

# REVIEW & OUTLOOK

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**INDEXES**

(Close as of: 5/18/01)

DJIA:	11301.74
S&P 500:	1291.96
NASDAQ:	2198.88
S&P 400:	532.02
S&P 600:	231.04



## THE ECONOMY - The Week In Review

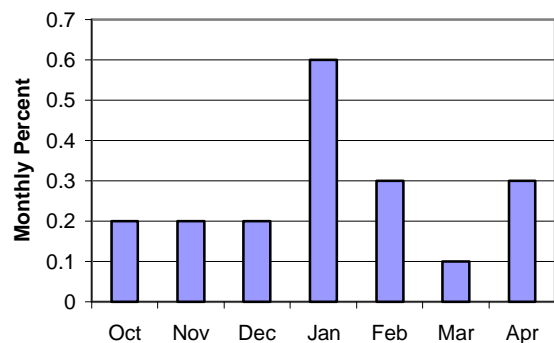
### Fed Rate Cut

The big news of the past week was the Federal Reserve's interest rate cut on Tuesday, May 15th, which lowered the Fed's target for the federal-funds rate by one-half of a percentage point to 4%. This was the fifth rate cut this year and the lowest the federal-funds rate has been since May 1994.

The Fed stated in a press release that accompanied the rate cut that: "With pressures on labor and product markets easing, inflation is expected to remain contained." The Fed went on to say that it continues to believe that "...the risks are weighted mainly toward conditions that may generate economic weakness in the foreseeable future."

While the Fed cut rates on Tuesday, May 15th, the stock market didn't react until Wednesday, May 16th. But when it did react, it reacted in a big way. The DJIA

**Consumer Price Index**



Source: Federal Reserve

closed at 11215.92 on Wednesday, May 16th, up 342.95 points, or 3.15 percent. This was the Dow's first close above 11000 since September. The S&P 500 was up 2.85 percent to close at 1284.99 and the Nasdaq closed at 2166.44, up 3.88 percent on Wednesday, May 16th. The index values at the end of the week were as follows: DJIA closed at

*(Continued on page 2)*

## INVESTMENT STRATEGY

### A FEW GOOD IDEAS MAY BE ALL YOU NEED!

I attended the Wesco Financial Corporation's annual meeting a couple of weeks ago. For those not familiar with Wesco, let me give you a little background on the Company. The majority of the shares of Wesco are owned by Berkshire Hathaway. Charles Munger, who along with famed investor Warren Buffett runs Berk-

shire Hathaway, is the Chairman and CEO of Wesco.

It is always interesting to attend the Wesco shareholder meetings and hear Charlie Munger speak and answer questions from the audience. Munger, who is

*(Continued on page 8)*

## THE ECONOMY - The Week In Review

(Continued from page 1)

11301.74; the S&P 500 closed at 1291.96; and the Nasdaq closed at 2198.88. All in all, it was a pretty good week for the stock market. However, as we discuss in the *Stock Market Valuation* section of this report, the rebound in stock prices pushed the stock market's valuation to a very high level.

### Other Economic Reports of the Past Week

A Federal Reserve survey found that banks are generally tightening lending standards, due primarily to the weak economy. Loan demand was also found to be down due to reduced capital spending and lower merger and acquisi-

tion activity.

A survey released by Manpower Inc., which tracks corporate hiring plans for the upcoming quarter, turned sharply down. This was seen as a particularly bad sign for the economy as hiring in the third quarter is normally the highest of the year.

The U.S. trade deficit widened in March to \$31.17 billion from \$26.86 billion in February. This may cause the first quarter GDP number to decline somewhat when it is released this week because it was assumed by the Commerce Department in making its advance estimate of first quarter GDP that the trade deficit would be lower.

