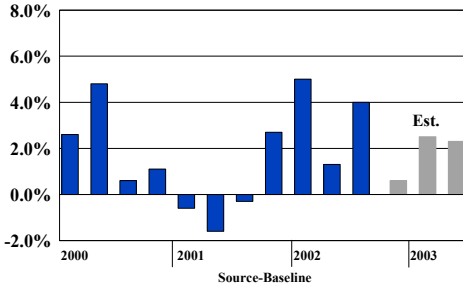


## Fourth Quarter 2002 Highlights

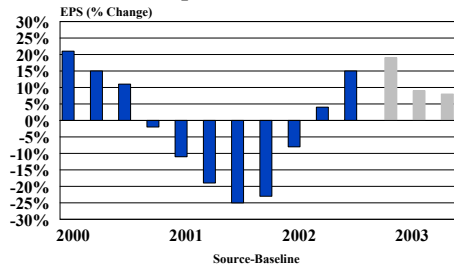
January 2003  
Issue 13

### Gross Domestic Product/GDP



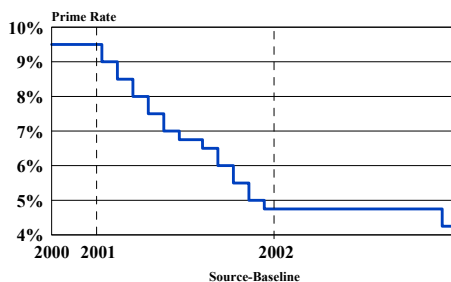
As The Economy Tried To Gain Its' Footing

### Corporate Profits



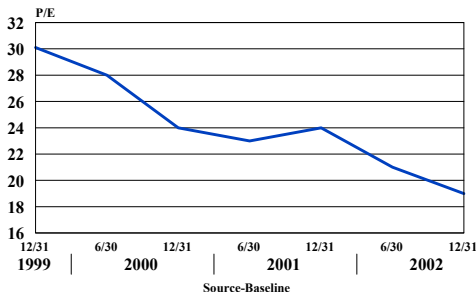
Corporate Profits Started To Improve In 2002

### Interest Rates

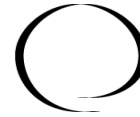


As Interest Rates Held At 40 Year Lows

### S&P500 P/E Ratio



While The Market P/E Continued To Fall



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## Adjusting to Shorter Economic Cycles

By Robert C. Gillooly  
&  
Justin W. McNichols

Since 1900, our economy has expanded and contracted 21 times. On average, the expansion periods lasted for about 3½ years followed by approximately 1½ years of contraction. Periods of very long expansions or very short expansions were rare. Then came "The Cycle". Beginning in March of 1991 and ending in March of 2001, the U.S. economy experienced its' longest uninterrupted growth spurt in 150 years. These 120 months of growth led to one of the greatest bull markets in history. There is an old saying in the investment business that 'a rising tide lifts all boats'. This certainly held true in the 1990's where a buy and hold strategy in the stock..

market worked almost without fail.

Besides a three-year stock market hangover, the new millennium has already given us a more sobering view about what a more normal economic cycle looks like. As we enter month 22 of an economic contraction, we have entered what some might call a 'growth recession'. This is characterized as a period when the economy grows at a rate under its' long-term capability. It also can mean uneven growth between industries and a lack of total commitment by business managers to ramp up their capital spending. Simply put, another ten-year expansion is likely to be decades away. After we recover from the expansion hangover, the next economic expansion should revert to a more normal three year duration.

During this next cycle, the stock market is likely to follow suit as analysts focus on less robust earnings peaks. So if the tide is not rising as high, more boats will be left behind. Portfolio managers will have to work harder for their returns and this often means more sector rotation, more trimming and

profit taking. This, in itself, may mean a volatile stock market for the foreseeable future but that does not mean there isn't money to be made.

Our strict discipline has basically been the same for the last 65 years – buy quality companies with higher growth rates, at lower valuations, with lower debt and great management teams. This will not change. However, we realize that a ‘buy and hold’ strategy we were comfortable using in a ten year expansion, should give way to a slightly more active strategy in a normal economic environment. Does this mean turning a portfolio over as much as the average mutual fund (over 100%)? Absolutely not. To us, this means regularly trimming and adding to core positions on significant rallies and shorter-term declines, while continuing to incorporate tactical positions to portfolios. Not only do we feel we can accomplish this without straying from our tax sensitive nature, but being more active will actually help stabilize a portfolio.

By changing our thinking a bit to match the environment at hand, an inevitable shortening of the business cycle, we feel we can continue to outperform our peers, and more importantly look out for our clients' best interests.

