



From: Founders Capital Management

—2002: A Year on the Swing—

In 2002, investors experienced emotional swings in the stock market that sometimes left their stomachs in the air as the stock market continued its slide into a third straight year. As depicted in Norman Rockwell's picture, the theme of this year's letter is "The Big Swing."

This year's stock market activity reminds us of Mark Twain's words in *Pudd'nhead Wilson*:

October. This is one of the peculiarly dangerous months to speculate in stocks. The others are July, January, September, April, November, May, March, June, December, August and February.

Although the stock market had a negative inclination throughout the year, we recommend that investors keep themselves steady and focused on the future to avoid temporary motion sickness.

The discussion ahead centers on:

1. The relationship between portfolio performance and stock market movement
2. The importance of focusing on the value (vs. price) of a company
3. The concept of asset allocation and diversification
4. Assessing risk when allocating capital

PORFOLIO PERFORMANCE & MARKET MOVEMENT: Performance is Relative; Losses are Absolute

This unique time in investment history provides an opportunity to talk about short-term "relative" vs. long-term "real" performance, and to focus on what is truly "relevant."

While investors realized larger-than-normal gains in the late '90s, pundits increasingly expressed concern about growing expectations as the market tide rose to unprecedented levels. During this same time, there was much discussion about portfolio performance relative to market performance, and it was pointed out that most money managers were still under water when their results were compared to the S&P 500 index. Since the market tide has pulled back over the past three years, we feel it is necessary to switch gears and look at real performance.

If a money manager states that he has achieved a minimal loss compared to a stock market average with a cumulative loss of more than 40%, many investors would still frown. Why? Because *performance is relative; losses are absolute*. Someone who allocates capital can gloat over the fact that the “relative performance” of his portfolio is stellar compared to a drowning market, but the reality is that an investor is not likely to swim a great distance (i.e., increase his wealth significantly) with a “real performance” that has been barely treading water. During a year of prevailing investment losses, “relative performance” becomes a meaningless concept to investors, who will quickly point out what is “relevant”—*real performance that is associated with positive returns*. No one wants to lose his or her wealth. Of course, investors cannot have their cake and eat it, too. During years in which the stock market average outperforms a personal portfolio (even though both may display a positive return), it is all too easy to turn around and then point to “relative returns.”

The concept of what *seems* relative when investing (comparing returns, prices, risk, etc.) can become confused with what *is* relevant. A so-called relative comparison reminds us of The Dead Grandmother/Exam Syndrome pointed out in a satiric maxim by Mike Adams at Central Connecticut State University:

A student's grandmother is far more likely to die suddenly just before exam time than at any other time of year.

Just as relating the death of grandmothers to student exam time lacks real relevance, investors should be wary of seeking to identify irrelevant relationships between the performance of their portfolio and various indices.

Another area that seems to be relative to an investor’s behavior regarding stock purchases involves the ratings assigned to companies by “Wall Street analysts.” Wall Street is a “hemline business.” Just as in the fashion industry, moving the hemline up or down makes money. Wall Street is in the business of creating new ideas, repackaging old ideas, and selling them to companies and individuals who are compelled to do what is “fashionable.” To leverage the capabilities of a Wall Street firm, investment bankers will boast of their underwriting prowess, including their outstanding research capabilities. Investors should remind themselves of this “cat minding the canary” strategy employed by many Wall Street firms. The financial firms selling their ideas to companies are the same firms that place a rating on a company's stock, so everyone has a need to look pretty. It would be extremely unfashionable for an analyst to place a low rating on a company’s stock. This can impede the ability of the investment banker to gain lucrative underwriting deals from a company. Conversely, a high or elevated rating may provide the investment banker greater access to a company and position him to obtain deals where he was previously shut out.

