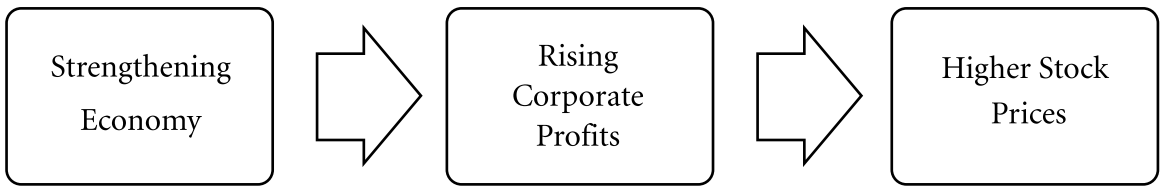
Saybrook Capital
Investment Review

March 31, 2004

Since late in 2002 our outlook for the equity market has been based on a simple, three-part paradigm, which we show in the diagram below:



We foresaw a recovering economy after the recession of 2001, which had been caused by a steep decline in the overvalued stock market and the negative economic reverberations that resulted from the September 11th terrorist attack. We believed that fiscal and monetary incentives, along with the traditional resilience of the dynamic domestic economy, would lead to stronger economic conditions sometime in 2003. We anticipated that more buoyant economic activity would produce increased business sales, positive operating leverage, and sharply higher corporate profits. Based on our expected earnings recovery, we believed stock valuations were quite reasonable, and we expected higher stock prices to follow from a healthier economy and rising corporate profits. In 2003 the model worked.

The upturn began gradually, but by late last year consumer spending and industrial production had moved to high levels and the gross domestic product began a sharp recovery (+8% in the third quarter; +4% in the fourth; and estimated +5% in the 2004 first quarter). Moreover, business capital spending had begun to improve and exports of U.S. goods were stimulated by the decline in the U.S. dollar. This widespread strength in economic activity, in turn, led to accelerating corporate revenues. Since most businesses in the last few years severely restrained their expenditures, the upturn in volume that began last year has been leveraged into sharply higher profits. After declining meaningfully in 2001 and remaining weak the following year, corporate profits (as measured by the S&P 500) rose 16% in 2003 and are expected to increase at least another 15% this year to reach a new record level. Of course, the third part of our model was clearly fulfilled in 2003, as improving earnings and a small increase in the stock market price/earnings ratio led to a 26% climb in S&P 500 equity index.

We believe that this simple paradigm will continue to operate this year and possibly for a few years into the future. The first two components (a growing economy and rising corporate earnings) are still solidly in place. A number of factors are likely to keep economic activity strong. Both lower taxes and moderate interest rates should continue to stimulate individual and corporate expenditures. Consumer activity may slow somewhat after the benefits of tax refunds and significant home mortgage refinancing diminish, but the recent upturn in new jobs should help maintain healthy personal spending. Confidence in the recent positive employment trend is strengthened by the sharp upturn in help-wanted ads in the last two months. Business spending is also finally showing significant life, as a wide range of companies has reported an acceleration in their operations. Several of these (e.g. UPS, 3M, and GE) serve a very broad spectrum of the economy, and their reports of higher sales volumes indicate good breadth in the upturn of economic activity. The economic growth of major Asian nations (Japan, and particularly China and India) bodes well for U.S. exports. While much of Europe seems to be having only a moderate business upturn, there appears to be enough worldwide growth to encourage discussion of a "synchronized global recovery".

Two possible restraints on U.S. economic expansion are elevated energy prices and early signs of rising inflation, which could lead to higher interest rates. We believe, for a variety of reasons, that energy prices may stay higher than in past cycles. This would be good for that sector (as a result we have purchased our first oil and gas stock – XTO Energy – in some time), but it should not slow the economy significantly. Energy costs are a lower percentage of total economic activity than in earlier decades, when there were several painful upturns in prices. Moreover, in inflation-adjusted terms, oil and gases are well below their levels of the 1970's and early 1980's (two other periods of high energy prices).

