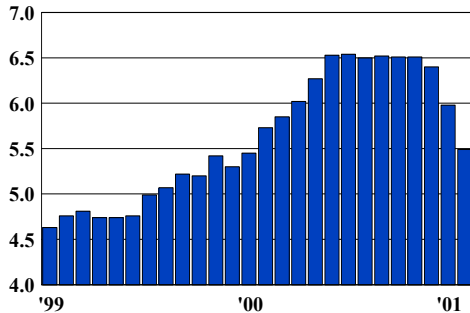


First Quarter 2001 Highlights

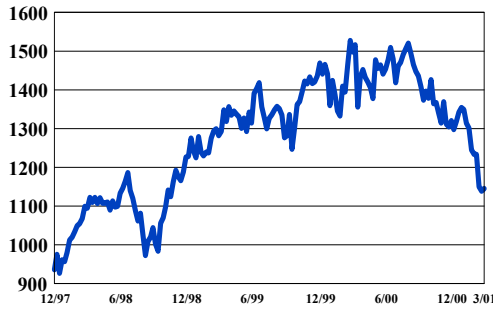
April 2001
Issue 7

Federal Funds Rate



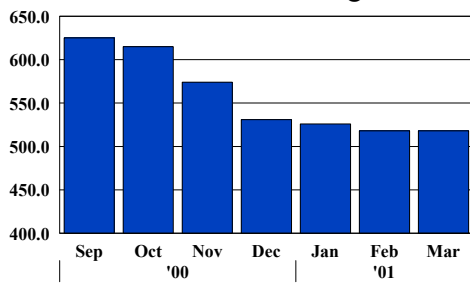
Interest Rate Cuts

S&P 500 Index



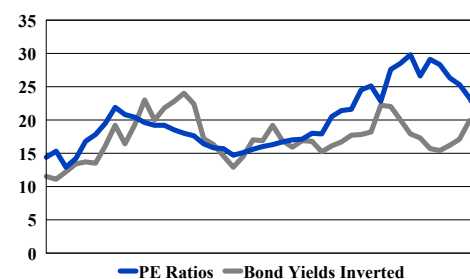
Didn't Inspire The Market

Dow Jones Est. Earnings 2001

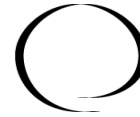


As Earnings Hopes Were Reduced

PE Ratio Vs. Inverted Bond Yields



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Economic Outlook

By Charles D. Osborne

The weakness in the economy is not fatal by any means. The inventory problems in the tech area will be worked out in time, and the panicky discussion of a recession needs to be examined a little more closely.

We have been reading quite a bit about the possibility of a recession. This is not surprising given the collective angst mentioned in our last report. A recession is hell on corporate profits, and without profits it is pretty hard to make money in stocks. So what is going to cause this potential recession? Consumer spending is over 60% of the economy and that is a good place to start.

We have heard that consumer spending will turn negative because:

- Confidence is falling
- The stock market has tanked and the wealth effect has reversed
- Layoffs at high tech companies
- Debt loads are unsustainable

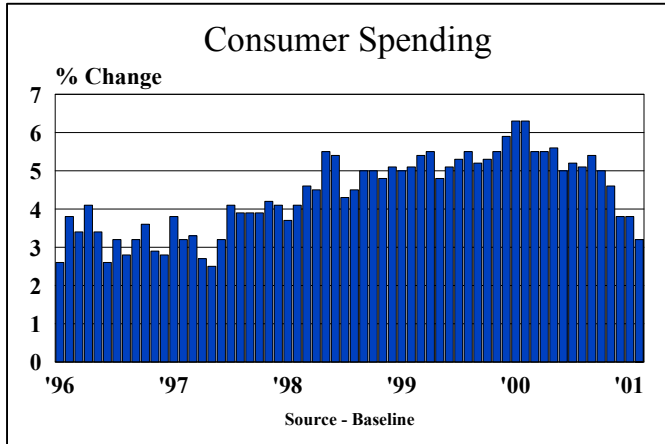
- Energy costs will sap pocketbook power

Beyond the consumer, the other possible causes for a recession are that Japan and Europe will detract from the U. S. economy due to their own economic weakness. Lower consumption abroad, means fewer exports by our manufacturers. In addition, a weak domestic economy will have a hard time attracting foreign investment.