(Continued on page 8)

## ECONOMIC FORECASTS

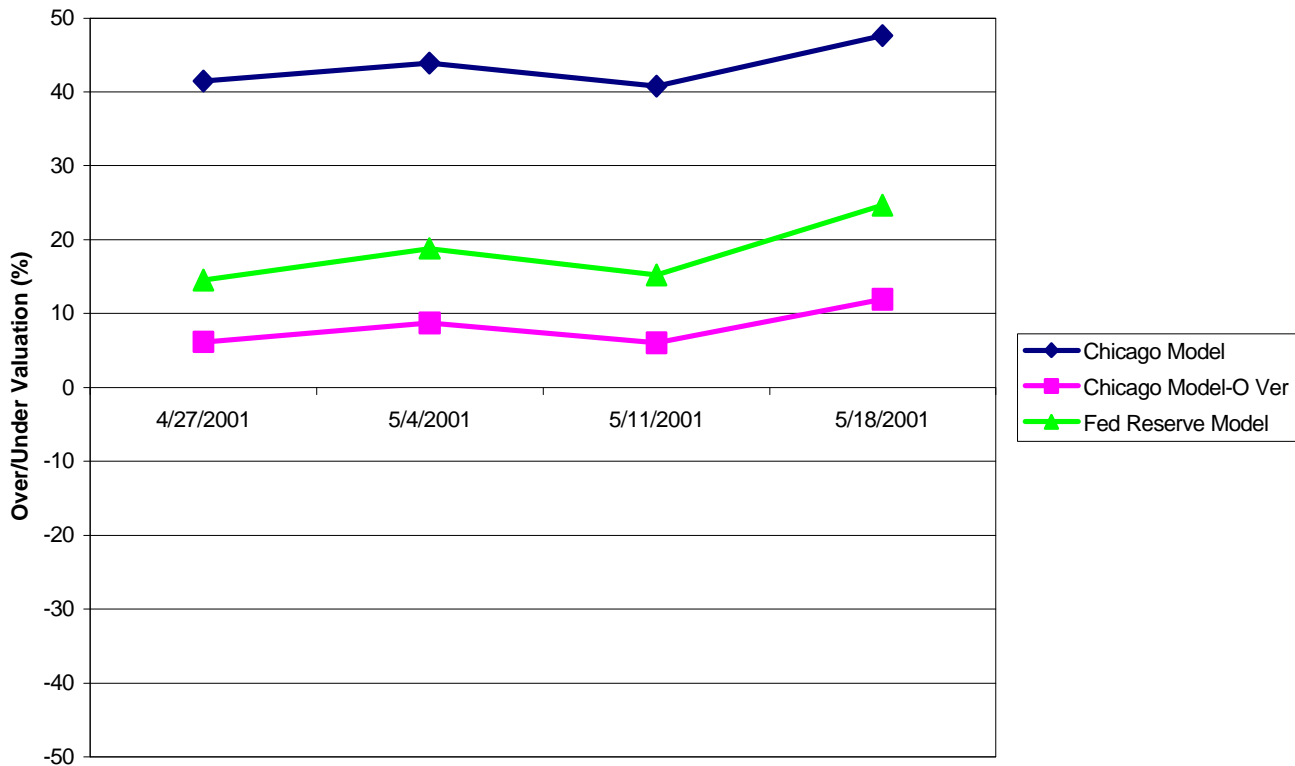
(As of May 18, 2001)

<u>ECONOMIC FACTOR</u>	<u>Actual</u>				<u>Forecasts</u>	
	<u>1997</u>	<u>1998</u>	<u>1999</u>	<u>2000</u>	<u>2001</u>	<u>2002</u>
<b>Percent Change</b>						
Real GDP	4.4	4.4	4.2	5.0	1.9	3.3
GDP Price Index	2.0	1.3	1.5	2.1	2.1	2.0
Gross Domestic Product (GDP)	6.5	5.7	5.8	7.1	4.0	5.3
Consumer Price Index (CPI)	2.3	1.5	2.2	3.4	3.0	2.5
<b>Variables In Levels</b>						
Unemployment Rate	5.0	4.5	4.2	4.0	4.6	4.8
3-Mo. Treasury Bill Rate	5.06	4.78	4.64	5.82	4.3	4.5
10-Yr. Treasury Bond Yield	6.35	5.26	5.64	6.03	5.0	5.3
30-Yr. Treasury Bond Yield	6.61	5.58	5.87	5.94	5.4	5.5