For example, several years ago, a large media/Internet company was trading at around \$50 per share. In the midst of pursuing fees associated with one of the largest mergers in history, Wall Street analysts raised their projection on the stock to \$75 per share. The documented support for this future price was backed up by spreadsheets with more than 100 intricate moving variables (subscriber and advertising growth, etc.) projected out for a period of many years. Once these variables were run through the sausage machine, a financial model discounted all the projected future free cash produced by the business to obtain today’s supposed value. When manipulating many variables in a model, including the numbers to figure today’s value of future free cash flows, you can get just about any number you desire. This reminds us of Ben Graham’s words in *The Intelligent Investor*:

The more dependent the valuation becomes on anticipation of the future—and the less it is tied to a figure demonstrated by past performance—the more vulnerable it becomes to possible miscalculation and serious error.

Respectfully, we would like to add:

The more dependent the valuation becomes on multiple variables—and the less it is tied to a few identifiable key factors—the more vulnerable it becomes to possible miscalculation and serious error.

What was overlooked in this thorough analysis is the fact that several key variables, such as the demand for subscription online services and advertising, were much lower than what was predicted in the future. A highly competitive environment, plus a business model that was somewhat suspect from the beginning, led to a business value that is less than anticipated. Subsequently, the current share price fell to around \$13. Incidentally, as this merger deal was completed, one Wall Street firm that had been pounding the “invest now” drum and announced a \$75 price target for the stock ended up collecting more than \$60 million in fees from this same company it represented.

Many investors respond to an invitation to folly by relating the price of every stock to the analyst’s target, while ignoring the value of their own holdings. They perceive the stock market as a “gambling casino,” likening a good investor to the savvy poker player who knows how to read his opponents and play his cards right (i.e., buy low; sell high). These investors ignore company valuation and rational economics with the hope of catching a “greater fool” who will purchase paper at a rising price, or give them an opportunity to unload their paper before it falls to the floor. Under this scenario, the greater wealth of the seller is achieved by finding a “patsy in the crowd” who will pay a higher price for paper than it’s worth. This all-too-pervasive activity ignores Ben Graham’s fundamental definition of sound investing:

The allocation of capital which, upon thorough analysis, promises safety of principal and an adequate return, after taking inflation into account.

VALUE VS. PRICE: Investing Rules that are Relevant

We liken allocating and managing capital to driving a car, and paying attention to a few simple rules of the road:

Drive defensively:

Allocate and manage capital defensively to maximize the probability of arriving safely at your destination. This means you must understand the sensitive issues impacting the environment around you and adjust your driving to changing conditions.

Eliminate distractions:

When you’re behind the investment wheel, shut off the radio and cell phone to avoid blasting market programs and analyst calls that can interfere with good driving judgment.

Keep your eyes on the road:

Maintain a balanced view of the investment road. Do not try to look too far forward as you may lose focus on what is going on around you. Similarly, do not drive by staring in the rearview mirror, because anticipating the future solely by relying on what’s happened in the past is an

invitation to an accident. Rely on your senses, and constantly check the investment vehicle for surprises that could permanently damage your ability to move ahead and may interfere with creating greater value for the passengers riding with you in the investment vehicle.

When analyzing an individual investment, we seek a few simple insights that are relevant. First, on the financial side of the equation, we seek to *approximate* the intrinsic value of a business (not the precise price at which it is quoted), while at the same time estimating the current yield on a potential investment and the growth in this yield over time. Important ingredients to these equations are:

- the current and future profits for the business
- the capital intensity of the business
- the current and future cash available to business owners
- management's ability to allocate capital in a favorable manner to shareholders
- the current selling price of the business

(At this point, we remind ourselves that in financial circles, *quantitative analysis is necessary, but not sufficient.*)

Second (and this is the hard part), we isolate the important attributes of the business and ask three questions:

- What are the interesting prospects for the business?
- How predictable are these prospects for the future?
- What price are we willing to pay for the prospects inherent in the business?

