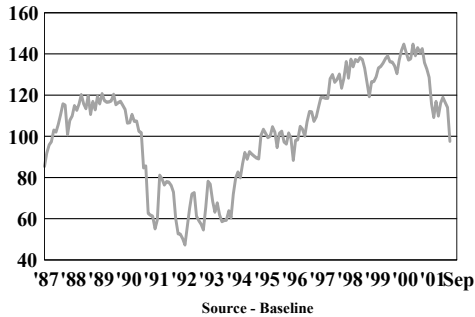


Third Quarter 2001 Highlights

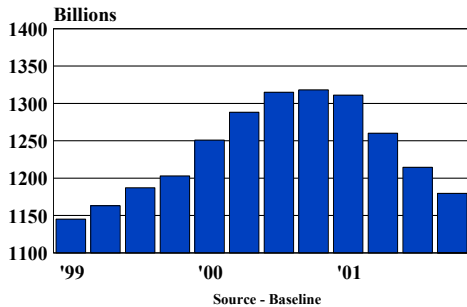
October 2001
Issue 9

Consumer Confidence



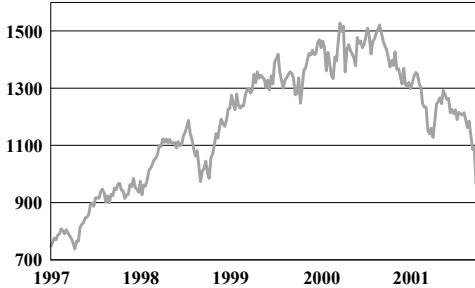
Consumer Confidence Continues To Drop

Capital Spending



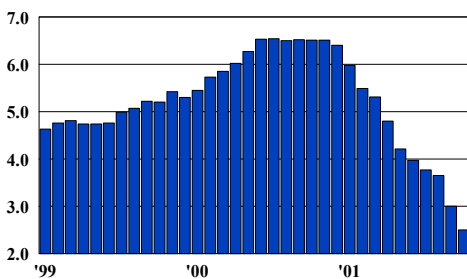
While Capital Spending Is Declining

S&P 500 Index



And the Market Lags

Federal Funds Rate



Despite Lower Interest Rates



OSBORNE PARTNERS

Capital Management

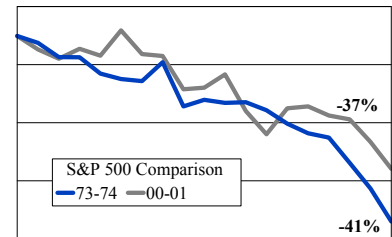
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A Perspective

By Charles D. Osborne

In two years we saw the market at dizzying heights only to be felled by a massive shift in capital, turmoil originating in the Middle East, and volatile oil prices. This all followed the threat of a presidential impeachment and preceded a recession. Consumer sentiment plunged. The years were 1973 and 1974, but the parallels are disquieting. The very similar drops in the current stock market leads us to examine if we are in for the same rough realignment of our economy. Back then was the beginning of an inflation cycle that lasted years. The problems today are different, but the market is indicating this period will also be as tough.

In looking back in time for some historical period where the market had fallen as much as it has recently, 1973 to 1975 immediately came to mind. The market dropped 37% from the peak during March 2000 to September



21, 2001 versus the 41% drop during 1973-74. The deepest recession since WWII followed that market drop, with manufacturing unemployment rising to 12% in 1975. Major institutions such as Penn Central faced bankruptcy, and our country went through a massive transformation dealing with inflation that lasted almost ten years.

CAPITAL SHIFT

After the end of the Vietnam War, our economy was very vulnerable. We had geared up for a wartime economy and the displacement of capital was evident. The end of the war meant soldiers coming home looking for work, and plants and factories idled as production shifted to peace time activities. Starting in 1998 our technology and telecom sectors went through the equivalent of a war build-up, first with the Y2K accelerated replacement cycle, then with the internet bubble. Billions of dollars of capital were poured into this sector. It

was like a wartime buildup except the capital did not come from the government, but investors.

The demand for telecom and technology equipment was enormous. First from the fear that our software would self-destruct on the date change to 2000, then with the hopes that a new economy had been born. We were wrong in both cases. The former never materialized and the old economy concepts, like profits, were still required to make investors happy. Orders for telecom and computing equipment and software disappeared. Businesses had accelerated their replacement cycle and the internet wipeout caused a vast supply of gear to be on the market. Inventories swelled at companies like Nortel and Compaq. The (war) bubble had burst, and as with every boom there was a bust.

