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Stocks Stall Near Dow 10,000 -Next Move Up?

Back in November, 2003 when much of the financial media was making excited noises about an impending return to the Dow 10,000 level and prospects for further stock gains, we wrote: "At best, the market should stall in the 10,000 to 11,000 range for months before eventually advancing. At worst, 10,000 to 11,000 is the top for this market cycle."[1] I reiterated this caution last February. With Summer 2004 upon us, the prognostication appears to have been correct. Despite a brief rise to Dow 10,700, and a surge of investor bullishness in the first quarter followed by a plunge below 10,000 in May, little headway has been made for most U.S. equities. Memories of the cost of an over zealous commitment to growth stocks in the 1990's has kept investors disciplined. And, as suggested in our tongue-in-cheek scenario presented with the November prediction I suspect a lot of stock market wealth, recovered in last year's rally is being liquidated in order to buy tile for bathroom and kitchen remodels.

With clear signs of an economic recovery, especially the decline of unemployment claims, it is likely that second quarter earnings reports for our equity holdings will be healthy. If this phenomena proves widespread, improved earnings may put a firm foundation under the Dow 10,000 level. Anecdotal evidence (conversations with friends in business) suggest the economy is humming along nicely. In other words, I'm turning more positive. But until the Fall election results are clear, I believe the markets and our holdings in particular, may struggle to fulfill their potential. Without being drawn into stating what election result I think would be best economically for the country, I suspect that neither party will do anything to derail the somewhat fragile economic recovery we are experiencing. All this being said, I try to base equity investments on bottom up criteria, the fundamentals of a given company and it's industry group.

Warren Buffet's 20 Punch card

Continuing with last month's discussion of lessons learned, or re-learned while at the Berkshire Hathaway annual meeting, May 1 2004, it would be valuable to quote from an article that Bill Mann penned for the Motley Fool web site (www.fool.com) shortly before this year's meeting:

"…people show extraordinary willingness

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to put their money at risk on companies they know nothing about. To me, this shows a basic mental block when it comes to money. Why does a $1,000 car repair bill throw people into paroxysms, where $1,000 in a brokerage account amounts to "play money"? I figure it's the same thing as the genius of poker chips -- you no longer view them as having the same underlying currency value. If I lose on this hand or this trade, eh, so what? I've got plenty of chips left…

Clearly such an attitude has helped a good many people torpedo their financial futures, either one bad trade at a time, or in times of rapid decline, all at once. <u>But what happens when you take the discipline of thinking of trades as being extremely precious and limited in quantity?</u>[2]

Does that change the perception of each one?…

If you only get to make 20 decisions ever, that would make you value each and every transaction a heck of a lot more than otherwise, don't you think? So many investors still seem to take the "Fire, ready, aim" approach to deploying their own assets. Buy something because Joe from the gym mentioned it -- heck, it's going up! -- and endeavor to learn about the company later…

Consider the discipline that you would show instead if there were a bean counter ready to shut off the spigot on new investments. Right away, this is bound to make you focus intently on your decisions. You would likely limit your investing to areas and industries that you have studied"

This concept first came to me from reading <u>The Warren Buffet Way</u> (Robert Hagstrom Jr.,©1995 John Wiley & Son.). It is a useful brake on careless investing. Our clients find that certain stocks have remained in their accounts for extended periods of time. This is because much thought has gone into stock selection. I try to find and buy businesses I'm comfortable staying with because they exhibit unique qualities and or competitive advantages. Years ago as a stock broker, and before I'd grasped the 20 punches concept, I tried to please quite a few clients who valued action over results. These folks have either left me or were invited to find another advisor as I became clear that my purpose was to protect and build client wealth, not to provide entertainment. Current long time clients know (often from earlier experience) that compulsive trading produces an inevitable result: precious capital is frittered away. The broker earns fees but the client is alternately ecstatic or inconsolable - is that any way to live? My clients think not.

