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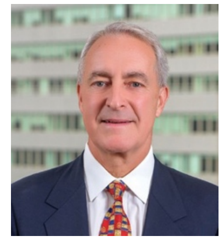

Thoughts for Investors

Albert C. Boris, III
Managing Director, Investments

Fall Newsletter to Clients

OCTOBER 2004

"Statistics are no substitute for judgment"
– Henry Clay, lawyer, statesman, U.S. Senator

While most investors are happy that earnings and the economy are rebounding, pundits claim these folks are too happy. They believe investors are overly enthusiastic and that share prices are too high relative to earnings per share. In other words, they think stocks are, in general, overvalued. I disagree with this universal statement. In this newsletter I will explain how they arrived at this conclusion. I will also explain why the age-old market adage "It's a market of stocks, not a stock market" is returning to prominence and why it will be important for investors to use their judgment when investing.

The time has come to go back to using judgment for gauging the potential for a stock. According to the American Heritage Dictionary, judgment is defined as "the formation of an opinion after consideration or deliberation." While mathematical formulae may be involved in the "quantitative" phase of the process, there is no way to "calculate" whether the stock would be a good buy. Using judgment to form an opinion also involves "qualitative" research, which is more subjective and requires experience. A very dangerous substitute for experience, and one that is increasingly utilized is the theory of "back testing." Back testing is the process of developing a formula and then using historical data to see if it would have worked. If it does, then it is assumed it will work in the future. This is not always correct (a fact pointed out by Benjamin Graham, Warren Buffet's teacher.)

In a past newsletter I wrote about four characteristics of a successful company. These form the core of my research and the basis for my judgment regarding a particular stock. The four are: 1. Large Market Opportunity, 2. Superior Products and Execution, 3. Barriers to Entry, and 4. Good Management. All four characteristics contain both quantitative and qualitative elements and their relative importance changes over time. Judgment is how much I am willing to pay for each of these characteristics. However, it is not as simple as calculating a value above or below which I will sell or buy. Recently, trying to calculate value has been foremost in investors' minds and has replaced judgment as prime criteria for picking a stock.

"Torture numbers, and they will confess to anything"
– Gregg Easterbrook, artist

The stock market has always tried to calculate the value of companies. Among the methods used are mathematical formulae that calculate numerous financial ratios. These ratios are then compared to those of other companies in a particular industry, for instance one steel company to another. Some investors even mistakenly use the ratios to compare companies in different industries, a dangerous technique. For example, it's tough to compare the financial efficiency of a company that needs lots of expensive capital equipment, say an airline, to that of a software company which needs very little capital. The most commonly used financial ratio is the P/E or price-to-earnings ratio, which is simply a stock's price divided by its earnings per share. A company with a stock price of $20 and earnings per share of $1.00 would have a 20 P/E. In other words, investors are willing to pay 20 times that $1 per share in earnings. P/E ratios can range from low single digits for automobile companies to triple digits for Google. The greater the perceived value of the company, the higher the P/E ratio investors will pay for the stock.

In the 'good old days' of the last bull market, everyone loved stocks and all the buying kept pushing P/E ratios, i.e., valuations, higher and higher. Some companies had no earnings and therefore infinite P/E ratios. While high P/E ratios are not justified for all companies, that's not universally true. In hindsight, no P/E ratio was too high to pay for Microsoft in its early days. In fact, Bill Miller, the famed manager of the Legg Mason Value Trust, has publicly stated his regrets about selling Microsoft years and years ago simply because it had what many people considered a high (read unattractive) P/E ratio. In reality, you only paid too much if no one else will buy it from you at a higher price. So why did investors continue to pay higher and higher P/E's?

The tendency to pay higher P/E ratios (read valuations) across the board for many stocks was, and still is, fostered in part, by investors' love of index fund investing (and mutual funds that "copy" the indexes.) Vanguard spent much time promoting the S&P 500-index fund as a low cost way to invest in stocks. While cost is important, it distracts from the real task-- building a portfolio of stocks or funds that has the potential to appreciate. Index investing has made the task more difficult.

