Saybrook Capital
Investment Review

December 31, 2003

At the start of a new year, it is constructive to discuss potential equity returns going forward for the near term (2004) and the longer term (2005-2009). We have expended considerable time and thought on this project, as we believe it is an important exercise to examine the major variables that influence the returns for both of these periods. Realizing that forecasting is, of course, a humbling activity, we feel that the value in this project comes from examining and combining the variables more than in the precise projected outcome.

2004

The end result for equity performance in the current year is as uncertain as always in January. However, the major variables affecting the performance of the equity markets seem to us to be unusually clear: corporate earnings and interest rates. We have considerable confidence that the US economy is recovering in a strong fashion and that there will be a healthy increase in corporate profits this year. Moreover, interest rates are currently very low, and, in our opinion, price/earnings ratios for most stocks (especially if the technology industry is excluded) are reasonable. The dilemma for us in forecasting equity returns this year is just how strong corporate profits will be and when – not if – interest rates will rise. We anticipate a gain in S&P 500 earnings from $54 in 2003 to $62-63 in 2004 due to expected healthy growth in the economy and positive operating leverage for most corporations resulting from strenuous cost cutting in recent years. For some time, we have been forecasting a price/earnings range for the S&P 500 of 15-20x and have been comfortable with this range given the very low level of interest rates. A combination of mathematical analysis, historical precedent and qualitative judgment supported this valuation range in 2003. Assuming $54 in earnings for the S&P 500 in the year just finished, the S&P 500 index ended the year with a trailing valuation of 20.6x.

As 2004 begins, we are somewhat less confident in the appropriate valuation range for the benchmark stock index. This is largely the result of the uncertainty in upcoming interest rate trends. It is our opinion that, due to the combination of an expected strong economy, considerable fiscal and monetary stimulus, and the weak US dollar, there may well be an upturn in inflation during 2004. Even a modest rise from the current approximately 1% rate towards 2% would be enough to move long-term interest rates from the current 4.2% to close to 5%. Moreover, as it becomes clear that inflation has started to rise, we think it is likely that the Federal Reserve will begin to raise short-term rates from the present 1% towards 2%. There is a strong correlation between interest rates and price/earnings ratios, and we think that the combination of higher inflation and rising rates could deflate P/E ratios somewhat during the current year. We anticipate a valuation S&P 500 of 18-19x 2004 earnings versus the 20.6x valuation for 2003 earnings. This would restrain near-term appreciation despite significant growth in profits.

While we cannot be certain of how strong corporate earnings will be in 2004 or how much interest rates may rise, our best assumptions on these important factors and on valuation parameters lead us to look for only a modest increase in equity prices this year, perhaps in the 5-7% area. We would qualify this forecast of a fairly small gain in stock prices with two points. First, in the last few months of 2003 the stock market rose nearly 10%, which probably anticipated much of the healthy growth in corporate profits expected in the current year. Therefore, the modesty of this year's expected gains is paradoxically a result of the exceptional stock market appreciation of 2003. Another important factor to keep in mind is that a gain of 5-7% from equities will likely exceed the returns of the other common investment alternatives, cash (where the yields will probably be 1-2%) and fixed income. The investment return from the latter asset category in 2004 could be negative to flat if interest rates rise as we expect.

The current year could provide better equity returns if earnings per share growth is even stronger than anticipated or price/earnings ratios stay higher than rising interest rates might justify. This could be caused by increased demand from both individuals, who are beginning to return to the stock market, and institutions, which are required to add to under-funded pension plans and are rebalancing assets from fixed income to equities. Another factor, which could influence the stock market rise in 2004, is the possibility that the economy follows a normal 3-4 year cycle of growth. This has been the most typical pattern for the US economy and it would suggest further earnings growth into the middle of the decade that would support additional equity appreciation. On the other hand, results in 2004 could be lower if interest rates move higher than we anticipate or geo-political risks rise. For the time being, however, we are assuming modest gains in equities in the current year, but returns that are superior to the financial alternatives.

Long-Term Common Stock Returns

An analysis of equity returns since the 1920's shows that the total annual return for common stocks has averaged 9-10%. However, there has been considerable debate since the recent bear market that such favorable results may not be achieved in the future. There are a few well-known scholars and some stock market strategists who are forecasting significantly lower investment returns for equities in coming years.

The table shown below reports the annual investment results for our consolidated accounts over four different time periods (1, 3, 5 and 10 years).

Investment Results for Consolidated Saybrook Capital Accounts
(total annualized return)

	1 yr	3 yr	5 yr	10 yr
Total Portfolio	24.3%	4.1%	5.5%	12.4%
Equities Only	27.1%	5.2%	6.6%	13.9%

There clearly was a wide range of annual returns during this period. Certainly,the ten-year number is more representative of the long-term results because it smoothes outthe single-year ups and downs that occur in the stock market. Rather than just rely on historical performance, it is worth analyzing the variables that make up long-term equity investment returns in the context of current conditions. This enables us to make a reasonable estimate of what an investment in common stocks could return over a multi-year period. We won't sustain the suspense any longer. We believe that the broad US stock market can still produce an annual total return of 9%. Here are the components of this estimate:

Model for Estimating Long-Term Annual Total Return From US Common Stocks

Estimated Annual Rates	
Population Growth	1.5%
Worker Productivity	2.5%
Real Gross Domestic Product	4.0%
Inflation (range of 2-4%)	3.0%_
Gross Domestic Product	7.0%
Growth in corporate revenues and profits [1]	7.0%
Market Appreciation [2]	6.5%
Dividend Yield [3]	2.5%
Total Return from U.S. Common Stock	9.0%

1. Assume that corporate revenues grow in line with US GDP and that profit margins for total American industry remain constant.
2. Assume price/earnings ratios decline moderately from year-end 2003 as interest rates rise gradually.
3. Current yield is 2.0%. We assume managements will increase dividends more rapidly than earnings due to new lower tax rates on dividends.

We believe that this is a good working hypothesis, albeit over-simplified, of what will make up long-term equity returns in the United States. We know from history that annual results rarely are in line with these long-term averages. The gains in 2003 were clearly above trend. Moreover, Saybrook Capital's investment record over 26 years suggests that good portfolio management can earn a long-term return somewhat higher than that of the broad stock market.

The final point to note when examining potential multi-year investment results is that the annual returns (+8-10%) we project for common stocks over a number of years will probably be significantly superior to those available from fixed income securities or cash equivalents (5-6% and 2-4% respectively). Therefore, despite the partial recovery from a three-year bear market and the very strong gains achieved in 2003, we continue to believe that common stocks are the preferred investment in today's financial markets.