## Total Return Returns

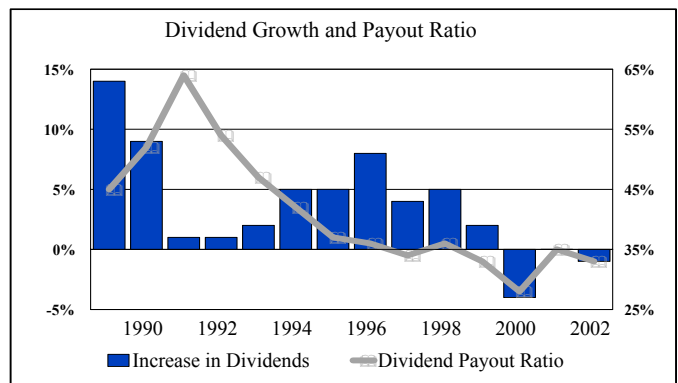
*By Charles D. Osborne*

We are excited by the discussion of making dividends tax-free. Contrary to our earlier belief that earnings could be put to better use, we now feel that some companies should be encouraged to pay out a portion to shareholders. A tax-free dividend would do just that. The change is based on our belief that the economy has slowed enough that total return, income plus stock price growth, over a shorter cycle will be required by long-term investors. There are also other reasons a dividend can support a stock price.

In today's world of low growth and low yields, the discussion of making dividends tax-free is more than welcome. Even without a favorable tax treatment, the concept of total

return from a stock portfolio is gaining favor. Dividends can support a stock price in weak markets and also keep management honest in all markets. Companies that are able to raise their dividends regularly, without crimping potential for growth, have always been attractive. One aspect that has limited their appeal is double taxation and this has allowed companies to find other things to do with earnings.

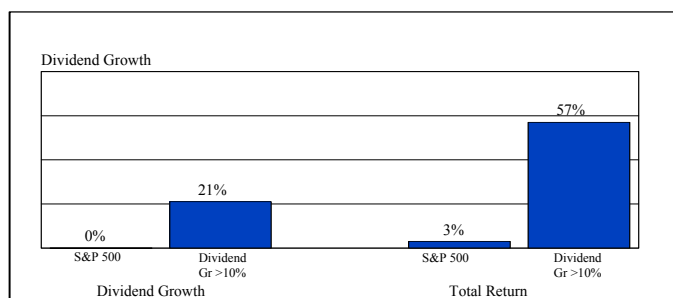
Dividends went out of style in the long growth cycles of the eighties and nineties. Analysts correctly pointed out that if companies bought back outstanding shares, the remaining shareholders would own a bigger portion of the pie. As earnings went up in these expanding times, so did stock prices. Dividends were fully taxed while capital gains only partially, so selling a few shares cost less in taxes than collecting dividends. Companies also used cash to reinvest in plants and equipment or buy other companies. These are still valid alternatives, but they are less attractive due to the slow growth and shorter cycles expected in the next few years.



We believe that economic cycles will be shorter than in the past twenty years and overall growth will be slower. We expect moderate consumer spending due to higher unemployment, smaller nest eggs, or the dysphoria created by terrorism and war. Added to this is an aging population that spends less, and a corporate culture that is not being encouraged to invest heavily in plants and equipment. These are the makings of slow growth. The stock market, as usual, is reflecting this outlook but there are rays of hope. More active position trimming and tactical purchases are one way of dealing with this, as discussed in the first portion of the Economic memo by Bob Gillooly and

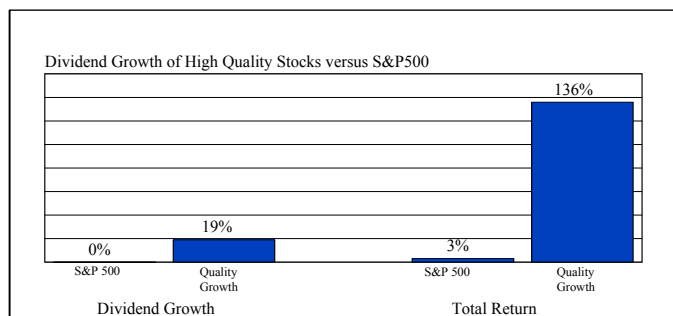
Justin McNichols. For the more defensive portion of a portfolio, we will look at stocks with good cash flow and the ability to pay out a rising dividend stream.

We are not advocating high yield stocks by any means. Most of those companies have little prospects for growth in good times or the ability to significantly increase their payouts. We still prefer quality growth stocks. In the upward portion of an economic cycle these companies will do well, and their stocks will reflect their rising earnings. **We are advocating companies that have the potential to significantly increase their yield from current levels.** It does not matter if a company has no dividend and \$40 billion in cash or if a small growth company with a tiny .5% yield, the rate of dividend growth over the last five years is the most influential factor. Many of the companies in our universe have these characteristics, and they will do very well under this scenario.



