Founders Capital Management, LLC
2004 Annual Report
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PRINCIPALS' LETTER
From: Founders Capital Management

2004: Looking for the Home-Run Pitch

The Red Sox had won more World Series by 1918 than any other club—five championships. Then, in 1920, Red Sox owner Harry Frazee sold Babe Ruth's contract to Colonel Jacob Ruppert's New York Yankees for $100,000 (plus a loan collateralized by Fenway Park) to finance his friend's play. The Yankees, who had never before won a championship, went on to win 26 World Series and become the most celebrated success story in the history of baseball.

Since 1918, Boston fans have watched the Red Sox in four World Series and lose each one in game seven. Many attributed Boston's chronic losing streak to the " Curse of the Bambino."

In 2004, the Curse was finally broken, and Boston fans celebrated their first World Series win in 86 years. In tribute to the Red Sox, the theme of this year's letter is the great game of baseball.

Unlike the Red Sox, 2004 was not a miracle-winning year for the stock market, as the S&P 500 gained 9%. We were not surprised by this year's average performance, the absence of a "home run market," or the market's volatility throughout 2004. As we have emphasized in the recent past and will repeat until conditions change:

> *Given today's uncertain economic environment—of low interest rates, high consumer and government debt, a shifting economy, and ongoing geopolitical issues—we do not expect the stock and fixed-income markets to perform in the future as they have in the past.*

Our performance in 2004 reminded us of one of Ronald Reagan's favorite stories from when he announced baseball games from telegraphic reports. In his 1965 autobiography, he describes what happened one day when the wire went dead:

> "I had a ball on the way to the plate and there was no way to call it back. At the same time, I was convinced that a ball game tied up in the ninth inning was no time to tell my audience we had lost contact with the game."

Mr. Reagan proceeded to give thorough descriptions of what may be the longest series of foul balls in baseball history, even providing a detailed account of a redheaded boy who scrambled for a foul ball. Part of this year's letter is devoted to describing some foul-ball hits (along with a few solid drives). However, we must remind ourselves that we are in the first inning of a nine-inning ball game and we corrected our swing to keep the ball in play.

From a manager's viewpoint, the fundamental question in assessing a roster of investments is: How is the annual performance of each player impacting the fundamental long-term value of our team? Our conversation this year focuses on:

- Intrinsic Business Value vs. Market Sentiment
- Growth of Mutual Funds, Index Funds, and Hedge Funds
- Structural Changes and the World Economy
- Positioning Capital in a Volatile Investment Environment

Intrinsic Business Value vs. Market Sentiment

Throughout 2004, we received several inquiries about our forecast of the market's direction. We understand and welcome such questions during these uncertain times and regret that neither we nor other market pundits can provide a definitive answer about where the market is heading.

We can affirm, however, that we have acquired securities at prices that we feel confident will provide us a fair return over time, despite gyrating markets. These investments include fixed-income instruments that present a risk/reward profile commensurate with our expected returns, as well as portions of individual companies through the equity markets that offer a long-term margin of safety.

We also wish to emphasize that we are extremely sensitive to the volatile investment climate and will continue to allocate capital in a cautious fashion—you won't see us going "gaga" over Google and chasing speculative stocks.

What is most important to us is measuring the intrinsic value of a business. The term "intrinsic value" has different degrees of meaning to today's investors. The first degree is "central value." A company's central value is determined by accurately assessing the cash (discounted at an appropriate rate) that can be removed from the business in the future without impacting its need for capital to grow. This assessment is a difficult process; an accurate estimate of a company's value is difficult to ascertain because cash flows fluctuate and interest rates change. Although this method of valuation is less than precise, it's the only comfortable discipline we know of by which to evaluate investment opportunities with a high degree of probability. A second degree of intrinsic value, which we call "euphoric value," keeps pitching at today's swinging investors and therefore warrants some discussion.

To evaluate how these two degrees of intrinsic value—central value and euphoric value— differ, let's compare two types of investment opportunities:

(1) Let's suppose that PepsCo earns 30¢ for every $1 invested in the company, and that to continue growing at 10% per year, PepsCo must reinvest 5¢, leaving 25¢ on every invested dollar for the owners of the company. Let's also presume that PepsCo has been in business for more than 100 years and has achieved fairly consistent results during this time frame; and that PepsCo has built a large business infrastructure over the past century that is difficult for competitors to duplicate. Let's say that we can purchase this business that will earn $1 per share for $20 per share, or 20x earnings. Keep in mind the compounding effect of an entry yield of 5% ($1/$20), a 10% annual growth rate, and 30% earned on each new dollar invested in this established company that has worldwide name recognition.

(2) "Newtech" on the other hand, earns 25¢ for every dollar invested in the company, and to continue to grow at a rate of, say, 35% per year, Newtech must earn 50¢ for every dollar invested in the business. Given this shortfall, to support the more aggressive growth of this company, the owners must continually invest an additional 25¢ beyond what is earned from the operation of the business. Let's also assume that Newtech has existed for five years and during that time has demonstrated inconsistent growth and earnings, growing 50% and earning 35¢ on every dollar invested in some years, but growing 20% and earning 15¢ on every dollar invested in others. And suppose the market is enthralled with Newtech's periodic demonstration of high growth and high return and bids up the company price far beyond a central value, to what we call the euphoric level. Let's say we can purchase this business that will earn $1 per share for $85 per share, or 85x earnings. This presents an entry yield of 1.2% ($1/$85), a 35% annual growth rate, and 25% earned on each new dollar invested in this start-up business.