Finally, the third scenario that will send us into a recession is that technology and telecommunications orders have fallen off the cliff, and appear not to be recovering anytime soon. By extension, the Internet bubble was all myth and no meat.

Of the three arguments, the only one that holds water is the last, and that has to do with an oversupply of inventory. Taken together or taken separately, each problem has a solution that either is in effect already, or will be discovered in time. Address them one by one and you will see what I mean.

It is true that the rate of increase in consumer spending is slowing down, but it is still rising. In fact, it will rise as long as there is full employment. That is the key metric, and it negates all negative arguments regarding spending. As long as people are working they



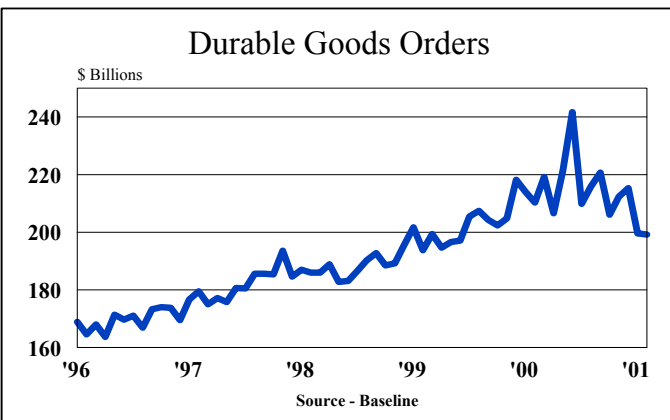
“Spending is still rising but at a slower rate.”

will spend their paycheck.

Confidence has dropped from peak levels, but confidence in the current environment is solid, and only future expectations are turning negative. The overall levels are still far above where we were in the last recession. Future expectations can also change very rapidly, in either direction.

The stock market has tanked and people are shaken up by it, but upon reflection we had a fabulous ride up. Long-term investors are still well ahead over a reasonable period of time. More importantly the correlation between wealth and spending is not nearly as important as income and spending. Our studies have shown there is a six-month delay before habits begin to change due to a change in wealth. Furthermore, the damage has been done in absolute dollars already. If the NASDAQ went to zero, less money would be lost than has been lost in the last year. That is as simple as the arithmetic can get, as the index has gone from 5000 to 2000.

Layoffs at high tech companies are of a very different



“Durable goods orders have a very high correlation with stock market returns”



“People are still at work despite well published layoffs.”

work force than in prior slowdowns. These are young, highly educated and mobile workers in an economically diverse area, and should be able to find new employment easily. They are not tire workers in Akron in 1974.

Debt loads as a percentage of income is high, but lower interest rates will help. If measured as a percentage of assets it is within normal bounds. Real disposable income is in normal ranges, and inflation outside of energy is in check.

Energy costs are killer, but people will adapt to them. We did in the 1970's when a gallon of gas quadrupled in price. Europeans changed their behavior and so will we. For example, in California high energy consuming companies will insist on peak period pricing over rolling blackouts so they can plan around it. Thermostats will be adjusted, alternative energy sources will be used, and consumption will moderate. People adapt, although it will be a good idea to know your grid number for planning purposes this summer.

As long as we are in a state of full employment then all consumer-spending arguments go away. A paycheck is more important than any other thing to a consumer. The correlation of wealth to spending is delayed and minor. People spend their incomes not their assets. We have full employment despite all the noise about layoffs. Debt loads are sustainable and energy costs manageable. Therefore, consumer spending may slow, but our guess is that it will be temporary and possibly insignificant. So what about the other reasons for a recession.