Investing in the S&P 500 index means investing in only 500 out of thousands of stocks. When you merely automatically invest money in the index you don't know whether you are paying too high a P/E for any of those stocks. Yet the prospect of putting a portfolio on "auto-pilot" through index investing is very appealing because from 1995-1999 it appeared easy, profitable, and foolproof. The whole market just seemed to keep going up. Eventually index investing spiraled out of control. Low cost index funds attracted more money. More money flowing into the same 50 stocks raised their prices and P/E ratios. Rising stock prices meant higher returns. Higher returns led to even more money flowing into the funds and even higher P/E ratios. Throughout this cycle, the media remained fixated on the low cost of indexing and not on the higher and higher valuations of the stocks in the index. It appeared no one wanted to take the punchbowl away from the party. There was an additional negative consequence. As a result of all the "paper" profits, people felt less compelled to save. As of June 2004, according to the NY Times, the US savings rate stood at 1.2% of yearly income. This is hardly enough to build a retirement account. (Many now believe rising home prices will bail them out and consequently are still not thinking about saving.)

"Torture numbers, and they will confess to Nothing is more difficult, and therefore more precious, than to be able to decide.

– Napoleon Bonaparte, French emperor

What a difference a bear market makes on people's outlook, strategy, and ability to make a decision. Today, valuation is almost all that people talk about when discussing the worth of stocks. Today, investors don't buy, sell or hold a stock based on the merits of the company's prospects as they should, but rather on its perceived valuation as represented by its P/E or any of the other financial ratios. There are even websites which beckon you to enter the names of all your stocks and let them automatically "calculate" whether your stocks are good "values." It sounds so easy; yet not employing judgment is a very dangerous way to invest. First, any mathematical calculation depends upon accurate data going into the calculation, in the vernacular of computer programmers – garbage in, garbage out. If your calculation of a company's E(earnings) in the P/E ratio is not calculated the same way as someone else calculates it, your valuations will not agree. You might adjust your earnings for write-offs, goodwill, stock options, uncollectible accounts, off-balance sheet items, obsolete inventory, etc. and someone else may not. Also, some have argued that because many hedge fund managers are descended from the same teachers, they use the same formulae, and consequently get the same valuation signals at the same time. The result is that all react the same way at once, contributing to the great volatility that a stock may experience. Recall that the Money Masters were agreement that formulae only work for a short period of time (if at all.)

In summary, a bear market is often a time when investors make sweeping statements about the stock market and swear that they will never again overpay for any stock. Their sentiment pendulum swings from greed to fear- so the whole market is labeled as overvalued and every shadow is a ghost. If investors had historically depended upon an autopilot system (such as indexing) to do the work for them they will question that system and look for another system (technique) to replace it. Investing is a combination of art and science, with systems, techniques, and formulae alternately working and then failing to work. Forming an opinion about a stock after careful deliberation, i.e., using judgment, forces investors to commit to a stock before investing. If one does invest, that commitment must lead to being patient. Patience is the single most important attribute of a successful investor. An investor's number one concern should always be to identify his/her goals and then outline how best to achieve said goal (s) with the least amount of risk. I would suggest that rather than worrying about the stock market in general, concentrate on using your judgment to identify the best stocks in the market. Remember that it's always "a market of stocks not a stock market."

November 2 is Election Day. Please exercise your greatest right as a citizen of The United States of America. In case you need to be reminded of the value of this right, below are two inscriptions.

"Freedom is a light for which many men have died in darkne

– From the wall of the memorial of the Tomb of the Unknown Revolutionary War Soldier in Washington Square, Philadelphia, Pennsylvania

"Beneath this stone rests a soldier of Washington's army who died to give you liberty"

– From the tomb of the Unknown Revolutionary War Soldier, Washington Square, Philadelphia, Pennsylvania

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Hear the Other Side

The Boris-Kaplan Group // 1735 Market Street, Suite 1400 // Philadelphia, PA 19103 // T 215.563.2300
www.alexbrown.com/boriskaplan

If you would like to discuss the topic of this newsletter, or our team's approach to investing, please feel free to contact us by email at al.boris@alexbrown.com.

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