An investor should be familiar with the company that interests him and should be comfortable with the industry, the company's competitive position, and the organization's management. An investor who is not able to assess these attributes should pass on the opportunity to allocate money to that business, since he does not truly understand the investment. Once an investor is familiar with a business, he should wait for its price to reach a "comfort zone" before taking advantage of a deal. The individual planning to allocate capital should ignore the ups and downs of the general stock market and remain focused on an interesting business to purchase. Then he should wait until a business's share price reaches a point at which the company is "on sale," i.e., selling at or near his price target. Purchasing a company at this point provides an opportunity to obtain a fair return on an investment over a long period of time.

Once we own a business, a key question that we continually address (regardless of the company's "price quote") is:

How is the company building value to create long-term wealth for its owners?

An investor should be far more interested in buying a business positioned for long-term growth in value at 10% per year (and willing to weather a short-term fall in share price) than in watching a business fall in value with the hope that a foolish investor will come along and bid up the share price by 20%. In the first scenario, the "real value" of an investor's holding is increasing, but in the latter situation, the "real value" of his holding is decreasing.

With all this investment knowledge (what we are writing about is not new), investors have a consistent desire to speculate—even in situations in which the company has a strong position in

its industry. In fact, it is our opinion that market volatility is becoming more prevalent as communication streams become faster and more widespread. Consequently, this growing environment of extreme volatility can provide a great opportunity for rational long-term investors.

An example of irrational behavior is evident in the trading of several companies over the past year. At the end of April 2002, PepsiCo was trading at around \$52 per share, which represented a market value of \$89 billion for the company (a company's market value is determined by the share price times the number of shares outstanding). Within a three-month period, PepsiCo was trading at \$35 and had a market value of \$60.5 billion. The appraised value of PepsiCo fell more than 32% in 90 days. Of course, an investor should question what material changes took place in 2,160 hours at PepsiCo that led to such a large deterioration in its market appraisal. If he looked at the company's prospects for 2002, he would have seen that very little changed. PepsiCo was projected to earn approximately \$1.90 to \$1.95 per share last year (a large portion of the earnings is cash available for owners), and will most likely grow its earnings at upwards of 10% in 2003. PepsiCo's Frito Lay division is growing pound volume at 5%, Pepsi's concentrate volume is growing at 3%, and the Gatorade/Tropicana division's volume is growing at 7%. Given these conditions, if a private negotiation for a 100% purchase of PepsiCo began in April, would the buyer have been able to negotiate a 32% reduction in price? Probably not.

We estimate the intrinsic value of PepsiCo to be north of its \$42 price quote (we don't provide an exact number, since various business analysts will arrive at different dollar values). At an initial investment of \$38 per share, a buyer is obtaining an investment yield of around 5.1% (\$1.95 earnings per share/\$38 market price), growing at 10%⁺ per year. It is our feeling that future prospects for PepsiCo's stable of powerful brands remains promising and fairly predictable. In this context, it is our opinion that individuals were offered an opportunity to make an investment in PepsiCo at a "fair" price. As a side note, the company is building wealth for shareholders: PepsiCo used \$1.9 billion of 2002's earnings to purchase 46.6 million shares of its own stock between July and October, 2002. We hope they continue to cash in the chips!

Clearly, we are interested in owning businesses that continue to grow in value, and our excitement grows by the day as we watch a SMALL number of new investment opportunities magically appear in a stock market with "still" higher-than-normal prices.

THE GREAT DEBATE: Asset Allocation and Diversification

The subject of asset allocation and diversification has incited great debate over the years and spurred the development of various investment models whose goal is to maximize returns while minimizing risk via "optimal" diversification.

The theory of asset allocation and diversification encourages an investor to spread his investments over several asset classes (stocks, bonds, real estate, etc.), and among numerous ventures within these classes to minimize his exposure to a large loss in any one area or security. While this theory has some validity, extreme adherence may continue to expose an investor to large potential losses. An overemphasis on the dual marriage of asset allocation and diversification reminds us of Aesop's fable:

The Man and His Two Wives

A man whose hair was turning grey had two wives, one young and the other old. The elderly woman felt ashamed at being married to a man younger than herself and made it a practice whenever he was with her to pick out all his black hairs, while the younger, anxious to conceal the fact that she had an elderly husband, would similarly pull out the grey ones. Eventually, between them, he was left without a hair on his head.