*"...the rebound in stock prices pushed the stock market's valuation to a very high level. "*

## STOCK MARKET VALUATION (AS OF MAY 18, 2001)

### S&P 500 Valuation



What a difference a stock market rally can make! At the present time (May 18, 2001), we believe the stock market, as represented by the S&P 500, is overvalued by about 25%. This is up sharply from an estimated overvaluation of about 15% in the previous week.

One of the great things about financial modeling is that it allows you to examine and analyze your assumptions. The three models charted above use different sets of assumptions for earnings growth rates, interest rates and other factors; and thus give three different perspectives on the current stock market valuation. The *Chicago Model – O Version* and the *Federal Reserve Model* show overvaluations of 11.9% and 24.6%, respectively. Both of these models use fairly aggressive assumptions for earnings growth rates. The *Chicago Model*, which uses a more conservative set of assumptions for earnings growth rates as well as past earnings and interest

rates, shows an overvaluation of 47.6%. While we do not necessarily believe that the market is overvalued by 47.6%, it should be noted that many of the assumptions used in the *Chicago Model* are realistic. If the market were to accept these assumptions as representative of future conditions, there could be further significant declines in the indexes. It is important to be aware of this possibility and to monitor the variables that are inputs to the models for any signs that possibility is becoming reality.

The workings of these models will be explained in a future article in this weekly commentary. For now, let it suffice to say that we tend to favor the Federal Reserve Model and, even given its aggressive set of assumptions, believe that it is currently giving the most accurate estimate of the stock market's overvaluation at around 25%.

## STOCK HIGHLIGHT: MBNA CORPORATION

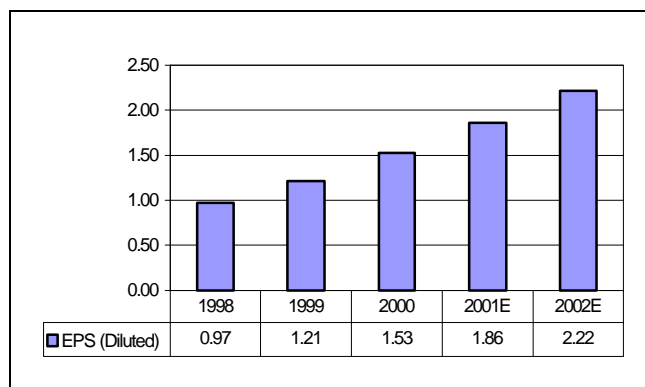
Price (5/18/01):	\$36.75	Beta:	1.53
52-Week Range:	\$25.5625 to \$40.1250	Shares O/S (Basic):	851.8 million
Dividend:	\$0.36	Market Capitalization:	\$31.3 billion
Dividend Yield:	0.98%	Fiscal Year End:	December
EPS:	\$1.60	Industry:	Regional Banks
EPS Growth (5yr):	27.2%	Float:	647.4 billion
Avg. Daily Vol.	2,545,272	ROA (3/01):	3.90%
P/E (Basic ttm.):	22.97	ROE (3/01):	24.18%
P/B (3/01):	4.63	P/E/G	1.15
P/S (3/01):	11.07	P/E/G (2001E EPS):	0.99
Profit Margin (3/01):	48.7%	5Yr Est EPS Growth:	20%
Current Ratio (3/01):	n/a	Symbol:	KRB
Debt/Equity (3/01):	0.90	Exchange:	NYSE

### BUSINESS

(Source: MBNA Corporation)

MBNA Corporation, a bank holding company and parent of MBNA America Bank, N.A., a national bank, has \$88 billion in managed loans. MBNA, the largest independent credit card lender in the world, also provides retail deposit, consumer loan, and insurance products. MBNA.com ([www.MBNA.com](http://www.MBNA.com)) provides credit card, consumer loan, retail deposit, travel and shopping services.