Given these two scenarios, most conservative, commonsense investors would choose to place their money in PepsCo based on its predictable growth, consistent earnings, excellent capital allocation program, and fair price. Logically, PepsCo will most likely sell at or near a central value. Newtech, on the other hand, with its difficult-to-determine variables, presents the opposite: Large price gyrations based on unpredictable growth, inconsistent earnings, and a sporadic capital allocation program. Newtech will most likely sell far above or perhaps well below a central value (which would itself be difficult to determine). In addition, Newtech has a business model that is new and unproven. The company is subject to competition from many entrants in its business who would also like to take advantage of the potential high growth and high returns.

In spite of the lessons learned from the stock market bubble of the recent past, many investing individuals continue their quest for the "home-run pitch," hoping to triple or quadruple their money by investing in companies such as Google, Yahoo, and e-Bay. While these are all very good companies that have collectively risen in price by more than 60% during 2004, our analysis leads us to respectfully conclude that these companies are priced at euphoric levels. (Note that this is not a statement that we expect the price of these companies to stop rising.) We acknowledge that these entities have value, but we are not sure what their value is. A quick look at the total market capitalization of these companies, however, shows that purchasing these three businesses outright would cost around $180 billion. In contrast, we could spend that $180 billion to purchase almost all of PepsiCo, McDonald's, and Disney—and we do not presently consider these companies to be selling at bargain prices. The collective profits of PepsiCo, McDonald's, and Disney was approximately $8.5 billion in 2004, while total combined revenues for Google, Yahoo, and e-Bay was around $9.5 billion, with profits accounting for $1.9 billion. Therefore, in the first case, we would be paying around 21.5x profits for the collection of businesses, while in the second case, we would be paying almost 95x profits.

The danger clearly lies not only in how one assesses a business, but also in the price one pays. A heavy reliance on the future of a newly formed business reminds us of a quote from Security Analysis:

> "The analyst must take possible future changes into account, but his primary aim is not so much to profit from them as to guard against them. Broadly speaking, he views the business future as a hazard which his conclusions must encounter rather than a source of his vindication."

Each day at Founders, we sing the 7th inning stretch baseball tune to remind us of the dangers of purchasing companies at prices that rely heavily on future growth in profits (sing to the tune of "Take Me Out to the Ballgame"):

> ***Take me out to Wall Street***
> ***Let me follow the crowd***
> ***Buy me some stocks and future contracts***
> ***I don't care if I ever get $$$ back***
>
> ***Let me root, root, root for an upswing***
> ***If it doesn't happen it's a shame***
> ***For it's one, two, three strikes, you've lost***
> ***At the old market game.***

A third degree of intrinsic value runs opposite to euphoric value—we call it "depressed value." Sometimes (and this is the exception rather than the rule), great companies with excellent growth, earnings, and capital allocation records become severely depressed due to:

- A nonrecurring event that affects immediate earnings,
- An anticipated future event that could affect the company's consistency, or
- An analyst's downgraded rating.

When this happens and the possibility of the precipitating event occurring or recurring is low, or the analyst was misinformed, a great company becomes a great bargain. When we're served this home-run pitch, we consider it time to "swing for the fence."

In today’s market environment, we are seeing more companies priced at euphoric vs. depressed levels. We will not participate in the frenzied chase of companies priced at euphoric values in hopes of a future increase in a stock price that is disconnected from the value of the business. We prefer instead to acquire businesses in the fair- to depressed-value categories.

> ***Unfortunately, there are very few home-run pitches in the investment game, and at the time of this writing, we do not see any companies selling at depressed prices that signal the opportunity to significantly add to our equity holdings.***

Growth of Mutual Funds, Index Funds, and Hedge Funds

Many individuals are nervous about placing their money directly into the stock market but desire the fast returns associated with purchasing newly formed, high growth companies. To minimize their risk, maximize returns, and avoid losses similar to those during the last bubble deflation, many such individuals have turned to a strategy of combining “hot” mutual funds, newly formed index funds (i.e., exchange-traded funds, or ETFs), and hedge funds. These investors remind us of ostriches, sticking their heads in the sand to avoid having to look at potential danger as they hope to obtain outsized returns. Consider these facts:

- In 1970, some 383 mutual funds held $55 billion in assets. By 2004, more than 8,000 mutual funds were managing $7.3 trillion in assets, of which approximately $3.7 trillion was invested in stocks.
- The passive investment in index funds (a portfolio of investments that are weighted the same as a stock-exchange index to mirror its performance) has also become popular. Wall Street now offers the opportunity to concentrate investments in index funds that target various sectors, such as healthcare or technology.
- There has been an explosion in the lightly regulated hedge fund industry during the past five years. There are now more than 7,000 hedge funds holding close to $1 trillion of investor assets. Unlike mutual funds, which are "long" (i.e., make only buy-sell decisions) on the purchase of a stock, a hedge fund engages in more aggressive strategies and positions, including short selling, trading in derivative instruments such as options, and using leverage (borrowing) to enhance the risk/reward profile of their bets.

A little history on the evolution of fund investing: Twenty years ago, if you wanted to invest in an open-end mutual fund (which has a floating number of outstanding shares) in contrast to a closed-end mutual fund (which has a limited number of shares, is listed on an exchange, and trades like a stock), you would review the prospectus, complete an application, and send a certified check along with the application to your chosen fund. Fulfilling this process to become part of the fund took three to four weeks. When you wanted to sell off your fund holdings, you would send a notarized letter stating the amount you wished to liquidate, and three to four weeks later you would receive a check.

Today, an investor can buy or sell open-end mutual funds, index funds, and closed-end funds such as an ETF instantly through a broker. If the investor is not satisfied with the returns of ABC fund, she can sell all or a portion of it and buy XYZ fund. This capability has led investors and brokerage firms to trade open-end mutual funds, index funds, and ETFs like stocks.