While I am constantly grazing on investment information, in search of good investments, it is rare that a tasty patch of clover is unearthed. So it was for most of the past few months: none of the many situations reviewed were compelling, and in fact we took profits on a couple of holdings. In recent days, however it became plain to me that at least one generic drug company has been sold off by restless "growth" investors because the company has failed to bring any block buster copycat drugs to market in the past six months. It is trading about 25%-30% below intrinsic value, at the same price seen a year ago, but with greater cash flow and shareholder equity. After reviewing the large pipeline of new drug applications, management's intelligent use of capital, and the likely approval of a big new medical product this Summer, we purchased for nearly all discretionary accounts.

My approach is evolving, influenced to some degree by my experience at the Berkshire annual meeting. Slavish adherence to a requirement that a stock be purchased only when trading at a 40% discount to intrinsic value may miss other considerations that justify a purchase. One of the nuances I took away from the Berkshire meeting was to continue to give greater weight to management *quality* and other non-quantitative considerations when deciding whether to buy, hold or sell a position. Berkshire's co-Chairman, Charlie Munger was strongly influenced by author Philip Fisher (<u>Common Stocks and Uncommon Profits, 1958</u>), and in turn influenced Warren Buffet to gravitate away from Benjamin Graham's strict requirement that a company be purchased only when available at a large discount to book value. Fisher posits that simply buying a business because it is cheap can leave the investor holding a badly run business that will continue to be an underachiever. Fisher offers many ways to judge the quality of a business, giving prominence to the competitive strategy management has devised to deal with the future. Buffet and Munger have demonstrated their ability to balance quantitative intrinsic value analysis with qualitative considerations by the success of their many acquisitions over time.

In the same spirit, I recently decided to apply more qualitative judgment in selecting a purchase, Exxon-Mobil for most discretionary client accounts. This is one of the few corporations in America with a AAA credit rating. Management, almost always promoted from within (current CEO Lee Raymond has been with the firm for 40 years) was considered out of touch when competitors like Enron were claiming to generate huge profits from energy trading only a few years ago. Their conservatism is legendary, yet the company has increased shareholder value and dividends year after year, despite wide fluctuations in energy prices.

producing companies. Perhaps the timing is imperfect, but the quality of Exxon Mobil, is indisputable. Thus for appropriate accounts, we positioned in this "super major", a company that has consistently grown shareholder wealth and increased dividends regularly; a company that has recently taken a novel approach to development of it's gas properties by sharing the risk and capital costs with a competitor, while retaining significant upside potential. Exxon Mobil is also ahead of the curve with regard to the looming demand for imported liquefied natural gas (LNG), and is involved in projects to build infrastructure which will allow the nation to enjoy sufficient supplies of a relatively clean fuel, while producing a profitable new venture.

Exxon-Mobil Share holder Equity

1996	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*	*2003*	*2004*
$62.6	63.1	62.1	63.5	70.7	73.1	74.6	89.9	91.7[3]

Note: All figures are Billions of US dollars

As shares of integrated petroleum production companies recently stalled near their quantitative fair value, I sold a profitable position for some accounts in Occidental Petroleum. I'd become skeptical of management's quality, and since the stock appeared fully valued, there was no other reason to stay on board. Still, I want my clients to own upstream energy assets and to own only the very best quality oil producer. While I would have loved to buy Exxon Mobil at a big discount to intrinsic value, I believe we are in a secular (long term) bull market for oil and natural gas, and there are signs that another leg up may be under way for oil

Let's end this month's Trusted Advisor with a chuckle or two:

From the ***Washington Post*** alternate word meanings contest:

- Coffee: the person who is coughed upon.
- Abdicate : to give up all hope of ever having a flat stomach.
- Negligent: describes a condition in which you absentmindedly answer the front door in your night gown.
- Flabbergasted: appalled over how much weight you have gained.

(Footnotes)
1 Trusted Advisor Vol. 2 No. 9, November 2003
2 Emphasis added
3 2004 Shareholder figure for XOM as reported at the end of the first quarter 2004, not a full year figure.