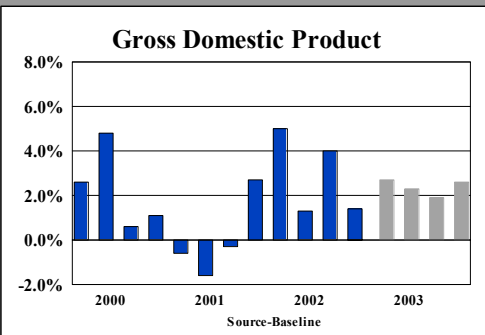
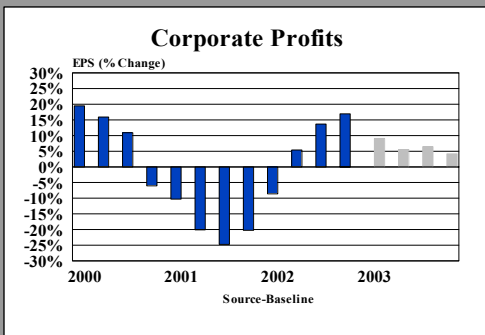


## First Quarter 2003 Highlights

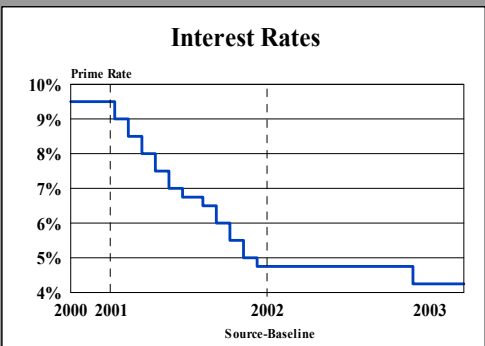
April 2003  
Issue 14



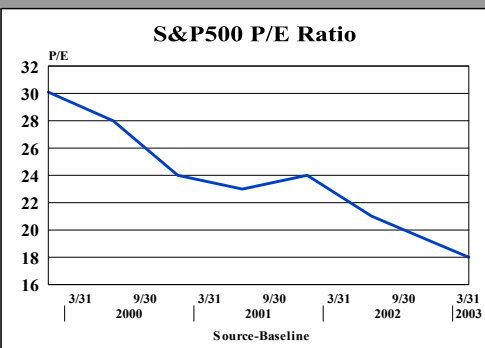
Economic Growth Remains Lackluster



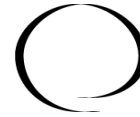
As Profits Are Trending Down Again



But There's Still Room For Rate Cuts



The Valuation Of The Market Remains Cheap



# OSBORNE PARTNERS

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## A Recovery Stalled

By Charles D. Osborne

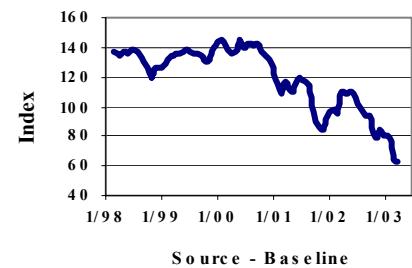
We usually write these economic pieces at the end of the quarter in order to review trends we saw develop in the last few months. At the end of this quarter war news dominated the markets and paralyzed commerce. Like others, we are concerned about the duration and effect of this war, but need to keep this all in perspective.

The foreshadowing of war in the first quarter and at the end of last year caused a national anxiety attack. Business and commerce slowed noticeably as managers and consumers hibernated, debated and procrastinated. Consumer confidence plunged and related spending on houses, cars and durables all followed. Business spending was already so low that the effect was less noticeable.