Now that investors are being thrown multiple pitches in a frenzied investment environment, let's ***PLAY BALL!***

STRIKE ONE

Investment companies primarily make their money from "management fees," which they assess against the assets of their funds. Fees run from 1% to 2% of assets, plus 20% of profits for hedge funds. Attracting more money leads to more assets, and thus more money from fees. This is a highly competitive business. Some brokerage firms earn additional income through various forms of payment from investment companies that "offer" funds to clients. In addition, fund companies “shower” gifts and supply financial assistance to brokers for investment seminars that target individuals seeking financial advice. Predictably, many clients end up with these funds in their portfolios.

STRIKE TWO

In this "feeding frenzy" environment, fund managers are pressured to pursue higher-risk strategies to maximize short-term results, thereby positioning their firms to attract assets. Many funds—especially hedge funds—leverage their assets (i.e., borrow money to buy securities), sell short (i.e., borrow securities and sell them with the anticipation of falling prices, then buy the same securities back at a lower price), buy/sell various ETFs, and speculate with derivatives (contracts or agreements whose value is derived from interest rates, foreign exchange rates, prices of securities, or financial or commodity indices). This all adds up to: HIGHER RISK!

YER OUT!

In relentless pursuit of increased returns, many fund managers now use computer programs to buy and sell various securities/indices, in essence betting on the market's rise or fall. These computer programs now account for more than 50% of all trading volume on the New York Stock Exchange. The result: Funds chasing the same stocks, in many cases squeezing supply and demand. At the end of the day, this can create activity similar to the 1920s "bull pools" and lead to extreme market volatility.

Since many funds are now higher risk and trade like stocks, brokerage firms are offering "funds of funds" (we swear we're not making this up). Funds of funds are mutual funds that invest in other funds, rather than in individual securities, to diversify risk—even though one of the original objectives of mutual funds was diversification. Let's not overlook the 1% to 2% fees paid by investors for these funds of funds, which invest in other funds with annual fees, which frequently trade stocks. This all adds up to: MORE FEES!

It is not our intent to knock investment in mutual funds, index funds, or hedge funds. These strategies have provided valuable options for investors, and numerous reputable funds with excellent managers have performed well for many years. We do wish to knock, however, the "hare vs. tortoise" approach of pursuing wealth for individuals or fund companies. Many innocent investors do not realize the risk consequences of running for the quick buck, and it is our opinion that an investment firm should bear the ultimate responsibility of informing its clients of all risks, even if it means sacrificing a share of the growing assets.

Structural Changes and the World Economy

It is important to understand that the volatility in today's investment environment is linked with a dynamic we term "changing economic flows." We associate changing economic flows with changes in the flow of trade, money, employment, information, etc. between countries. Consider, for example, the changing macroeconomic flows in U.S. trade with China. When the U.S. imports extraordinarily large quantities of goods from China, China ends up with outsized amounts of U.S. dollars. China then transfers these dollars back to the U.S. by purchasing U.S. government securities. This recycling creates high demand for U.S. government bonds, keeps U.S. interest rates low, and allows U.S. consumers to continue purchasing goods using inexpensive credit.

Imagine, though, what would happen if China had a financial crisis and needed to quickly sell its U.S. government bonds: U.S. interest rates would spike, U.S. consumers would cut back on purchases as their cost of credit rises, and imports from China would freefall. The initial positive economic flow could thus reverse and become negative, creating economic fits and starts that would lead to market volatility.

Changing flows of intellectual capital (i.e., employment) can also impact markets. There was a lot of discussion during the past year about the exportation of American jobs to India and China. An article written last year by Ted Fishman and published in *The New York Times* pointed out Mao Zedong's view that:

> "China could leapfrog other developing countries by employing an effectively unlimited supply of human labor. Chinese farmers and urban laborers would take the place of the expensive machines that the Western industrial powers had spent 100 years developing; China's wealth, Mao reasoned, lay in its abundant population."

In due course, Mao proved right, although China was unsuccessful in its attempts during the late 1950s to implement his Great Leap Forward. *The New York Times* article addressed the current migration of hundreds of millions of farmers from the Chinese countryside, and how government policies are making it easier for them to leave. The article pointed out that the country's embrace of market capitalism over the past decade and the government's insistence that farmers fend for themselves are combining to all but evict farmers from the land. For hundreds of millions of farm families, the government-allocated land plots are insufficient to generate enough money to support a family. According to the Chinese government, the average city income is $1,000 a year—three times the average countryside income. This disparity has set in motion the largest human migration in history. The *Times* article states that by 2010, nearly half of all China's population is projected to live in urban areas. All these so-called migrating farmers are accepting employment in growing manufacturing regions. (A compelling note: The number of Chinese who have left farms to search the cities for work currently exceeds the entire work force of the U.S.)

According to the same *New York Times* article, 12% of China's exports to the U.S. now end up on Wal-Mart's shelves, and because Wal-Mart's trade with China accounts for 1% of that country's gross domestic product, the company exerts tremendous downward pressure on prices. Its buying power enables it to dictate, in effect, what a Chinese manufacturer will get for producing goods American consumers want. By selling Chinese-made portable DVD players with seven-inch LCD screens for less than $200, for instance, Wal-Mart helped cut the price of these trendy devices in half over the past year. Competitors have no choice but to match the chain's prices or go under.

Although we all enjoy the benefit of competition allowing us to buy goods at discounted prices, there is a case to be made regarding the siphoning off of American jobs by low labor-cost countries such as China and India. On the other hand, these countries are essential to giving American companies, which we own, a competitive edge through low-cost labor and a highly populated developing market that may purchase our companies' products in the future.

Yu Shi Ju Jin (Translation: "Look out world, here we come.")

China is becoming a large economic influence that many believe will dominate the global economy for the next 100+ years. Over the past 25 years, China's real economic annual growth has averaged 9%, while growth in trade has averaged 15% annually since 1978. While China's projected century-long domination of the world is based largely in reality, many individuals associate this forecasted dominance with a continuously smooth and rising "100-year ride." In our view, this expected "smooth ride" is not realistic.