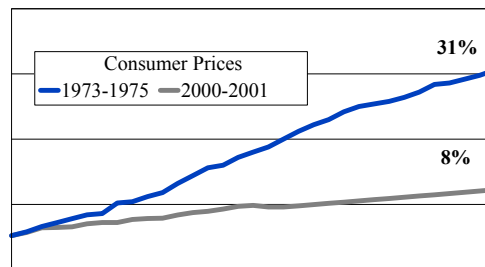
OUTSIDE FORCES

In 1974 the Arab Israeli conflict was shockingly brought home to us in the form of gas lines and spiraling prices. Americans were introduced to the acronym OPEC and oil prices were predicted to go to one hundred dollars a barrel. Our country went through a very expensive and long-lasting change in the way we dealt with and paid for energy. The increased security caused by the World Trade Center Attack will also be expensive and long-lasting. Where inflation was the problem in the seventies, deflation is the danger today. The short term shocks to travel, recreation, and retail industries added to the already weakened technology and telecom sectors and could cause a deterioration in employment beyond the predicted seven percent level. In addition, restrictions on travel and security could seriously dampen world trade. The gains we made with the fall of communism could be reversed. We did adjust to the energy problem over time, and hopefully the new security measures in our lives will be absorbed quickly. The damage to our psyche is another matter.

OUR DAMAGED PSYCHE

Just like those of us living in earthquake country where we know there is a possibility of disaster hitting us without warning, the people in America will eventually numb to their fear and get on with their lives. If, and this is a big if, there are no more attacks, we should start spending, saving, investing and moving about freely. The real damage done by accelerating inflation in the

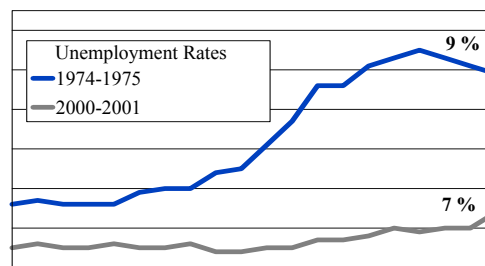
seventies proved to have had a bigger and longer lasting negative impact on consumer psychology.



On the political front, President Nixon’s resignation and the Watergate scandal were much more shocking to the country than Monica. The departure of Mr. Nixon and his key advisors left a huge void in leadership, while Mr. Clinton survived and the transition to Mr. Bush was interesting, but essentially smooth. The Arab-Israeli conflict seems never ending, and most likely will find even more ways to affect us. Perhaps the unified feeling of the world against terrorism right now may help resolve this aspect of the problem. Let us hope so.

CONCLUSION

We have a far better economy than we did in 1974. Unemployment is expected to peak at 7%, not 12%.



Interest rates are falling, not rising, and prices are stable. The threat of deflation is being dealt with by monetary and fiscal stimulus. There is no inflation to speak of, productivity is still improving, and corporate profits should recover in 2002. The internet bubble did not lodge its talons as pervasively or as long as the war buildup, and was not as dramatically abandoned. In fact, the internet and technology in general have become more pervasive in our lives, not less. The risk of deflation is real, but with our diverse economy, continued free trade and good leadership we should be able to avoid it.

Finally, it is noteworthy that after the big drops in 1973 and 1974 the market rose 35% in 1975, and closed near its all time high of 1000 again in 1976.

Sector Analysis In The Aftermath

By Robert C. Gillooly

As terrible as it may sound, in most major crisis' or events, there will always be companies that benefit from tragedies and countless others that will sustain a negative impact. It is now our job to try and figure out what the various short and long-term implications of this new economic and political scenario will be. Here are a few selected industries and sectors we think you will find of interest.

Technology:

Prior to the attacks, a consensus was building that the decline in technology capital spending may have hit bottom in the third quarter. After the quick falloff in our economy, it now appears that the losses this quarter and next may be much sharper than anticipated. Parallel to all other sectors, corporations are hurriedly trying to cut expenses to meet lower demand. What this means is, all non-essential variable costs will be closely examined.

Near term emphasis will be placed on companies re-evaluating their systems to ensure that in the event of a business disruption, they have redundant capabilities at alternative locations. Businesses will also need to invest in core technology needs until the next growth phase begins. Until that time, the longer companies wait to spend on the necessary technology to take their business to the next level, the greater the chance the tech sector will undergo a sharp rebound to make up for lost time.

