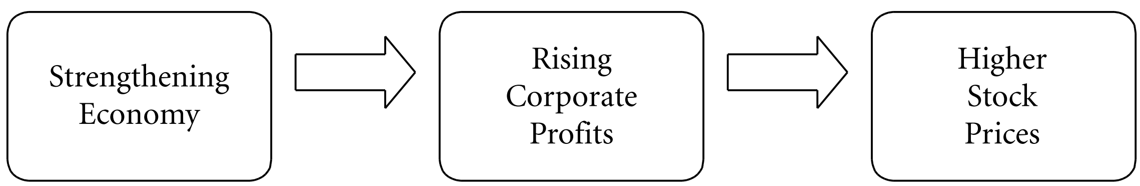
Saybrook Capital
Investment Review

September 30, 2004

We continue to believe in our economy/profit/stock price paradigm (shown below), which we have discussed in recent Investment Reviews. The first two components of this forecasting model continue to be realized, as the economy has grown fairly strongly, and corporate profits have risen significantly. However, equity prices have moved very little, staying in a narrow 9% range for the S&P 500 throughout this year and recording only a very modest increase since the beginning of the year.



In our opinion, the limited progress of equity prices in 2004 is a function of two concerns. The first has been uncertainties about the national election and progress in achieving our goals in Iraq. The second is a fear that the significant increase in energy prices may restrain economic growth in 2005. We acknowledge these concerns. However, we also recognize that in most economic recoveries in the United States there are slow phases, or to quote Federal Reserve Chairman, Alan Greenspan, "soft patches", which are typically followed by renewed growth. This was certainly the pattern after the recessions of 1981 and 1991, and we think that this will be the case in the current decade. We believe strongly in the self-sustaining nature of the U.S. economy which encourages expansion until some cataclysmic development occurs, bringing economic growth to a halt. Examples of such momentous events are the combination of 8% inflation and 13% interest rates in the early 1980's and the bursting of the technology bubble in the late 1990's. We do not think that the current economic recovery phase has experienced such an event that could abort the renewed growth which began in 2002. A few sentences from our last Investment Review summarize our current opinion on the economy:

> *If history is a guide, the economic cycle is in the second or third inning, as the previous strength of the consumer translates into cash for companies, which is*

then invested into inventory restocking, capital equipment, and job creation. These expenditures pass through to other businesses and consumers and the expansion cycle continues. Fortunately, inflation can be self-correcting (even in energy prices), as evidence shows that the recent soft spot here and abroad releases some of the pressure on prices.

If our view on the economy and corporate profits proves correct, we believe that the paradigm will be accurate and equity prices will rise in the coming months, after a period of little gain for most of 2004.

Deployment of Surging Corporate Cash Flow

For some time we have observed an interesting phenomenon on corporate balance sheets. Both the companies we own, as well as the corporate world in aggregate, are holding levels of cash as a percent of assets not seen since the 1960s. The reasons for this build-up are fairly clear, but whether the trend continues and how companies deploy these assets have major implications for equity markets going forward.

After increasing gradually in the 1990s, US non-financial corporate cash as a percent of total assets has surged since 2002 to nearly 10% of total assets. As the nearby chart shows, cash as a percent of assets has jumped 50% in just the last three years. On one hand, companies are enjoying a growing economy and high profit margins, leading to record earnings and cash flow. However, in an era of geo-political risk, intensifying regulatory scrutiny, and increasing conservatism in corporate board rooms, management has been reluctant to spend these profits, instead stashing them in the assets column on their balance sheet. Companies rarely race out to hire new employees or acquire new equipment at the first sign of an economic upturn, but GDP and profits have now been increasing for almost twelve quarters. Normally by this point in a business cycle, corporate officers have regained the confidence to reinvest in their businesses. This cash influx will be further enhanced by the nearly $100 billion in overseas profits freed up in the repatriation provision of the just-approved corporate tax cut. This represents billions of dollars of cash that existed on US companies' balance sheets but was left abroad to minimize taxation.

