2005-06, we expect pent-up demand and massive cash holdings to propel corporate expenditures, helping to offset any consumer slowdown.

Because we believe that 15-17x earnings is a reasonable valuation for stocks given current inflation and interest rate conditions, the continued economic and profit growth that we expect should be reflected in rising equity prices over the next twelve months. We believe equities can provide a total annual return (appreciation plus dividends) of 7-9% over the next few years, a superior return to that available from cash (2-3 1/2%) or bonds (4-6%). Since the market low in 2002, the greatest strength in equities has been in small capitalization companies and "deep-value" stocks. In recent months, however, investors have begun to shift their attention to larger companies, especially those that are reasonably priced and provide above-average growth. This describes our typical "undervalued growth" stock, which we expect to return above-market results in the next few years. Our moderate out-performance in the first quarter possibly harbingers a shift in focus to established, growth-oriented companies.

We rarely spend time in our Investment Reviews discussing individual holdings. However, we think two unrelated occurrences in our portfolios over the last quarter deserve mention.

XTO Energy

The last few weeks have marked a full year of a successful investment for Saybrook Capital in a different type of company. We generally focus our attention on companies that we believe can achieve superior long-term growth and whose stocks are distinctly undervalued. This strategy has kept us away from investing in commodity-type companies, marked by distinct cycles in demand for their products and in their pricing. The inherent cyclicality of commodity businesses makes it difficult to forecast superior long-term growth.

However, in early 2004, our attention turned to an anomaly in the energy market. Prices for petroleum and natural gas had risen steadily since early 2002, reflecting the economic recovery following the recession of 2001. Oil prices in early 2004 at $33 a barrel and natural gas at approximately $5 per 1,000 cubic feet (MCF) were sharply above the $20 and $3 level of early 2002. Energy analysts and investors commonly assumed that prices for such energy products would “revert to the mean”, a popular phrase suggesting that prices for oil and gas would return to their long-term averages in the low $20’s and mid $3’s respectively. A year ago, energy companies were selling at modest prices relative to 2004 earnings estimates, as investors assumed future profits would fall reflecting the expected retreat in energy prices.

In early 2004 it occurred to us that the conventional view of energy pricing and behavior for oil and gas stocks might be missing some important recent developments. Indications of rising energy demand were emerging, both in the recovering industrialized world and even more so in the surging economies of developing nations, particularly India and China. Furthermore, increasing evidence showed that energy supply was not keeping up with demand. Some OPEC countries had the excess supply to increase production but might not readily do so if it risked depressing prices. Other oil and gas producing nations appeared to be experiencing flat or reduced output in recent years.

This tighter supply/demand balance led us to consider that energy prices might not revert to the mean and that some exposure to the energy sector would be prudent. However, we wanted to find a company with fundamental growth qualities. In March 2004, after considerable analysis, we discovered XTO Energy and were impressed with its characteristics. XTO, a domestic producer of natural gas and oil, benefits from an excellent management team and an outstanding record of annual gains in production. Its history of steady production growth results from a combination of smart acquisitions and well-executed

drilling programs. Its earnings are sensitive to energy prices, but we were confident the company could continue its record of increasing production. If prices held steady, the company's earnings per share were likely to rise sharply with its growing output of natural gas and oil.

For most of our clients, we invested in XTO in March 2004 at prices between $18 and $20 per share, when earnings estimates for that year and 2005 were approximately $1.35 and $1.30 per share, respectively. Analysts continued to assume that oil and gas prices would return to lower levels by 2005. Thus its modest 14x 2004 earnings ratio seemed normal. However, the assumption of declining energy prices in 2004-05 has proved to be faulty, as shown in the following table:

March 2004:	Oil (bbl)	Natural Gas (mcf)
Actual Price	$33.30	$5.00
2005 consensus estimate	$27.50	$4.50
'Reversion-to-the-mean' estimate	$22.50	$3.75
April 2005:		
Actual Price	$52.50	$7.09
Futures market for mid-2006	$53.50	$7.13

Instead of the forecasted reversion to the mean we find today oil is priced over $50 a barrel and natural gas at $7.00 per mcf. As a result, XTO is likely to earn as much as $2.40 per share this year and the stock is selling close to $32, which at 13.3x is approximately the same valuation as a year ago. XTO has simply risen along with its sharply higher earnings, and our average gain in the stock is approximately 75% over the last twelve months.

We have taken some capital gains for all of the accounts that purchased the stock a year ago. For some we trimmed our position after the stock rose during the year, and for individuals we waited for the gains to become "long-term" in March 2005. We have reduced our positions in XTO to approximately 3.5% of assets. We continue to believe that energy prices may stay at a higher level than is commonly expected, and we want to retain a position in XTO as long as it can achieve healthy production increases, which are estimated at 20% annually over the next two years.

AIG

The second stock that deserves discussion is American International Group (AIG), the world's largest insurance company. We will resist the urge to rehash the last two months of financial headlines, but, needless to say, AIG is the latest company to be embroiled in accounting scandals. Initially attracted to AIG in 2002 when insurance stocks were out of favor due to the weak economy and concerns of exposure to terrorist attacks, we were impressed by AIG's leadership in China (the company was founded in Shanghai in the 1920s) and its triple-A balance sheet. As the economy recovered and AIG's international operations grew we participated in its strong stock appreciation in 2003-04.

In late 2004, AIG became the target of accounting investigations by the New York State Attorney General's office. Among other things, AIG is accused of exploiting certain re-insurance products in order to "smooth" its earnings. In the early stages of the scandal's unfolding, we felt that the charges had real merit and that the company possessed fundamental problems, particularly with its leadership. While we do not claim to have superior understanding of the intricacies of corporate re-insurance underwriting, we benefited from our past experiences in the industry. Saybrook Capital sold all positions in AIG in February at around $70/share: a sizable profit for almost all accounts. In the months that have followed, several AIG employees have pleaded guilty to criminal charges, most of senior management has resigned, and the CEO has been indicted. The stock is now 30% below its highs for the year.

We do not believe, as some do, that our capitalist system and corporate leadership are fundamentally flawed. Contrarily, we recognize that there are many high-quality companies that are led by managers for whom integrity and shareholder value are their paramount goals. It is our job to seek these firms and avoid companies that are plagued by mismanagement and conflicts of interest.