**Stocks that grew dividends >10% over the last 5 years, outperformed the S&P**

As part of this research, we looked at companies that actually raised their dividends by more than 10% a year, for the last five years. Of the almost four hundred names found, the average total return for the period was 56% higher than

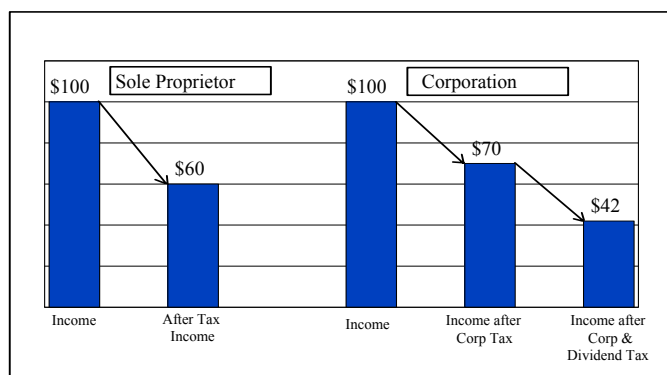


**Stocks that grew dividend >10% over the last 5 years, and met quality screens, outperformed the S&P**

companies that did not meet our quality growth criteria and found that in this same five year period these companies had a return 108% higher than the S&P.

The stock market has been so poor over the last three years; investors are looking hard at stocks. Management at some companies realize that the whole industry has been tarnished by a few greedy executives. They need to restore this confidence, which could be accomplished by turning over some of the cash flow to investors. After a period of issuing stock options that enriched management, shareholders could look forward to solid returns. Accounting issues would be more apparent if management establishes a payout ratio, the portion of earnings allocated to dividends, but did not carry it out. **You can fake earnings, but you cannot fake dividends.** This alone might encourage individual investors to come back into the stock market. On top of these fundamentals is the proposal to do away with unfavorable tax treatment of dividends.

There have been various proposals to eliminate the double taxation of dividends. The concepts have gained the attention of President Bush, thanks apparently to Charles Schwab bending his ear. They are now being presented as part of the tax cut economic stimulus program. There is a good chance of something getting done as even significant Democrats, such as John Kerry, back the proposal as being fair.



**The effect of double taxation on dividends for \$100 of income**

Right now dividends are taxed once at the corporate level as part of earnings, then again at the income tax level of

the shareholder. Owners of private entities, such as partnerships or closely held companies, that disperse all income only get taxed once on that income. This unfair treatment of double taxation is finally being addressed.

One plan regarding the double taxation would be to make dividends wholly or partially tax-free to investors, or they could be treated as capital gains. On a corporate level, dividends could be allowed to be taken as a deduction from income. This second method would actually cost the government twice as much, so it has less of a chance.

We like those companies that meet our growth criteria and still have the cash flow to start paying out a portion of their earnings in dividends. If you can get a 2% yield from a good quality company like Pfizer, when interest rates on Treasury Bills are closer to 1%, and that dividend is being raised regularly, then you are being paid to wait for the inevitable expansion. If those dividends are tax-free, then all the better. If the companies are solid and have good earnings potential in an expansion, then earnings will also drive the stock price up.

We are strongly encouraged by the discussion eliminating the double taxation of dividends. We feel the timing is perfect, as investors are seeking assurance from management that cash flow is real. In a low-income, low-growth environment, a little extra cash can come in handy. Those stocks that will do best in this scenario are not high yielding issues, as much as those with potential to grow their dividend regularly. We will seek to find these companies and add them to the more defensive portion of the portfolio.

## The Present Economic Situation Versus Past Troughs

*By Justin W. McNichols*

As we enter 2003, Osborne Partners decided to compare this economic low with the last two lows seen in the early and mid 1990's. Here are the results. Remember the comparison is versus economic lows after which the stock market rose 42% (12/31/91-12/31/94) and 110% (12/31/94-12/31/97) three years later.

Variable	Start 2003	Start 1995	Start 1992
S&P 500	875	460	330
Trailing P/E	18.5x	15.0x	17.4x
2yr Forward Earnings Increase	31% Est	32% Act.	37% Act.
10yr Treasury Yield	3.9%	6.0%	6.7%
S&P Dividend Yld/10yr Treas.	0.49	0.47	0.53
Inflation CPI	2.2%	2.8%	3.0%
Inflation Commodity Index	236	237	211
Unemployment	5.8%	6.1%	7.4%
Ave Hourly Earnings	\$14.30	\$11.40	\$10.60
Dollar Index	114.5	93.0	97.0

Presently, the P/E is slightly higher with far lower interest rates, a similar relative dividend, lower inflation, lower unemployment, higher hourly earnings, and a stronger dollar. Arguably, the market starts the new year in better economic health than past troughs. FYI, at the October 2002 low, the S&P500 traded at 16.9x.

## A New Addition To OPCM

Brett Prior recently joined OPCM as a Research Associate after relocating to San Francisco from New York. Brett attended Yale University and received a B.A. in Political Science and International Studies. Brett is also a CFA charterholder.



Prior to OPCM, Brett worked as a Research Associate at Fred Alger Management, a buy-side investment manager in NY. During his tenure in securities analysis, he has followed diverse sectors including: technology, healthcare, industrials, and energy. Brett enjoys sailing, snowboarding, motorcycling, and mountain biking.