China's rapidly building economy is causing bubbles to form in areas such as real estate, cars, and commodities such as steel and cement. In addition, China's inability to generate enough power to support its infrastructure is leading to tens of billions of dollars of government unapproved investments to build new power plants. All this activity is leading up to a possible problem for China: ***Overinvestment.***

China's government has encouraged the state-owned banks to freely lend money to support growth. This has led to easy credit, which in turn is leading businesses to obtain so-called "free money" to make large capital investments in facilities that produce cheap manufactured goods to supply the appetites of consumers throughout the world. Currently, an estimated 90% of China's manufactured goods are in oversupply, but investment in fixed assets continued to grow at 30% during 2004 and contributed to almost 50% of China's gross domestic product. As one example: In the past year, car manufacturers including General Motors, Ford, Toyota, Honda, Nissan, and Volkswagen collectively announced more than $20 billion of new investment in China. During this time, China produced almost five million cars, although demand was for only 2.5 million cars. Even though demand for cars in China has grown at an annual rate of 25% over the past decade, car-loan defaults reached 50% in major cities such as Beijing and Shanghai. In response, the Chinese government decided to crack down on state-owned banks offering easy credit to consumers, and consumer demand for cars turned negative in September 2004 as loans became scarce.

Clearly, China's desire to be a "manufacturer to the world" could lead to infrastructure construction outpacing the country's consumption of the goods it produces. If a slowdown in consumption occurs, China's factories could lie motionless, and its banking system could be severely strained if businesses are unable to repay loans.

One may ask why this can't be controlled. The reasons are many, including bureaucratic complications between China's government and its vast population of 1.3 billion living in 31 provinces and 656 cities. Communication is also difficult, with seven major dialects and 80 different languages spoken. And there is the natural inclination of any developing country to aspire to a higher standard of living for its citizens.

Overall, we predict that the transition for countries such as China aspiring to serve as so-called manufacturers to the world will be far from smooth, and as economic shifts take place, the global markets will experience volatility as in similar periods in the past.

In the changing global marketplace, it is natural for countries and companies to jockey for maximum position, using isolationist tactics or by "controlling" changes in the production of goods by altering the flow of capital, currency, and jobs to their benefit. We believe that this is where problems occur. Countries and companies that are unwilling to embrace the emerging interdependence of wealth, endeavoring instead to maximize their own riches at the expense of others, could find themselves in the same position as the hapless protagonists in Aesop's familiar fable, "The Goose that laid the Golden Egg*:*"

> A man and his wife had the good fortune to possess a goose that laid a golden egg every day. Lucky though they were, they began to think they were not getting rich fast enough, and, imagining the bird must be made of gold inside, decided to kill it to secure the whole store of precious metal at once. When they cut it open, they discovered that it was just like any other goose. Thus, they neither got rich all at once, as they had hoped, nor enjoyed any longer the daily addition to their wealth.

Positioning Capital in a Volatile Investment Environment

Every action has a reaction, and as countries attempt to control the "economic goose" in their favor, the result is imbalanced government budget and trade deficits, rising commodity prices, and gyrating currency exchange rates—leading to volatility in world markets as we transform into a more interdependent society. A few salient points:

- The low cost of goods produced outside the U.S. has led to imports outstripping exports—the U.S. trade deficit now exceeds $600 billion (6% of GDP).
- The U.S. trade deficit is leading countries such as China to purchase U.S. treasuries when they are flooded with U.S. dollars from the purchase of Chinese goods by U.S. consumers.
- The aggressive purchase of U.S. treasuries by various Asian countries is leading to lower-than-normal interest rates in the U.S.
- Savings by U.S. families is at an all-time low, and total U.S. consumer debt now exceeds $9 trillion as consumers take advantage of low interest rates, borrowing against the equity of their homes and maximixing lines of credit.
- The U.S. government budget deficit has now topped $425 billion, and the government borrowed money to fund the recent economic recovery and the war in Iraq.
- The world market has begun to question whether the U.S. government and consumers will be able to pay back these massive loans in a timely manner. A potential loss of confidence in the U.S. dollar as a result of our excessive borrowing could lead world markets to stop accumulating dollar-denominated assets. Such a loss of confidence could spur rising interest rates as countries sell U.S. treasuries.

Attempting to manage these variables would create a tentative economic environment. Since we do not know if or how these variables might be managed, and how that will impact the markets, we will focus on allocating capital with intelligence, which in our view means appropriating capital with objectivity and wisdom. We are objective about the markets and our investments, taking a rational view of expected risks/rewards. We are also mindful of investment wisdom, which dictates that we care for our clients' money as if it were our own. Although we cannot foretell the future course of an uncertain market, we will continue to seek to position our capital in ways that maximize the protection of our total principal and achieve fair returns.

MANAGEMENT'S DISCUSSION & BUSINESS UNIT REVIEW

Equity Investments

We recently made an investment in gold and silver bullion through **Central Funds of Canada**, as well as a mining stock—**Barrick Gold** (a goose that lays gold and silver eggs). The rationale underlying these purchases is addressed in the preceding discussion—high trade deficit, budget deficit, consumer debt, etc.— which logically leads to devaluation of the U.S. dollar. The U.S. dollar is used as the world reserve currency, with central banks holding some $2.3 trillion of dollar assets, and is the primary currency for world trade, including the purchase and sale of gold and silver. Gold and silver are maintaining their value relative to other world currencies, but as the U.S. dollar weakens, it costs more dollars to purchase an ounce of gold or silver. Thus, in dollar terms, gold and silver rise as the U.S. dollar weakens.