### CONDITIONS STILL IMPROVING

All this noise however cov-

## Consumer Confidence

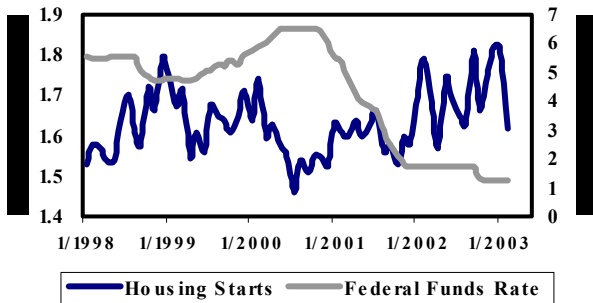


*“War talk frightens consumers”*

ered up the underlying economics of a recovery that was well underway. Recoveries by definition are sluggish and this one was exacerbated by the effective use of low interest rates and low inflation. It took the sting out of housing, one of the most volatile sectors of the economy, but it also took the pop out of the recovery. In a typical recession, housing starts fall through the floor. In contrast, during this period we actually saw above trend line growth. Hence, without a plunge in housing there was no spike in demand. The entire cycle was muted at the top and the bottom and the onset of the war has just extended the sluggish portion of the recovery.

Business expansion also slowed but the base was already so low that it was less noticeable. In fact, productivity in manufacturing has improved so much that any rise in demand was easily met. In addi-

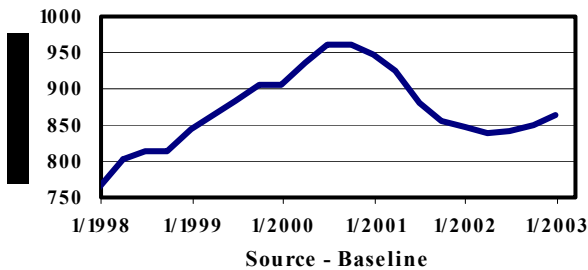
**Housing Starts and Federal Funds Rate**



*“Low interest rates fueled housing”*

tion, the normal replacement cycle of many products, which had been deferred, now is kicking back into gear. Finally, corporate profits have clearly hit bottom and are on the mend. Income statements are much cleaner (and more thoroughly scrutinized) and balance sheets continue to improve.

**Real Capital Spending: Equipment & Software**



*“Business spending improving”*

**WAR SHOULD NOT DERAILED RECOVERY**

Wars on foreign soil typically do not negatively affect the domestic economy, only the threat of terrorism makes this war any different. Yet that threat was with us during the start of the recovery, and will unfortunately be with us for some time to come. In our opinion, people are adjusting to this threat and moving on with their lives. Of course if another horrible attack occurs, we will be set back again. Still, it is human nature to want to have a better life while you worry about the immediate future.

**OPTIMISM NOT MISPLACED**

There are so many things that have gone wrong in the last

three years, and so many things that could go wrong, it is extremely difficult to be optimistic even long term. Yet it is important to remember in these times that somehow we always muddle through, and this time will be no different. Despite world wars, atom bombs and depressions, the world has not ended and our condition has improved. In the 1930’s and 1940’s we had a depression and a world war, yet after the dust settled the economy recovered and life improved. In the 1970’s we had an oil embargo, a presidential resignation and a recession that makes this one look like boom times. Capitalism and open trade have proved to be the best systems, and democracy the best form of government. This is not to say that our problems will go away, but that over time an optimistic view is the sensible one.

**What Everyone Knows Isn’t Worth Knowing**

*By Justin W. McNichols*

As the market falls for the most prolonged period in modern history, what do you hear and read from the media? A laundry list of reasons why the market will continue to fall for years. “Corporate profits are down”; “Consumer confidence has plummeted”; “Another CEO is indicted for failing to pay income tax on his Francis Bacon painting”; “Strategist Mr. X from firm Y says the market can go down 50% more.” Near each bottom, there is so much of this negativity that the belief is it’s different this time, and the market will never appreciate again.

When the market rises for a meaningful amount of time, what will you hear and read from the media? Another laundry list of reasons why the market will rise precipitously for the foreseeable future. “Corporate profits are up”; “Inflation and interest rates are low”; “Strategist Mr. Y from firm X says the market can go up 50% more”. Near each top, there is so much positive news, the prevailing thought is: Why would anyone trim stocks when everything is so good? All of the day to day news is excellent, your portfolio acts well, and maybe you are thinking a Francis Bacon painting is in your future.