Japan has been in a stagnant phase since 1990 and they import less than \$65 billion of our goods. In our \$9 trillion dollar economy, that is not very much. The truth of the

matter is, Japan is just not that consequential to our economy. Less than 15% of our GDP is from exports to all countries and America will always get a good share of capital flow. Foreigners cannot afford to take money out of our Treasury Bonds or out of our corporate markets because our rates are better and our currency is more stable. We recognize that on the margin, much damage can be done, but not to the central force. The biggest problem is not the effect of world business on us, but the effect of us on world business. Which brings us to the tech and telecom area.

Tech and telecom spending has collapsed. Many companies are reporting that customer orders are being deferred indefinitely. Although the equipment or software may be desired, purchasing managers have held back due to uncertainty over the economy and oversupply of inventory. It is our belief however, that tech and telecom orders are being deferred not eliminated.

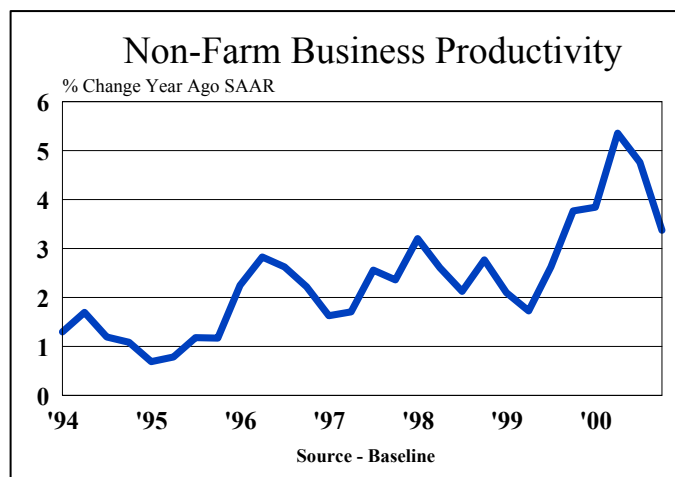
Spending on tech is often the smartest thing companies do with their money. Changing technologies and improving telecommunications are the future, and that has not changed. It is just a very fast moving pendulum. The inventory build-up for Y2K and the Internet bubble caused the pendulum to swing too far to one side. The speed of information made economic weakness apparent very quickly, and almost universally, purchasing managers pulled back. The collapse of the Internet created an inventory glut that may take two or more quarters to work out. However, lower interest rates, attractive pricing, and innovative products will eventually work their magic.

Much of the Internet use is free, and consequently companies couldn't make money. It seems obvious now why they went out of business. The next phase will most likely be paid services, or larger companies will incorporate the web as part of their overall strategy. Still, the early free flow of capital helped create many useful and exciting things. Most of us have now fully adopted the Internet in our lives and businesses. So even if the investments were a bust, and pulled down the whole tech and telecom sector, our lives have added a new dimension, and growth in this sector will resume.

For investors, corporate profits are the biggest worry. A drop in demand, coupled with rising labor costs, and fixed plant costs create a profit squeeze. The squeeze can be offset by improvements in productivity. However, these are step function improvements and the need to spend capital is a painful decision. You must first spend the capital to get to the next step of cost savings. In an uncertain time purchasing managers will defer the big decision and this

hurts capital spending. Consequently the company suffers through lower profits until they can afford the Oracle software or the new Sun server.

This is not to say that these problems are not painful, but it is to say that there is light at the end of the tunnel. The collapse in tech spending may well pull us into a recession,



“Productivity is still rising.”

but the fundamentals of our economy are solid. Unemployment is low, inflation is controlled, productivity is up, and world trade is accessible. We can restore consumer confidence with skillful leadership, a perception that the market has hit bottom, and a realization that people still have jobs. Lower interest rates and the diversity of our economy will help ease the pain. Finally, remember that the stock market tends to recover first and by as much as six months before any actual economic recovery.

When a new client transfers to our firm, the first thing our portfolio management team does is analyze their portfolio. In almost every case, the portfolio is in need of an upgrade to **DVD**. For us, the upgrade does not mean throwing

Upgrading from a VCR to DVD

By Justin W. McNichols

away the old VCR and replacing it with a new DVD player, instead, it means an upgrade in the portfolio's **D**iversity, paying closer attention to **V**aluation, and adding our time tested **D**iscipline.