Outside of our gold/silver investments, we continue to invest a large portion of our equity capital in companies with competitive advantages that are difficult to duplicate, that will not be impacted by low-cost labor, and that are capable of selling products that will do well in markets such as America, China, India, and Russia. Many of our companies do a significant amount of business internationally, and the decline of the U.S. dollar could actually be a benefit to their earnings as they accept local currency for goods sold overseas and convert the higher-value currency to dollars.

> *We continue to focus on the long-term prospects of our business operations and evaluate how our businesses are increasing value for shareholders over time. This concentration on business activity is what ultimately drives the company's stock price—not the psychological feelings of individuals seeking to make money on "paper trade."*

Following are highlights of our holdings during 2004.

Overall, our **Food and Beverage Division**, PepsiCo and Coca-Cola, hit **a double**. PepsiCo had stellar results, while Coke's business experienced a slowdown. In the 4th quarter, PepsiCo reiterated its earnings forecast for 2004, at $2.31 per share—a projected 12.5% increase in earnings over 2003. In 2005, PepsiCo expects to grow earnings at approximately 10%, to $2.55 per share. Behind this tremendous growth lies a powerful combination: A dominant snack food business and a strong beverage business, especially in the noncarbonated market. PepsiCo's management plans to increase media investment in Frito-Lay North America brands by more than 50% in 2005. The extra spending will focus on brands such as Lay's, Doritos, Cheetos, Tostitos, Light, and Baked! In addition, PepsiCo plans to emphasize its diet portfolio in 2005, which includes reformulating Pepsi One cola and relaunching Diet Sierra Mist under the name, Sierra Mist Free. The company also plans to extend new product offerings in its noncarbonated portfolio, with Aquafina Flavor Splash, a line of flavored waters sweetened with sucralose, and Aquafina Sparkling, a line of sparking waters.

What is impressive about PepsiCo's performance is the growth in its international division. The company's international snack and beverage volumes grew 7% and 11%, respectively, during the 3rd quarter, driving half the company's operating profit improvement. This represents unprecedented growth for a consumer products company, and we look forward to continued great performance from PepsiCo's immense stable of brands during 2005.

On the opposite side of the beverage field, Coca-Cola hit a foul ball in 2004. In the second half of the year, the company announced slower-than-anticipated growth in 3rd and 4th quarter earnings. In addition, growth in worldwide unit-case volume stalled to approximately 1%. Coke's management team blamed the declining quarterly performance on poor weather in Europe and problems executing its business strategy in North America.

We believe Coke is going through a "rough patch," much of which can be fixed through better business execution. Coke's day-to-day business calls for a plan that "gets back to basics" of building a beverage business.

We also believe that Mr. Neville Isdell, Coca-Cola's new CEO, will successfully execute a plan at Coke similar to the one used by McDonald's CEO a few years ago to get the restaurant chain back on track. Mr. Isdell held an investor meeting in November 2004 to outline a strategy to improve the company's performance, highlighting, as we had anticipated, three fundamental current problems:

(1) ***The company has underspent in marketing its brands.*** To deal with the level of underinvestment in marketing, Mr. Isdell indicated that Coke would permanently step up marketing expenditures by $350 million to $400 million. He emphasized the importance of reinvigorating brand Coca-Cola with renewed efforts to attract new drinkers and provide existing drinkers with more options to remain in the cola category as they age. Coke's self-assessment was that it has not spent enough, or efficiently, to attract new drinkers, or to address the health concerns of its aging core customer base.

(2) ***Coke has not taken advantage of the fast-growing noncarbonated beverage segment.*** Coca-Cola faces a major challenge in the advancing noncarbonated beverage market, with less than 3% global market share. We expect Coke to focus more in the future on such products as Minute Maid juices, Powerade sports drink, and Dasani water. Coke recently announced that the company will sell lemon- and raspberry-flavored water under the Dasani brand.

(3) ***The Company has gaps in its execution.*** Points (1) and (2) are intertwined. Coke has been distributing noncarbonated beverages through its "partially owned" bottling network, with little success, because the logistical requirements for selling carbonated drinks differs from selling noncarbonated drinks. Carbonated drinks have a higher turnover than noncarbonated drinks and are more profitable, and thus current distributors are resisting an increased emphasis on the less-profitable noncarbonated beverages. Coke may need to build an alternative distribution system for noncarbonated drinks, which may prove time-consuming.

    Coke will begin to ensure that *the right mix of product type and size will be placed in each market.* Ensuring that a proper mix of 2-liter bottles, 12 oz. six packs, etc. may sound mundane, but this vital "blocking and tackling" with bottlers could put Coca-Cola back on the road to expansion and provide a framework for profitable growth in mature markets with large populations.

We still believe Coke's greatest growth opportunity lies in the future. Repeating an important point made in previous letters: The average per capita consumption of Coca-Cola products in China is 10 servings annually. In countries such as the U.S. and Mexico, per capita consumption of Coca-Cola products exceeds 450 annual servings. Coca-Cola is a very profitable company that will earn close to $5 billion in 2005, and we believe Coke has a very big future in the global beverage business.

McDonald's, our largest **Restaurant** holding**,** keeps hitting **home run after home run**. McDonald's continues to post great results and win market share from other fast-food competitors. The company reported that systemwide sales for all McDonald's restaurants increased approximately 7% in 2004. December 2004 marked the 21st consecutive month of positive U.S. comparable sales growth—up more than 9% for the year. These are the results of a company that was in a "major slump" two years ago, and every investor was trading this future home-run hitter for any other player in the league. Subsequently, McDonald's decided to slow down the growth rate in its basic stores and to focus on increasing sales through its current business system and rolling out new products, including McDonald's Premium Salads, Happy Meal Choices, and breakfast offerings such as the McGriddle Sandwich. All these products performed well and contributed to growth in sales. McDonald's latest innovation, which will be introduced throughout 2005, is Deli Select Sandwiches. Six different sandwiches are currently being tested in more than 400 restaurants. The deli sandwiches are moderately priced, at $4 each, with an opportunity to add a side dish and a soda for an additional $1.50. If you happen across one of the restaurants testing the new deli sandwiches, give it a try and experience how McDonald's is expanding its menu "beyond the burger."