Humor aside, this is the way the stock market functions. It is the only “market” in the world where the store is crowded when prices are high, and empty when prices are low. Unfortunately, most investors fail to look forward, and base their decisions on information that is known by all.

So how does one combat these incessant fears at the bottom and exuberance at the top? The concept is simple, but mastering it is difficult. The concept: Remember how you feel at extremes. When the market falls for an extended period, do you tend to worry, watch the financial markets less and less, and wish you were mostly invested in cash only to see the market rally days later? When the market rises for a meaningful period, do you wish you had more invested? Do you wonder why anyone would sell anything with all of these positive reasons to be in the market? Subsequently the market corrects. If the answer to any of these is 'yes', you are like 99% of investors. So how does the Investment Team at Osborne Partners combat these common feelings?

Although we are showered with news, earnings, rumors, and opinions, each of us has spent years conditioning ourselves to identify extremes. No one can call tops and bottoms...ever, but we know extremes when we see them. Human nature makes everyone feel like selling at bottoms and adding more to equities at tops. However, we have conditioned ourselves to act otherwise whenever possible. Additionally, we use many factual indicators to show us extremes. Some of the most useful are:

**The % of Bullish versus Bearish investors:** The simple idea is when the majority is bullish, everyone has already bought, so the market is likely to fall. The opposite is seen when the majority is bearish.

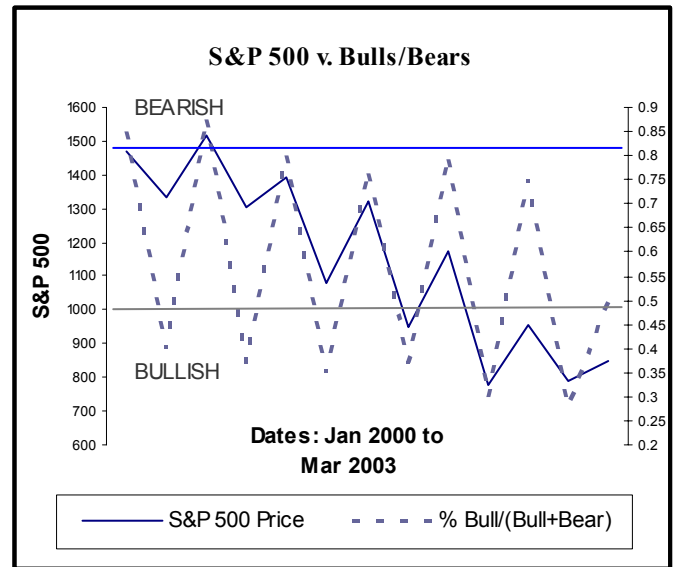
**Put buying versus Call buying:** Same idea – when everyone is betting the market will go down, it is likely near the bottom.

**Volatility Indices:** These show how much premium people are paying for put and call options. The higher the premium, the more anxiety, the closer to a bottom. The opposite is seen for low premium which shows complacency or an upcoming top.

**Cash levels:** The higher the cash level held by investors, the closer the market is to a bottom.

**Valuation models:** We manage and monitor two fact related models which give broad signals on market valuation.

The experience, conditioning, and indicators are not used for making grand market calls. They are used to avoid grand market mistakes. This is exactly the reason we strive to be fully invested at extreme lows, while trimming positions when the market is in the realm of expensive.



*The % of bulls versus bulls & bears combined (dotted) shows markets typically correct (solid) when most investors are bullish. Vice versa, bottoms are built when the consensus is bearish.”*

The synopsis is, we avoid emotional extremes by focusing on the data, and maintaining a long-term perspective. So the next time the “market” is having a 25% off sale and the store is empty, walk in and buy something. The market shows us time after time to look forward, because what everyone *already* knows is not worth knowing.

