Saybrook Capital
Investment Review

June 30, 2003

The most powerful stock market rally of the last several years almost perfectly coincided with the second quarter of 2003. The strongest quarterly returns since 1998 were made possible by a confluence of events that were neither expected nor discounted by the capital markets. The 20%+ return for the S&P 500 since March 19, came in three abrupt surges marked (in chronological order) by the following occurrences:

- Early April: The relatively quick end to the combat portion of the war in Iraq. Notwithstanding recent peace-keeping difficulties, the bloody street war in Baghdad never came to pass, therefore lifting a major uncertainty that had weighed heavily on the markets. The direct market impact of this conflict is largely over, but stocks would certainly benefit from a sustained drop in the price of oil.

- Late April/Early May: After at least 8 quarters of earnings disappointments, corporate profits were better than analysts expected for the first quarter.

- Late May/Early June: Despite Bush's initial proposal in January, investors were not expecting the level of fiscal stimulus delivered by the tax cut approved in June. In particular, very few people anticipated a reduction in the capital gains tax rate.

The challenge for investors is to determine how much of these new developments have now been discounted by today's higher stock prices, and what factors will continue to have impact over the coming quarters. Such a strong surge as we have experienced is not at all unusual. In fact it closely follows historical templates, especially 1974-75 and 1991. Stock rebounds in these two periods reveal that such a market move is possible at the beginning of a new bull market or, likewise, in the midst of a secular bear market. (There have been four 15% or more rises in the S&P 500 since March 2000.) So, clearly the study of historical patterns can only tell you so much about future trends.

In developing an investment strategy going forward, it is instructive to look beyond the catalysts of recent gains. While some near-term headwinds certainly exist, we feel there are several factors that could or will lead to a continued improved market over the next couple years. These include:

- Unprecedented global fiscal and monetary stimulus
- Better profits for US multinationals because of the weak dollar
- Rising earnings with improved quality
- Potential for lower energy prices
- Excess levels of liquidity
- Record low interest rates resulting in few attractive alternatives to equity

Many of these issues have been reviewed thoroughly in the financial press and in our past reports. However, a couple of these points have changed since the first quarter or have not received the attention they merit.

The recently signed 2003 tax bill is the most significant to investors. Unlike the 2001 bill, this cut is front-loaded for maximum near-term stimulus. Even accounting for the estimated $100 billion offset from higher state and local taxes, there is still $90 billion in federal stimulus this year alone. Beyond stimulating consumer and business spending (which ultimately determine the "bottom line" for GDP growth), the new tax laws will change the way assets are valued. The lower tax rate on dividends and capital gains will increase the after-tax return from equities for individuals. This should result in higher equity values, which would provide lower capital costs for growing companies. Likewise, the dramatic drop in the dividend tax rate could improve corporations' overall governance and particularly their use of cash flow, potentially making the corporate financial structure more transparent for investors. We believe investors have only begun to receive the benefit of these changes.

The 2003 tax law changes also impact our clients' portfolios directly. In addition to increasing the after-tax return for our taxable investors, lower capital gains rates also provide us somewhat greater flexibility to sell a stock that has approached its intrinsic value. These tax changes do not, however, alter the type of investment ideas, which we pursue. Saybrook Capital does not chase dividend increases or speculate on payout announcements, which seem to be today's 'tactics du jour'. But, by their nature, many quality growth companies possess a long track record of regular increases in their quarterly payout.

Another positive occurrence in the last three months was that corporate profits broke their two-year trend of over-promise and under-delivery. Recent earnings are not exceptional, but they have exceeded the expectations of Wall Street and corporations' conservative guidance. While energy company profits and currency gains have had a considerable impact, slight signs of broader revenue growth as well as operating leverage are encouraging. Investors should not (but might) be surprised if three years of cost cutting, layoffs, and other productivity gains lead to a better bottom line. Perhaps the more important development, although not fully reflected in the markets' gains, is the increase in the **quality** of companies' earnings. The much publicized gap between "reported" and "operating" earnings narrowed significantly in the first quarter, possibly signaling the end of the serial write-offs and other "one-time" charges that have negatively impacted investors' confidence in the equity market.

Attention should also be paid to growing liquidity that has the potential to positively influence equity markets. Aggressive monetary policy, record mortgage refinances, and tax incentives are serving their purpose of channeling cash into the economy. By definition, liquidity that is not absorbed by the economy is funneled into banks and capital markets. With money market rates approaching zero and bond yields at 45-year lows, equities are increasingly being considered the only viable investment option. Hedge funds attempting to shift from short to long positions and pension funds increasing their contributions and rebalancing towards equities could be other positive influences on stock prices.

While these factors increase our long-term convictions, there are several negatives that justify caution, particularly for the near-term. Even a bull market is often plagued by corrections of 10% or more. While in hindsight these drops make excellent buying opportunities, such periods can still be painful for investors. Today's bullish investor sentiment and low volatility demonstrate a complacency that is fertile for such corrections. The current market cannot be called overvalued, considering present low interest rate levels, but at the same time the compelling stock price multiples of March are no longer available. It is more difficult for investors to find undervalued ideas, and the stock market is more susceptible to a negative "adjustment".

The greatest potential headwind, however, is the economy and profits for the last half of 2003. Economists have been pointing to a second half recovery since the beginning of the year, citing the stimuli listed previously. The second half is no longer in the future, and every slight sign of economic improvement has so far been countered by glum warnings and data. On the other hand, economic data is notoriously hard to measure, especially at critical inflection points. All data are subject to revision, and many of the "headline" numbers, such as employment rates, are actually trailing indicators. The benefit of hindsight often presents a far different picture. 1992, for example, saw GDP growth initially reported in the 1-2% range, even though equity markets seemed to be discounting a stronger economy. Final revisions calculated that GDP actually grew around 4% in 1992, too late to help George H. W. Bush. You can bet that George W. Bush will do everything in his power to show a robust recovery by next year and not fall victim to his father's fate. Indeed, there are fundamental reasons why the stock market traditionally performs the best in presidential election years.

While much uncertainty still exists in the economy and for companies, we believe that the favorable factors outweigh the negatives. Accordingly, we have positioned our portfolio for an improving 2003-04 economic climate. Cyclical holdings in media and industrial sectors reflect our expectations of an economic rebound, and the operating leverage that accompanies it. But the heart of our portfolio is made up of secular growth companies, in such sectors as healthcare, consumer, and finance. In a low inflation environment, everyone realizes the difficulty in finding companies with superior long-term growth prospects. As investors search hard to find growth, they become willing to pay more for companies that can deliver it. Whether or not the market corrects in the near-term, the steady type of growth stocks that we own should excel as investors look for predictable growth. This will enable Saybrook's portfolio to outperform in a market where steady growth is rare, as well as produce solid absolute returns over the next few years when the economy resurges.