Growth of Cash as % of Assets

Through 2Q04. Excludes financial subsidiaries of GE, GM and F.
Source: Morgan Stanley Research.

This divergence cannot continue forever. Since we believe that corporate profits will continue to grow, albeit at a moderating pace, we think that companies will accelerate deployment of these funds. How this cash is put to work, considering the wide variety of corporate finance alternatives, will be a large factor in how companies perform in the years ahead.

Companies face a range of options for their funds besides earning a meager yield in their cash management account. These include: debt reduction, mergers and acquisitions, research and development, stock buy-backs, dividend payments ("special" or quarterly), capital investments, increasing payroll, building inventories, or shoring up under-funded pension plans. Different companies, in varying sectors, and at particular stages in their growth cycle require their own specific cash deployment strategies, so there is no "right" or "wrong" method. But Saybrook Capital invests in "growth" companies, and we look for certain signs that management is deploying cash toward the goal of enhancing long-term shareholder value.

The best indication that a corporation is focused on profitable long-term growth is deployment of their rising cash flow towards physically building its business. This can be seen when a drug producer boosts its R&D, when a capital goods company invests in its physical plant, or when a services firm hires more workers. Acquiring other companies, while sometimes resulting in a clever strategic fit, often signals sloppy or inefficient use of capital.

Once management has committed business investments to a level conducive to superior returns on equity, further excess funds are best returned to the shareholders, ideally via quarterly dividends. After the 2003 tax changes, dividends and share repurchases are treated equally on an after-tax basis, so theoretically it makes no difference which vehicle is used to return the cash. However, share buy-backs, rather than reducing shares-outstanding for the benefit of investors, are often used to simply offset dilution from generous stock options. Saybrook Capital looks for companies that pay a quarterly dividend and have a record of raising these payouts in pace with growing profits. A regular dividend, as opposed to a one-time "special" payout, signifies management's priority of returning money to shareholders and its confidence in the company's future ability to generate steady cash flows. Additionally, in an era of single digit earnings growth with little multiple expansion (our market expectation), dividends may represent a significant portion of total equity return. We do not seek to invest in stocks with the highest dividend yields, since those are often companies in decline. Instead, we look for companies with undervalued growth prospects whose managements will use cash flow in excess of internal needs to reward shareholders with steady growth in dividends. We consider this to be a substantiation of a company's confidence in its future prospects.

We continuously examine the companies whose stocks we hold to determine how they are investing for future growth and to learn how their management will deploy growing cash holdings that result from expanding profits. Most of our companies are, in fact, expanding their businesses at a healthy rate:

• Many are adding new facilities, manufacturing plants, or, for retailers, new stores. Increasingly, these are located overseas to serve important international markets.

• Some of our manufacturing companies are building new factories simply to increase efficiencies and enhance productivity.

• We own a few companies that are making strategic asset acquisitions. These include XTO Energy, which has very successfully expanded by purchasing domestic oil and gas properties, and a few other companies that make smaller acquisitions and increase the profitability of these new divisions with superior management.

There are several cases among our stocks where management has recently initiated dividend payments, and we have seen a growing pattern among our investments of expanding dividends at a rate faster than earnings growth. Finally, there is the special case of the large $3 per share payout of excess cash by Microsoft. Along with this one-time event, Microsoft has also committed to increasing its dividend regularly and purchasing its own shares.

We like the balance of intelligent uses of increased cash that we see among our companies. Our clients should benefit from the growth of these businesses, both through long-term appreciation reflecting growing earnings, and through the sharing of these profits in increased dividend payouts.

We are excited to announce that Saybrook Capital now has an address on the internet. Investors can now go to our website to find a summary of our goals and strategies, an archive of our quarterly 'Outlook' reports, biographies of our investment professionals, and updated composite performance. We look forward to further customizing this site to provide dynamic access for current and prospective clients. Please visit us at: ***www.saybrookcapitol.com***