Finance and Insurance:

Though the attack meant to strike at the heart of our financial system, its relative impact will be far less than one might expect. The securities industry is likely to feel a setback because of the further delay in IPO's and other investment banking revenue. In the short run, it is possible that the heavy trading volumes we are currently experiencing may help offset their woes, but not nearly enough to cover for the investment banking side. Past history has shown us that often the best time to buy these stocks is in their darkest hour.

Insurance companies will have billions of dollars to account for in many areas, but this industry is so vast in our country that it should be able to absorb the costs without permanently damaging their balance sheets. In fact, 2002 could be good for these companies as they are likely to increase their premiums and perhaps offer new types of coverage for future attacks of this nature.

Retail:

There are a lot of question marks in this area. Retail stores did not do well in the days following September 11th. Americans were glued to their TV sets, so it should come as no surprise when literally almost every retailer reports third quarter earnings below expectations. The question remaining is, how much has consumer confidence been damaged and when will people begin to shop freely again? Current expectations for the Christmas season are already so low, it will not take much for some retailers to surprise Wall Street with some better than expected numbers.

Energy:

So far the attack is having the opposite affect on oil prices that the Persian Gulf War had. There are concerns about the availability of oil if a full-scale war develops in the Middle East, but Afghanistan is not Kuwait. Afghanistan does not produce much oil, nor does it block access to oil areas. Right now, the demand side is much more important. As our economy may be slipping into a recession, there will be a ripple effect throughout the world. A less robust economy in the U.S. and abroad will translate into softer demand for energy as companies cut their production. The price of oil is always volatile, and may remain so until we get a better picture of the changing conditions for the world economies.

In conclusion, as we look further out, the recent decline of the market has brought on very attractive valuations to selected finance and technology companies. It may be too early for their fundamentals to turn positive again, however, it may be right around the corner.

Where Is The Bottom?

By Justin W. McNichols

As I write this, the U.S. stock market has just experienced its worst one-week period since 1933. After a poor year in 2000 for stocks, 2001 is rapidly becoming the worst year in the history of the stock market. Year-to-date the S&P 500 is down over 27%, the Nasdaq is down over 40% two years in a row, and the average large-cap growth fund is down 34%. So where is the bottom?

Obviously this is very difficult to predict, however, history shows us a few facts that can help us gauge whether we are close. By studying the length and magnitude of previous downturns, we can see how the present one compares. Next, by comparing present investor sentiment with recent history and past bear markets, we discover where we are on the sentiment spectrum. Studying today's market valuation versus other periods is another useful exercise. Finally, reviewing past downturns can indicate the best course of action to take after a market has fallen by this amount.

Length and Magnitude. The last four bear markets dating back 30 years had the following characteristics: Each averaged down 28% for 17 months; the longest was 30 months (1980-2); and the worst drop was 47% (1973-4). The '2000-1' Bear has reduced the S&P 500 by 39%, and we are beginning month number 20.

Sentiment. Markets never bottom on good news. All bottoms are made at the point of worst fundamentals, terrible news, and the highest amount of pessimism or bearishness. Presently, mutual fund redemptions are very high, put option volume is near a record high, and the number of professionals who are bullish has fallen to 28% from 61% in January. Previous bottoms have been made during awful stock fundamentals, and professional bulls as low as 20%.

Valuation. An area where arguments arise everyday. The S&P 500 trades at a P/E of approximately 19x forward earnings versus over 30x at the April 2000 market peak. Past bear markets have bottomed between 14x and 19x, however, all bear markets are different. In many ways, our present economy is stronger than economies in all other bear markets. We have low/no inflation, low interest rates, low unemployment, no banking problem (1990-1), no energy crisis (1973-4), and the balance sheet of the consumer is in fairly good shape.

Concluding Analysis. With the S&P 500 at 966, it would seem that we may be within 0% to 10% of a bottom for Length and Magnitude, within a few weeks to few months for extreme pessimistic Sentiment, and within 0 to 5 P/E points (0-100 S&P points) of a valuation bottom. Based on history, the market is far closer to a bottom than a top.

Best Course Of Action. The final calculation I made was the following. On average, the S&P 500 was 78% higher exactly three years after a bear market bottom. The worst performance was up 56% (1974 low to Oct 1977). So, even if the S&P 500 fell by 20% MORE before it reached a bottom, we should expect the index to be in the 1200-1450 area within three years, (25%-50% higher than today). The best course of action when the market is pummeled for an extended period of time has been to use a strict discipline, and be a net buyer of the best companies trading at historic low valuations. For the past 250 years, the U.S. economy has overcome every type of negative economic scenario that life could present. This period will be no different.

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