Investment moral: An investor who spreads his wealth too thin through a dual marriage to asset allocation and diversification can end up losing not only his hair, but his shirt.

Although asset allocation and diversification seem relative to investment success, the approach often fails to focus on what is relevant. Investors should again remind themselves: “Risk is relative; losses are absolute.”

It is our opinion that investors would be better off focusing on potential losses rather than on relative risk. An example of investors’ lack of focus on possible future losses is evident with this past year’s fleet to fixed-income investments. In the past three years, while average common stock investments have declined more than 40%, investors have chosen to “balance” their investment portfolios. Individuals who were weighted heavily toward common stock investments decided it was time to place their funds in fixed-income securities. The “new” thought was to obtain the highest yield while maximizing the safety of investment principal (what goes around, comes around). As “all individuals” chased a similar thought, bond prices have now risen significantly, exposing investors to an increased risk of loss.

Let’s consider an investor who bought \$100,000 of the 6.25% U.S. Treasury Bond at par (maturing in 2030) when it was issued in 2000. Since that time, the yields on Treasuries have fallen quite dramatically. In the early part of December, this security was priced to a 5.20% yield-to-maturity, which translates into a bond price of 115. With yields so low, the above-market coupon that this security pays has become capitalized in a higher bond value of \$115,000. Basically, the investor has an unrealized gain of \$15,000—pretty darned good in today’s investment environment. Like every good investment story, however, there is a downside. If interest rates rise, the price gains in this bond will diminish. If interest rates were to rise by 100 basis points over the next year, the bond price would drop about 12.5%; if rates rise by 150 basis points, the price would decline more than 18%. An inverse relationship between the movement of interest rates and the price change in bonds is clear to see: When interest rates rise, bond prices fall; when interest rates fall, bond prices rise.

As investors continue to seek the safety of bonds and then become disenchanted with a 5.2% annual return on a 28-year investment in treasury bonds, they will naturally chase higher-yielding fixed-income investments. This “momentum” activity will force investors to face a multidimensional problem due to the fact that interest rates have now fallen to the lowest level in a generation.

Seeking absolute safety of principal and interest will be difficult as a large portion of higher interest-paying bonds are currently below investment grade. Many investors have moved their money toward fixed-income investments under the assumption that “bonds” offer a guaranteed safety of principal, along with less risk than common stocks. Unfortunately, this is not always the case. When an investor purchases a fixed-income security, it must be with the knowledge that this allocation of capital will most likely produce a limited long-term return.

There are inherent trade-offs in every investment, including bonds. When investing in a company, the advantage that a bondholder has over the common stockholder is his prior claim on profits, along with a promise of principal payment by the corporation. A priority on the distribution of profits and promise of a return of principal *does not constitute a guarantee of payment*, however. This so-called priority on profits and promise of principal payment must assume that the corporation has the ability to produce earnings to cover its obligation. This concept is not too distinct from the common stockholder who has a subordinate claim on corporate profits. In either case, a thorough analysis must be completed on a company's financial state, earnings, and future prospects regardless of the security that is purchased. Given this fact, our view is that there are a limited amount of "quality corporate bond opportunities," and we will continue to be selective when allocating capital to these low-return situations.

The future of interest rates and bond prices remain suspect given the low yields obtainable on short- and long-term bonds. A AAA-rated corporate bond that matures in 2005 currently offers a 2.5% annual yield-to-maturity. This small bond return is less than the dividend yield (3.1%) on the common stock of this same company. This corporation also has a long-term bond that matures in 2032 that currently offers a yield-to-maturity of 5.8%. If low interest rates are a temporary phenomenon, and we return to the previous higher interest rates, then long-term bonds such as the one described could deteriorate in value by more than 20%. With this said, there is a possibility that low interest rates will persist for a very long time. When looking over a 30-year time horizon, however, it is highly probable that interest rates will rise from their current levels, providing the long-term bondholder with a potential loss that is not unlike the loss incurred in common stocks.