Our **Technology Division**, primarily Microsoft, hit **a triple** this year. Microsoft's success is heavily tied to the growth of the PC and corporate server markets. PC units posted five consecutive quarters of double-digit growth since the 2nd quarter of 2003. PC unit growth is projected to slow to high single digits in the near future, reflecting tougher comparisons to the previous year. This considered, we are taking the long-term view. Currently, there are 600 million PC users worldwide, and this number is expected to exceed one billion by 2011. We believe Microsoft has a significant opportunity to capture the majority of this growth and to take advantage of other emerging markets such as mobile device software (mobile phones) and home/entertainment software (the Xbox game console and interactive television). In fact, Microsoft's Home and Entertainment Division just introduced a new game—Halo 2—which generated more than $125 million in sales on the day of its release (this is more than a blockbuster movie release), and Halo 2 revenues were expected to hit the $400 million to $600 million range over the holiday season.

In previous letters we pointed out that Microsoft produces more than $1 billion in cash per month, and accumulated more than $70 billion in cash and investments on its balance sheet. Microsoft decided to issue a special $3-per-share dividend in December 2004, representing more than $30 billion, and to repurchase $30 billion in stock over the next four years. Microsoft also increased its quarterly dividend from 4¢ to 8¢ per share. This far exceeded our expectations, and we applaud Microsoft's management team for returning this excess capital to shareholders. In early December, we received a large amount of cash and decided to place this capital in short-term (six-month) U.S. treasuries until better opportunities arise to reallocate the capital. In summary, Microsoft continues to grow its franchise in the cable, small business, and consumer areas, and to maintain a focus on shareholders, customers, and employees.

Our **Financial Service Division** hit **a single** in 2004, as our major holding, Berkshire Hathaway, contended with several curve balls that affected the company's 2004 results:

(1) Berkshire's share of Florida hurricane-related losses was larger than expected, at $531 million after-tax.

(2) Insurance premiums continue to soften as industry competition grows. In a soft pricing environment, Berkshire Hathaway chooses to underwrite less insurance, resulting in lower insurance premiums. This is due to Berkshire's desire to underwrite insurance business at a profit, as opposed to other insurance companies that "chase premiums" that will eventually be offset by larger payouts in the future.

(3) Warren Buffett's investments experienced a larger-than-normal decline in 2004. Coca-Cola—Berkshire's largest stock holding, representing about one-quarter of all equity investments—declined 17% in 2004, negatively impacted Berkshire's equity returns.

We have not lost any confidence in Mr. Buffett's capital allocation abilities. We do not judge the performance of Berkshire's equity investments over a 12-month period—we view the sport of investment as a marathon, not a 100-yard dash. In fact, we feel Mr. Buffett is allocating capital effectively, given the change in mix of Berkshire's invested insurance assets. Over the past 10 years, the percentage of Berkshire's insurance assets in equities has fallen from 83% to around 37% today. Meanwhile, the fixed-income portion of the insurance-invested assets has grown from 15% to 23%, and the majority of long-term bonds have been sold. So, where is most of Berkshire's money right now? Berkshire has approximately $40 billion in cash and cash equivalents, representing more than 36% of the insurance-invested assets and more than 25% of the total market value of Berkshire. A portion of this cash is designated for insurance payments, but our judgment is that Berkshire has approximately 45% of its stockholders' equity in stocks, in contrast to more than 100% in the past.

Warren Buffett is clearly loading his investment gun, and we will continue to adhere to his patient stance and allocate capital to Berkshire Hathaway in this somewhat frenzied market environment. Founders Capital Management considers Berkshire to be ballast for our investment ship, and we are confident in his ability to put this cash to good use and generate strong returns for shareholders over the long term.

(We are sometimes asked what will happen to Berkshire Hathaway's stock once Warren Buffett is no longer able to carry out his duties as CEO. We believe that Mr. Buffett is preparing for an eventual transition at Berkshire Hathaway. In December, Warren Buffett asked Microsoft founder and chairman Bill Gates to join the Berkshire Hathaway board. We think this is a wise move—in addition to substantial business savvy, Bill Gates can offer advice on management continuity once Mr. Buffett is unable to continue as CEO.)

Our major **Retail** holding has been **knocking the cover off the ball** and receives the Founders trophy for hitting the longest home run in 2004. We are thrilled with the strides Bob Nardelli and his team at Home Depot continued to make during 2004, with annual income per share expected to top 21%. Over the past 12 months, home improvement industry sales have grown at a 15% annual rate. This expansion is coming on the heels of a very good housing market, and Home Depot has benefited from this growth.

Home Depot continued to reinvest significantly in its older stores during 2004 while expanding into new areas. For example, the company recently opened a new Manhattan location. This unique, 150,000-square-foot store is configured differently from the typical suburban Home Depot, targeting the higher-income customer with significant emphasis on home decor. The tool rental business is prominently featured in the store, and home delivery is a major service offered in this transportation-challenged market. Home Depot is gauging how this new concept is accepted and may consider opportunities for expanding it to other urban markets.