When I wrote about **DVD** last quarter, the focus was on having a strict **D**iscipline that keeps our firm out of fads and manias, and in high quality long-term holdings. This quarter, the focus will be on analyzing a stock's **V**aluation in building our portfolios.

As recently as two months ago, equity strategists, analysts, portfolio managers, and even shoe shiners, were talking about how *cheap* technology stocks were. Why, because they were down so much. VeriSign was down from \$248, and could be bought for *only* \$80. PMC-Sierra was at \$248 and you could have had all you wanted for *only* \$100. Ariba was trading at \$175 and fell to \$42, what a great sale! 8 weeks later VeriSign sits in the \$20's, PMC-Sierra touched \$20, and Ariba freefell to \$5. The point is: A stock that is down (a lot) is not necessarily a value.

So when is a stock inexpensive, and how do we value a stock? We use two types of measurements in valuing stocks – Absolute Value, and Relative Value.

Absolute Value: If stock JWM is trading at \$20, and we feel JWM will earn \$1.00 per share in earnings, the P/E is 20 (20/1.00). On a historic basis, JWM has traded between 18-32 P/E. Since 20 is close to a historic low, JWM is deemed a value, meaning we will conduct our quantitative and fundamental analysis on the company. But is JWM stock really a value?

Relative Value: If stock JWM is trading at a P/E of 20 and the S&P500 is trading at 24, the Relative P/E is 0.83 (20/24). If historically, JWM trades between 0.40-1.00 Relative P/E, the stock does not look as cheap on a relative basis. Although Price/BookValue, Price/CashFlow, or Price/Sales, may be used for different industries like semiconductor equipment or media companies, we use absolute and relative value analysis for all industries.

By using Absolute and Relative Value, coupled with our quantitative and fundamental research, we have been able to avoid many of the cheap stocks that appear to be a value and then fall another 80%.

As news services report the stock markets daily ups and downs, they frequently refer to a category of issues know as the 'Blue Chip Stocks'. This leads us to ask what are these stocks they are talking about and what do they mean to us as investors?

What is a Blue Chip?

By Robert C. Gillooly

The term Blue Chip dates back to 1904 and is derived from the game of poker. The most valuable chips in a gamblers stack were the color blue, and hence the term 'Blue Chip' was created as an instrument of great value. Investment terminology derived from a gambling background is somewhat dis-comforting in this day and age, however, it turns out that the

literal translation this phrase that once represented 'of great value' still applies in the investment world (not to be confused with the gambling world).

Over the years the definition of a Blue Chip stock has changed somewhat. In the past, one might have assigned the following descriptive measures: consistent earnings; dividend paying; large companies; quality management and perhaps even less risky. Today many of the same principles hold true to these descriptions, but they have been adapted for contemporary times. For instance, dividends today are not used as much to reward shareholders; rather when a company repurchases it's shares, it increase the earnings per share and subsequently in theory, a company's stock price which then rewards investors.

As for being less risky, Blue Chips cannot fight the tide of a generally downward market, but their earnings risk is much lower. The volatility in their earnings pattern is far less than the general market and their balance sheet characteristics are better as well. It is also worth noting that after a big market decline, Blue Chips are usually the first to rise from the ashes.

After almost a century of investing, the common elements that today's Blue Chip stocks exhibit are wholly the same. A strong management team, the ability to weather an economic storm, a well-defined marketplace, and a brand name that has endured the test of time, all represent the characteristics of a fundamentally sound Blue Chip stock.

20th Century Blue Chips?

Technology: IBM, Xerox, Motorola

Food and Beverages: McDonalds

Retail: Sears

Telecommunications: AT&T

21st Century Blue Chips?

Technology: Sun Microsystems, EMC, Cisco

Food and Beverages: Starbucks

Retail : Home Depot

Telecommunications: Nokia