Inflation and the future value of a dollar impact the investor's "real return." Inflation has the largest impact on the long-term return for all types of investments. To an investor, the important return is the "real return" an investment produces. "Real returns" are determined by the extra purchasing power an investor achieves by placing his money at risk. Let's say you opt to reduce your family's consumption of bread by two loaves a week and place the savings into a high-grade bond. You decide to sell this security after five years, and buy more bread every week, as your family has grown. How would you feel if the investment allowed you to purchase only two additional loaves per week? (Or worse yet, only one loaf.) You certainly would not feel as if you had made any extra dough, since there was no "real return" from your investment. *At a minimum, to produce "real returns," an investment must achieve a rate of return that exceeds the rate of inflation.* To drive home this point: Suppose you decided to purchase the corporate bond mentioned above at a yield-to-maturity of 5.8% for the next 30 years. How would you feel about your investment if inflation slowly rose to 10% within the next decade? You would not feel like a real return exists on your original investment, as the inflation rate is higher than the yield obtained on the corporate bond. Although at this time the described scenario seems unlikely, a high inflation environment has existed in the past and will probably exist in the future.

In summary, our view on asset allocation and diversification can be seen as somewhat contrary to the norm. We allocate assets and diversify investments when the probability of an expected outcome is less than 100%. If we were absolutely guaranteed a 15% annual return for 20 years without any risk of loss (regardless of the asset class or security), we would advise making this single investment. But if we determine that there is only a 50% chance of meeting our expected investment outcome, common sense would lead us to identify several promising investment opportunities as a way to minimize our risk of not being correct. In the end, we may be somewhat agnostic between stocks and bonds, but the concept of risk is cemented in our minds

as we allocate capital to minimize our probability of loss while maximizing our probability of long-term, inflation-beating returns.

ALLOCATING CAPITAL: Assessing Risk vs. Return

Whether investing in stocks, bonds, or both, the relevant issue boils down to an assessment of risk vs. return. The investor faces many risks that can impact the return on an allocation of capital: Interest rate, credit, liquidity, currency, and volatility; as well as political and legal risks, just to name a few. There are three primary risks that we pay a great deal of attention to, however: Maturity risk, business risk, and management risk.

Maturity risk (in our worldview) is the length of time for which we expect to hold an investment. When we purchase any security, we acquire it under the assumption that we will hold it either until it reaches maturity (for a bond) or for a minimum 10-year period (for a common stock). Given this assumption, the previous example illustrates that we are extremely hesitant to accept a 30-year commitment to a corporate bond (or equivalent) that limits our long-term annual return to 5.8%. Although this return may seem high against today's low standards, the likelihood of interest rates rising between now and the next 30 years is almost certain, which would expose us to a potentially large loss of principal. We are not inclined to seek a small gain by betting that interest rates will fall further from this point (even though this could happen) while risking losing a great deal of principal if the tide moves against us and interest rates rise to normal levels.

Business risk involves an assessment of the spirited jungle in which a company must compete. The more competitive the environment, or the less stable a business, the greater the risk for an investor. We have a tendency to be attracted to companies that enjoy high returns on capital. However, competition is especially characteristic of industries with a high rate of return on invested capital as new money is magnetically drawn toward willing participants entering the race for high returns. This "chase" eventually drives down the return on invested capital to a rate common to an industry with a perfect competitive environment. For a company to avoid a diminishing return on its invested capital, it must fend off competitive forces that threaten its high returns. Thus, companies attempt to build walls around their business structures to ward off unwelcome competitors and to provide them an isolated environment in which to further nurture their business structure. We are constantly judging a company's competitive position and its business structure, preferring to participate in the acquisition of securities (both debt and equity) whereby the business is rather established and the competitive environment is somewhat stable over the long-term.