Home Depot has also made a large push to expand services, such as installations and tool rental. Providing services to customers is a two-fold strategy: Revenues from services provides Home Depot the opportunity to leverage its existing infrastructure and thereby improve the return on existing assets; and, similar to the strategy behind opening stores in urban markets, services generate another revenue growth opportunity as Home Depot confronts store saturation. The returns on this strategy are compelling, since Home Depot does not need to outlay capital to achieve revenue growth through its existing store base. This means that for every dollar of service revenue generated, a major portion of the money falls to Home Depot's bottom line and into shareholders' pockets through dividends or share repurchases. The potential profit is large. For example, during the 3rd quarter, service revenue expanded 26%, to $957 million, driven by growth in the installation of carpet, countertops, kitchens, and windows. Currently, Home Depot offers more than 23 national installation programs and performs more than 11,000 projects each day. These programs include the installation of products that are sold in Home Depot stores such as carpeting, flooring, cabinets, water heaters, and solid-surface countertops, as well as installation by third-party service providers of products such as generators, and furnace and central air systems. The total service revenue of $3.6 billion accounted for approximately 5% of Home Depot's sales in 2004.

Urban stores and services exemplify Home Depot's emphasis on the customer and innovation—a strategy that is paying off as Home Depot's financial results continue to improve. Earnings are expected to grow to $2.56 per share in 2005, up 12% from 2004. We love to watch Home Depot keep on building.

Our **Media Division**, led by Disney and Liberty, hit **a double** this year. During 2004, Disney lost $30 million in revenue due to hurricane-related closures at its Orlando theme park. In addition, the hurricanes impacted Disney's cruise line business, prompting the cancellation of one cruise and the delay of two others when ships were stranded at sea. Despite these short-term negative events, we believe Disney is on track to deliver improved performance in the upcoming year. This is due to the increased profitability of other divisions that counterbalance the negative events of the recent past. ESPN is extremely profitable and continues to grow at a double-digit pace. The cable division is launching two new channels in English and regional languages in India—a market of 100 million preschool children. The Disney Channel and Toon Disney Channel will feature cartoons, animation movies, family dramas, live-action adventure stories, and locally produced and hosted shows. In addition, blockbuster movies such as "The Incredibles" and "National Treasure" brought in more than $350 million by mid December, and the DVDs will be released in 2005. Disney is expected to report $2.7 billion in earnings ($1.35 per share) in 2005, an increase of approximately 17.5% over 2004. Disney continues to return excess capital to shareholders through its stock repurchase program and has the capacity to repurchase some 5% of outstanding shares. We are pleased with Disney's progress.

Liberty Media continues to grow key divisions at a fast pace. QVC, the home shopping cable channel, grew 14% in 2004 and is expected to grow at 9% in 2005. Large growth in Germany and Japan has been fueling QVC's expansion. A similar story is rolling out at Discovery Channel, which is 50% owned by Liberty Media. Discovery Channel grew more than 18% in 2004 and is expected to grow more than 13% in 2005, with overseas business accounting for a major portion of the increase. Liberty Media also owns large stakes in public companies such as Time Warner (4%), Sprint (8%), Motorola (2%), InterActive Corp. (20%), and News Corp. (17%). The value of these positions exceeds $20 billion. Liberty is attempting to realize this value through "special deals" that will not result in large tax obligations for Liberty shareholders. We will keep you updated on these deals as they develop.

In our **Healthcare Division,** during the 4th quarter we decided to liquidate our holdings in Merck and Pfizer. Our experience with these investments in 2004 has been like being **hit by a pitch** without the reward of a pass to first base. On September 30th, Merck withdrew its COX-2 pain-relieving drug, Vioxx, from the market due to adverse cardiovascular and stroke-related affects. In early November, *The Wall Street Journal* reported that Merck's senior management had been aware of the issues as far back as 1996. Previously, Merck 's management had claimed that it first was aware of these problems just a few weeks prior to pulling the drug from the market. Merck's potential exposure to litigation grew significantly as a result of the updated information, from an estimated $20 billion to upwards of $50 billion. Management's past awareness of health-related concerns about to Vioxx, and its failure to properly disclose them, caused us to lose faith in Merck's senior management, and we liquidated our holdings in the company accordingly.

Initially, it was reported that Vioxx's cardiovascular and stroke-related issues were due to the drug's chemical composition, and not a "class effect" associated with all COX-2 drugs. Subsequently, the *Toronto National Post* reported that Pfizer's blockbuster COX-2 drug, Celebrex, was linked to cardiovascular and stroke-related affects and had caused up to 14 reported deaths throughout Canada over the past five years. As it turns out, Canada's Adverse Drug Reaction Monitoring Program, part of Health Canada (the Canadian equivalent of the U.S. FDA), had collected 111 adverse-reaction reports on Celebrex over the past five years (they had collected 167 for Vioxx).

With negative information surfacing about Celebrex and the initial adverse reaction to Pfizer's stock price, we decided to personally assess the situation about COX-2 drugs. First, we called Tom Blackwell, the *Toronto National Post* reporter, to discuss his sources and the data in his article. (We would like to thank Mr. Blackwell for giving us 15 minutes of his time to discuss this article. He stated that no other money management firm had called him to inquire about the article, even though Pfizer's stock price had initially fallen on the news. We concluded that the market's reaction to his report was Ready, Fire, Aim.) Mr. Blackwell's insight regarding Health Canada's data, as well as the scientists he interviewed for his article, allowed us to deepen our research through publications in JAMA (The Journal of the American Medical Association) and The New England Journal of Medicine.

Ultimately, as is the case with most complex scientific issues, we learned that there was no conclusive evidence one way or another as to whether all COX-2 drugs present cardiovascular risks. However, given the debate and the associated risks of prolonged class action lawsuits for Pfizer as well as Merck, we decided to sell our position in Pfizer in early November. (A footnote to the story: Pfizer announced results of a study on December 17th that demonstrated a 2.5 times increase in the risk of heart attack for patients taking higher doses of Celebrex over an extended period of time. The final chapter of this story remains to be written.)

