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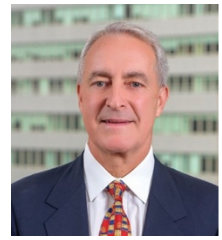

Thoughts for Investors

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Newsletter to Clients

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"In any moment of decision the best thing you can do is the right thing, the next best thing is the wrong thing, and the worst thing you can do is nothing."
– President Theodore Roosevelt

Spring is a distant memory and gone with it are memories of big returns in the stock market. What changed? Why is it so volatile? Is it Greenspan? Was it the presidential election? Oil prices? Why can't it just keep going up like it always does?

The day traders are long gone, having relinquished their celebrity status and gone back to real jobs. E-trade and dot.com commercials are now relegated to CNBC, much like the ginsu knife commercials on late night TV. The popular press has declared the end of the bull market and Warren Buffett's prediction has come true –"When the tide goes out we'll see who has been swimming naked."

Is it really over or just dormant, like leafless trees in winter? Is this the time to be planting new stocks in your portfolio? The consensus is always to wait until things look better and then, as we know, it's too late.

In this newsletter, I will try to show that successful investing is not a matter of timing but rather a thoughtful combination of doing your homework, getting in the market, and developing the patience to stay invested.

Doing Your Homework

"Reading after a certain time diverts the mind too much from its creative pursuits. Any man who reads too much and uses his own brain too little falls into lazy habits of thinking.
– Albert Einstein

Of course an investor has to do their homework and that requires reading. However, too many investors have let the financial press do their homework for them by creating lists of "best stocks for the New Year", etc. Needless to say, it's been of dubious quality. Furthermore, many investors believe that with index funds you can put your portfolio on automatic pilot. Investor's homework should revolve around four key areas that can affect a company's growth and therefore its stock price.

1. Market Opportunity. Is there a large market for this company's products? Is that market growing each year? Are they gaining market share? Is the industry consolidating and will they likely be one of the winners?

2. Products & Execution. Are the company's products different from those of their competitors? Are they better? Does the company have a diverse product line? Do they spend money on research to discover new products? Do their products actually work? Does anyone care about buying their products? Are their products widely available to all potential customers? Do they have an effective distribution system for getting the products to the customers?

3. Barriers to entry. How does the company keep competitors away? Do they have patents? Do they have a head start? Do they have expensive plant and equipment that a potential competitor would have to build? Do they have expertise that is not easily duplicated?

4. Management. This is the hardest to quantify yet may be the most important ingredient in a successful company. Who is in charge? Does the management team have depth of experience? How long have they worked together? Have they run a successful company prior to this one?

If you are examining a company as a potential investment and you give that company high marks in all these areas then you've identified a stock with a pretty good chance for appreciation. The next step is taking action.

Getting in the Market

"The biggest risk of the stock market is not being in it."

– John Templeton

"Action without study is fatal. Study without action is futile."

– Winston Churchill

Many people are familiar with the success of Cisco Systems. In the last 10 years its stock has risen from 9 cents to $50 per share. What many investors do not remember is that within that ten year period there were at least five times at which a new investor could have bought the stock at what turned out to be a bargain price. That's because five times over the last ten years the stock has suffered a gut-wrenching 40% or more decline, only to eventually end up even higher. Even investors who did their homework had to take that leap of faith to get in. The most successful of Cisco investors were those that added to their position in the midst of all the volatility.

"If you can't accept losing, you can't win."

– Vince Lombardi

Patience

"Often to lose patience is to lose the battle"

– Mohandas Gandhi

Of all the attributes of a successful investor the one that is the most important is patience. Take for example the story of the patient Wal-Mart investor. Wal-Mart came public in the fourth quarter of 1970. If the stock had been purchased by the typical stock mutual fund it would have been sold by 1971. A long term investor however, who held the stock through August of this year would have seen a $1000 original investment blossom to $4,273,980.14. What's equally spectacular about this story is how much patience was required to get that return! In 21 out of the last 30 years Wal-Mart stock declined by at least 20% per year, with declines of 80% in 1973-74 and 54% in 1987.

One principle investors can use to be more patient is what I call the "Arithmetic principle of investing". The arithmetic principle of investing is based on making the same size investment in each stock. The principle is that arithmetically, an investor can never lose more than 100 percent, yet potential gains are infinite. If this is truly understood by investors then they will continue to "come to bat" despite previously striking out. If an investor continues to do their homework, come up to bat, and be patient, then the number of strikeouts relative to hits should continue to decline.

To take the arithmetic principle to its extreme, suppose besides the $1,000 investment in Wal-Mart, you continued to invest $1,000 per month in other stocks over the thirty year period. Even if $359,000 of the $360,000 total investment ($1,000 per month x 12 months per year x 30 years) went to zero, the single $1,000 purchase of Wal-Mart rising to $4,273,980 would calculate to a 13% compounded annual return. Just think if one of those other 359 investments was Cisco Systems or Qualcomm!

The volatility we are experiencing today is no different than any other time. News stories in the press drive emotions, which in the short run drive stock prices. In the long run though, only company fundamentals drive stock prices. The ability to remain patient is what defines great investors such as Warren Buffett.

The "New New Economy"

I recently returned from the four day DB Alex. Brown growth conference for technology companies in Baltimore. This year marked a decade of attending this conference. This year's highlights included the emergence of what I call the "new new economy" company. A "new new economy" company is an "old economy" company that has broken its shackles by adopting the products and services being offered by "new economy" companies. For example, Wal-Mart has left Sears and K-Mart in the dust in part because Wal-Mart spends a half billion dollars per year on technology products and services. General Electric has also left their competition in the dust. Last year they substantially increased their purchase of Cisco Systems products and this year they plan to purchase even more.

The most striking sight at the conference was the number of young companies like Siebel Systems who count virtually all of the Fortune 500 companies as their customers. Ten years ago Siebel Systems didn't exist. Many "new economy" companies have now sold their products to "new new economy" companies like Walmart, General Electric, Merck, and American Express. The remaining Fortune 500 companies are working feverishly to join the fraternity of the "new new economy" and they will need the help of the "new economy" companies such as the ones that presented at this conference.

In summary, the stock market and growth stocks are not dead. There are still many entrepreneurs who are yelling "move over Bill Gates, it's my turn!" That's what makes this country great and the one with the best opportunities for growth. Now is the time to invest and while I believe the formula is simple – do your homework, get in the market (or stay in), and be patient, the execution of the formula is not.

"Bear markets are what return stocks to their rightful owners."

– John D. Rockefeller, Sr.

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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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