Regrettably, we must thoroughly evaluate **management risk**. In last year's letter, we refrained from pointing the finger at dishonest management teams that misrepresented themselves and the companies they led. We opted to address the fiduciary responsibility of the board of directors, focusing on the important role they play in overseeing shareholder interests. Given the increasing number of instances being exposed in which company management teams have pickpocketed shareholder wealth, the widespread feeling of mistrust among investors is understandable. Apparently, many top managers use "relative" pay packages, size of domain, and the importance of position as a determining factor for success. This ignores the "relevant" ingredient of management success—the character traits inherent in excellent leadership. Management should set the bar high with an unflagging commitment to complete integrity, honesty, sincerity, frugality, industry, and humility. They should ignore the temptations to abuse power and pursue the trappings of excessive wealth at the expense of employees, shareholders, and the community.

Sadly, management embezzlement of shareholder wealth is not new—it's just more pronounced now that the party's over. When market participants were getting giddy around the punch (wealth) bowl, and their paper wealth was increasing beyond their dreams, nobody seemed to mind management cutting to the front of the line for a free dip of the magic wealth potion. Investors should not turn a blind eye to management's desire to increase their wealth at the expense of shareholders and should watch for signs of abuse in executive benefits and compensation. In the current environment of greed and self-interest, we carefully review areas of company financial statements that provide management some discretion in accounting for earnings—pension fund assumptions, stock options, special purpose entities, etc.

The Practice of Arbitrage to Cover Risk

Our discussion on risk leads naturally to the topic of arbitrage. The word *arbitrage* initially referred to profiting from differences in price when the same security, currency, or commodity is traded on two or more markets. For example, an arbitrageur simultaneously buys one contract for silver in the Chicago market and sells one contract for silver in the New York market, locking in a profit due to the different prices for silver on the two markets. (The arbitrageur's selling price is higher than the buying price.)

Fundamentally, the arbitrageur takes advantage of disparities in the value of assets. His talent lies in the ability to recognize such disparities and to profit from the convergence of the different values. Popular sporting events provide a clear illustration of arbitrage: When the University of Connecticut plays Georgetown in basketball, you can usually count on someone selling \$25 tickets for \$50. Clearly, the individual who initially purchased many tickets for \$25 anticipated the sold-out game. When evaluating this situation, the person probably asked a few questions:

- How probable is it that the basketball game will be sold out?
- What will be the value of the tickets on game day?
- How far in advance must I purchase the \$25 tickets?
- What will the tickets be worth if the game is not sold out?
- What will the value of the tickets be if the game is canceled?

This arbitrageur analyzed the answers, determined that the outcome was very favorable, and realized a handsome profit.

As capital managers, we seek a margin of safety on our investments by attempting to be good arbitrageurs. We discipline ourselves to look for discrepancies in the short-term and long-term “value” of assets, and measure various risks, including the maturity, business, and management risks associated with each investment.

Let's move to several examples that illustrate our view on obtaining a margin of safety while conducting a proper assessment of asset allocation, diversification, and risk. In a world of textbook asset allocation, a financial advisor would propose a balanced mix of fixed-income and common stock investments. Within each asset class, a portion of the portfolio would be placed in the transportation sector. (Yes, this means an advisor would be recommending the purchase of airline stocks and bonds.) The theory behind this recommendation is to accept a high degree of risk within a small portion of the portfolio, with the understanding that several investments will turn out to do surprisingly well and more than offset the investments that deteriorate in value. *We believe this concept is severely flawed.* An investor should not knowingly allocate money to any situation in which the probability of losing wealth is extremely high.