Fixed-Income Investments

During the past year, we emphasized several points about fixed-income instruments that concerned us. We discussed several risks associated with this "secure investment vehicle," including the possibility of rising interest rates and of greater chances of default. At the end of the 1st quarter, 2004, we reported that we had not seen a long-term rise in interest rates. It initially looked as if our sale of longer-term bonds in 2003 had been premature, but things changed in the 2nd quarter 2004 as interest rates on the 10-year bond rose from 3.75% to 4.75% in a very short time frame. This quick movement in interest rates caused a loss of more than 4% to the average mid- to long-term bond portfolio in the 2nd quarter. In the 3rd quarter, however, the 4% loss was reversed, and the average mid- to long-term bond gained 4%. Interest rates have been relatively flat in the 4th quarter, and bond values remain unchanged. Although the roller coaster is an exciting ride, we are comfortable giving up some volatility in favor of maximizing our bond returns: By placing the majority of the money we received from maturing bonds into six-month treasuries yielding approximately 2.2%, we sidestepped much of this instability during 2004.

We are sticking with our strategy of avoiding longer-term fixed-income investments, which are more sensitive to rising interest rates, and placing the proceeds from maturing bonds in shorter-duration treasury securities. As these shorter-term corporate and government bonds come due, we continue to reallocate this money to the highest-yielding, safe, short-term bonds we can find.

In 2005, we will prefer to be safe rather than sorry, and we plan to continue reallocating money to short-term fixed-income instruments. Why? Our first motto when investing in fixed-income instruments is to *protect principal.* Given that the principal on fixed-income securities moves in the opposite direction to interest rates, we are extremely concerned that rising interest rates could significantly impact the value of long-term bonds. It does not make sense to us to accept the paltry 4.2% yields offered on 10-year government securities, and we are unwilling to risk losing significant sums of money to chase a 1.3% greater yield in trade for more than nine years of investment. We will patiently persist on our disciplined path until we find longer-term opportunities for this money to achieve higher returns, in exchange for a "fair risk." We think fixed-income instruments carry far greater risks than the returns being offered.

In addition, we are finding (but will not name names) that several so-called AAA securities with low yields carry greater risk than many lower-rated bonds. When an investor buys a lower-rated bond with a higher yield that is commensurate with the risk, she knows what is being purchased. However, when an investor buys a AAA bond with a low yield, yet unknowingly accepts a larger risk of default, this could lead to trouble. We applaud the bond rating agencies for their efforts to qualify bonds for investors, but with today's ability to "trade risk," the ratings on many bonds can change quickly. So far, we have avoided the "rating potholes" when we allocate funds to high-rated bonds, as we are mostly buying government issues.

In summary, we are comfortable with our fixed-income investments and feel the returns are fair for the minimal risk we are taking. We are also content with our current businesses and the future worldwide prospects for each of these operating companies. We want to assure you that we continue to be mindful of the risks in today's markets and will allocate capital in a way that minimizes any long-term effect on the *value* of our holdings (with the knowledge that we cannot control the short-term *prices* of our holdings).

WHAT'S NEW AT FOUNDERS?

We have finished our first year at Founders Capital Management, following the merger of Founders Investment Advisors and The Terrion Group in January 2004. The transition was seamless, and we can say with confidence that it is as if we have always been together. We're happy with the partnership, and everyone plays a key role in our organization. We would especially like to thank Lisa Nogueira for hitting so many balls this past year and keeping us coordinated. (Since she is such a slugger, we'll throw a few more pitches her way in 2005.)

In 2004, Founders was recognized as one of the "top 10%" of Schwab advisors in New England. Although we are pleased with this honor, we realize that it is you that put us there—thank you. We also recognize that our success is not determined by our size but by our performance and the relationship we establish with each of you over time.

We will be transitioning to a new portfolio software system during the 1st quarter of 2005. This change is necessary to accommodate Founders' growing business and to provide our clients with the finest reporting possible. We anticipate that the installation will go smoothly and that you will see an improvement in your quarterly reports in 2005.

Thank you for your continued trust. We look forward to serving you during the next year.

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FOUNDING PRINCIPLES

We regard Founders as a collection of members that have a unique attitude toward investing. *Although we are not a partnership, we consider ourselves partners with our members and invest our own wealth alongside that of our clients. (In other words, we "set ourselves around the same table.") This unique approach ensures that we treat our members' wealth the way we would like to have our own wealth treated and provides our members confidence that we are using the most effective methods to achieve our goals as we mutually build long-term wealth.*

Founders takes active and direct control of managing wealth *and makes all investment decisions. Founders offers a fee-based investment service and purchases securities directly for our members. There is no conflict within our firm—the client comes first. There are no "hidden" commissions or fees within a portfolio. We seek to minimize trading and to identify the best execution strategy when purchasing a security.*

Founders focuses on risk management when managing wealth. *Risk management serves as a foundation for successful investment. We believe it is extremely important that investors understand the risks they are taking when investing in securities. It is important to directly match an investment portfolio to risk tolerance, as a mismatch can lead to volatility that is uncomfortable for our members. We invest in quality securities at the right price that will be held for a period of years. This enables Founders to monitor investments more closely than if they were in various mutual funds with constantly changing positions, and to maintain lower investment management fees..*

Founders has a distinctive viewpoint—one that is rooted in seeking long-term value. *Founders' investment practices are value-based. We are disciplined and make investment decisions only after we have thoroughly measured the long-term value of a stock and/or bond. We are agnostic about the market and its direction, and we apply a rational thought process when we acquire any security. Our goal is to purchase quality securities that will obtain the highest compounding yield over the greatest length of time, ensuring that we have a "margin of safety" on each individual investment.*

Founders fully communicates with members and assists them in achieving their investment objectives. *It is our opinion that members benefit from a fiduciary and due diligence standpoint if they receive a high level of communication and commitment from the managers they have chosen to invest their funds. We are committed to keeping members informed of our investment choices, and we are open in reporting the pros and cons of each investment.*