## The Paradox of Value Versus Growth

By Kirk Michie

**Question:** Which equity investment style is more effective: *Value* or *Growth*?

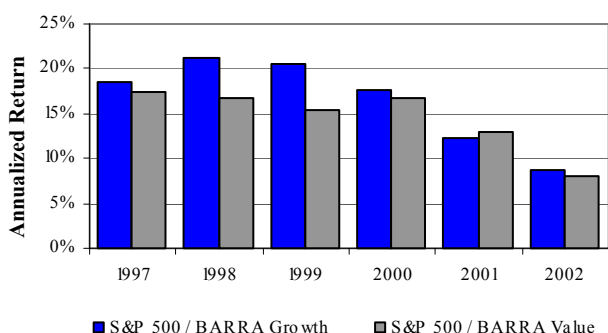
**Answer:** Yes.

In our judgment, they both work over time, and those investors should either choose the one that feels best to them, or combine the two styles in some strategic allocation. We’ll come back to that, however, after addressing a question that will have greater impact upon your investment success; How do I determine the most appropriate asset allocation or mix of investments?

Through time, determining the most effective mix of stocks, bonds, and cash to allocate among financial assets has proved to be far more important to successful investors than the choice of investment style. In the 1950's and 1960's, academics proved that balanced portfolios (those that combined stocks and bonds) meaningfully reduced overall portfolio risk – a notion that seems so obvious today that it barely receives much notice. This work was so significant at the time that it led, at least in part, to Nobel Prize awards for several of its early proponents, including Professor Harry Markowitz (City University of New York – Nobel Prize in Economics 1990), and his predecessor, Professor James Tobin (honored by the Nobel Committee for work in Economics in 1981). Through the next several decades, more work was done on Modern Portfolio Theory and Portfolio Choice. During the 1980's, financial scholars proved that over 90% of a portfolios return can be explained by its asset allocation, or its portfolio choices between stocks, bonds, and cash. While balanced investing theory continues to evolve and metamorphose to investors benefit, the Value versus Growth debate seems to generate more confusion than clarity. We believe that while any and all of these questions merit critical study, it is has been our experience since 1937 that paying close attention to the balance between equity, fixed income and cash is vital to investment success. We stick with larger companies because they're more stable and liquid, high quality fixed income to control risk, and maintain sufficient cash for opportunistic purchases and investors' liquidity needs.

So, which is better; Value or Growth? According to Callan Associates, Inc., a leading pension consulting firm, and the publisher of the *Callan Periodic Table of Investment Returns* (1983-2002), the rolling 10-year performance of Large Cap Growth and Large Cap Value are as follows:

**Rolling 10-Year Periods Ended**



Large Cap Growth tends to outperform Large Cap Value over longer periods of time, even through the difficult market environments of the past few years.

Clearly the better question is; what to do now? Our advice is simple. Focus on your mix of stocks, bonds, and cash – your overall asset allocation. Regardless of style, that is the best means to controlling risk and expectations for returns. Value has lead during the downturn based upon its defensive nature. However, Growth will once again outperform when the economy recovers. In our best judgment, attempting to switch back and forth over the years will more likely lead to disappointment and underperformance. Growth investing places a premium on better earnings and profit potential, and we believe that fundamentals are critical to long term success in investing. We believe that in the equity component of your portfolio, investing in companies with better fundamentals, and paying close attention to the prices you pay for those characteristics is the best methodology. That's neither Value nor Growth – that's just SMART.

## Update: The Market Versus Past Troughs

*By Justin W. McNichols*

As an update to the report last quarter, the table below shows how the Market today compares to the two most major lows of the last 20 years.

Variable	March Low	Gulf War I	'87 Crash
S&P 500 Index	789	314	240
P/E – Full Year Earnings	15.3 x	14.0 x	13.2 x
10 Yr Treasury Yield	3.55 %	8.20%	9.30%
Inflation CPI	2.2 %	3.0%	4.5%
Unemployment	5.8%	7.4%	6.0%
S&P 500 Last 10 Years	7.1 %	9.9%	11.0%

Although the media and sentiment say this market is never appreciating again, the facts tell a different story. Today's market measures favorably to past major market bottoms. Most notably, interest rates were over two times higher, while P/E's were only a couple of points lower.