Currently, there is an opportunity to pick up a Delta Airlines bond that matures in 2010 for 82.5% of par value, representing a yield-to-maturity of 14%. In concept, this would seem to be a very good deal. Delta is one of the stronger carriers in a weak industry and should be able to meet its long-term obligations. As long-term arbitrageurs, this 14% yield-to-maturity represents a large disparity compared with other bond yields offered with a similar maturity and credit rating. (Of course, we should not let Moody's or Standard & Poor's determine our investment decisions.) Our problem: The structure of the airline industry is loaded with risks—labor risk, management risk, business risk, etc. It is very capital-intensive and has a competitive climate that is close to legalized warfare. Since the whole airline industry has not made money since the Wright brothers took off at Kitty Hawk, what inherent changes are taking place that will ensure money is made in the future—for bondholders or stockholders? We feel there is a present danger of continued severe price wars as airlines are allowed to declare bankruptcy, only to emerge and place pressure on all industry incumbents who have to continue paying previous debt obligations. We will pass on this venture, and choose to violate several rules regarding perfect asset allocation and diversification. *“Our rule” is that the safety of a bond investment is measured by the entity's ability to pay, not by a property lien, special contract provisions, or the priority the security has in relationship to other issues.*

Flying to another destination, let's turn to a common stock investment whereby we feel the trade-off between risk and return is fair. Abbott Laboratories, incorporated in 1900, is principally involved in the discovery, development, manufacture, and sale of a broad and diversified line of health care products and services. From January to December 2002, the per-share price of Abbott Laboratories has fallen from \$55.75 to \$36.50, a decline greater than 34%. This is a larger decline than the general stock market and investors have watched the market value of Abbott Laboratories fall from \$87 to \$57 billion. Again, we should investigate any material changes that took place within Abbott Laboratories and/or the medical supplies industry this past year that led to a large deterioration in market appraisal. If we look at the company's estimated earnings for 2002, we would see that Abbott Laboratories will earn approximately \$2.00 to \$2.07 per share (a large portion of the earnings is cash available for owners), and will most likely grow its earnings around 8% in 2003. At an initial investment of \$36.50 per share, a buyer is obtaining an investment yield of 5.67% ($\$2.07 \text{ earnings per share} / \$36.50 \text{ market price}$), growing around 8% per year.

When we compare the trade-off of investing in a AAA-rated corporate bond over a 30-year term at a 5.8% yield-to-maturity vs. that of Abbott Laboratories common stock with an earnings yield of 5.67% that expands at 8% per year, an investor should choose the latter expanding yield. The expansion of a common stock earnings yield can provide the investor a long-term arbitrage opportunity. In 10 years, if Abbott Laboratories common stock price stayed at a “par value” of \$36.50, the earnings yield would be approximately 12.2%, represented by a growth rate of 8% per year. Although the price of a common stock can fluctuate greatly, we feel it is important for investors to preserve a rational view and maintain an outlook for an investment in common stocks similar to an investment in corporate bonds. We view an investment in common stocks in a comparable manner to an investment in lower grade bonds, both of which have a low priority on the claim of profits. The key measurement in both instances is the short-term and long-term profits (vs. the priority) that are available to the investor.

We are going to end on a reflective note. We do not know what the investing public will face during 2003 and have no prediction on the direction of the stock market. On the other hand, Abbott Laboratories can serve as a case study in long-term investing. From 1929 to 1932, Abbott fell from a high of \$12 per share to a low of \$4, showing a decline of almost 67% in four years.

Ten years after the crash of 1929, Abbott Laboratories traded at a high of \$72 per share. This is not a prediction of how a selected security such as Abbott Laboratories will act in the near term or grow over the next decade. It is important to emphasize, however, the significance of investing in businesses that have an ability to expand their value over a long period of time.

We view investing as an exercise in attaining the highest compounding yield over the greatest length of time, recognizing the importance of maintaining a margin of safety and protecting the principal on our original investment. This concept is cast in stone and will not change despite the volatile movement in the stock and bond markets.

Thank you for your support during a very difficult investment year. We wish you the best in the upcoming year and look forward to serving you in 2003.