Concerning inflation, certain raw material prices have risen sharply. However, because these costs make up only a small percentage of the total price of purchased goods, we think that overall inflation should stay under control. We do expect the Federal Reserve to begin raising interest rates by the end of 2004, but probably not to a level that will sharply restrict economic output in the next 1-2 years.

Stronger economic activity (consumer, business, government, and exports) is producing increased sales and higher corporate profits. Businesses are benefiting from higher productivity, rising profit margins and better earnings on overseas sales. Companies are reporting rising profits and many are raising their forecapricsts for future results, as economic activity in 2004 expands. We mentioned the expectation of 15% earnings growth this year, and we believe that profits should continue to rise at close to the long-term average rate of 7-10% in 2005. Of considerable importance, the quality of corporate earnings has distinctly improved. Companies are recording fewer extraordinary write-offs, so that reported profits are a better measure of real corporate activity. Moreover, rising earnings are being turned into higher dividends, which are an additional stimulus to stock prices. At this time, we expect a sustained expansion of the economy and further growth of corporate profits to continue through this year and 2005.

Corporate profits are but one, albeit important, contributor to equity market performance. How investors 'value' these and future earnings is the ultimate determinant of the price of a stock. The price of the S&P 500 index is currently 18x its expected 2004 EPS (its forward P/E is 18.2x the $62 consensus EPS forecast). This valuation is high relative to the long-term history of the index, which averages in the low to mid teens. On the other hand, it is low relative to the recent five-year period of 1998 through 2002 where it averaged 25x. Interestingly, over the last year this S&P 500 multiple has risen about 7% (from about 17x to 18x) – a far more modest rate than the price index has climbed. Why the discrepancy? In 2003, earnings grew at a rate nearly as high as stock prices.

The best way to determine a fair range for stock valuations is to compare the current period to a similar past economic environment. When we evaluate present levels of economic growth, interest rates, inflation, and other key indicators versus the period of the early to mid 1960's (another time when inflation and interest rates were quite low), we conclude that our current economic scenario can justify a similar valuation range of 15 to 20x forward earnings. Therefore, we think that the benchmark index is neither under nor overvalued at current levels. If valuations are able to stay in this range, with inevitable fluctuations, then we are confident that stocks can appreciate at the rate of their profit growth through this economic cycle.

During any period there are headwinds that could disrupt our three-part model, and today several tempests are threatening, both economic and geo-political. In the first quarter of 2004 a "perfect storm" of high energy prices, U.S. electoral uncertainties, and violence in Madrid and Iraq cut short the positive stock market momentum that had spilled over from 2003. The elevation of all of these concerns, in addition to forecasts of higher interest rates, will test the boundaries of the aforementioned valuation range, but it is progress in Iraq and the risk of further global unrest that bears the most attention. Geo-political pressures can impact the U.S. economy and corporate profits, but mostly on the margin in such areas as energy, travel, etc. Events that happen closer to home, such as the attacks on September 11, 2001, can derail an entire economic recovery. The more likely result of continued difficulties in the war or further terrorism is a rise in the equity "risk premium", which impacts how investors value companies' earnings, as opposed to the earnings themselves.

The existence of these headwinds can certainly impact valuations, and we think they could account for the aforementioned fluctuations within our multiple range of 15-20x. Under current known conditions, we expect this valuation range to hold, thus providing appreciation opportunities from current levels. It is the unexpected events, policies, changes, and rates of changes that could cause valuations to deviate from this range – either above or below. This is the true risk to our model.

Absent expansion in overall equity multiples, stock selection becomes the cornerstone to equity out-performance. Our "undervalued growth" strategy has two equal components. The first requires that we invest in companies with prospects for superior future earnings growth. The second ensures that we only buy those companies at undervalued levels. We can earn a respectable return as our companies deliver above-average growth in profits throughout the economic cycle. However, this return can be enhanced as investors reward our stocks with the higher valuations their growth merits, even as the overall market valuation. stays within its range.