### Diluted Earnings Per Share



FOCUS LIST - 4/2/01

Company	Symbol	Price 3/23/01	Current		P/E	5 Yr.		PEG	Div (Ind.)	Beta	Sector	Mkt Cap (millions)
			FY EPS Est	Est Crmt FY		Est %	EPS					
Anadarko Petroleum Corp.	APC	62.60	5.65	11.1	15.9	0.7	0.20	0.74	Energy	15676.9		
Applebee's Int'l, Inc.	APPB	34.25	2.73	12.5	15.4	0.8	0.11	0.53	Consumer Staples	864.3		
Arkansas Best Corporation	ABFS	17.25	2.80	6.2	9.7	0.6	0.00	0.83	Transportation	351.4		
Constellation Brands Inc.	STZ	66.50	5.19	12.8	17.4	0.7	0.00	0.88	Consumer Staples	1369.6		
Energen Corporation	EGN	31.74	2.31	13.7	11.8	1.2	0.68	0.26	Utilities	974.9		
Esterline Technologies	ESL	19.75	1.88	10.5	11.0	1.0	0.00	0.78	Capital Goods	407.9		
Fastenal Company	FAST	54.13	2.56	21.1	24.4	0.9	0.09	0.63	Basic Materials	2053.4		
Golden State Bancorp, Inc	GSB	26.85	2.68	10.0	10.3	1.0	0.40	0.91	Financial	3604.3		
Henry Schein, Inc.	HSIC	33.38	1.92	17.4	15.6	1.1	0.00	0.76	Health Care	1397.9		
Jones Apparel Group, Inc.	JNY	37.25	2.96	12.6	18.9	0.7	0.00	1.18	Consumer Cyclical	4444.8		
Lincare Holdings Inc.	LNCR	53.13	2.67	19.9	21.3	0.9	0.00	0.29	Health Care	2767.4		
MBNA Corporation	KRB	30.21	1.85	16.3	20.1	0.8	0.36	1.61	Financial	25732.3		
Philip Morris Companies	MO	43.40	4.06	10.7	12.6	0.8	2.12	0.24	Consumer Staples	96501.2		
Phillips Petroleum Co.	P	54.37	6.47	8.4	10.8	0.8	1.36	0.67	Energy	13880.7		
Robert Mondavi Corp.	MOND	46.25	2.96	15.6	17.9	0.9	0.00	1.05	Consumer Staples	738.3		
Soletron Corporation	SLR	21.04	0.90	23.4	29.9	0.8	0.00	1.98	Technology	13582.0		
Tellabs, Inc.	TLAB	46.25	2.10	22.0	28.1	0.8	0.00	1.95	Technology	18986.3		
Timberland Company	TBL	51.50	3.45	14.9	18.8	0.8	0.00	1.31	Consumer Cyclical	2044.4		
Toll Brothers, Inc.	TOL	37.00	4.69	7.9	14.2	0.6	0.00	0.34	Consumer Cyclical	1349.8		

**Additions - 4/2/01**

Sunrise Assisted Living	SNRZ	19.69	1.89	10.4	20.8	0.5	0.00	0.43	Health Care	425.2
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**Deletions - 4/2/01**

AmeriSource Health Corp.	AAS	49.05	2.27	21.6	17.7	1.2	0.00	-0.03	Health Care	2579.0
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**MODEL PORTFOLIO**  
**4/2/01**

Company	Symbol	Price 3/30/01	# of Shares	Portfolio Value	% of Portfolio	P/E		Div (Ind.)	Beta	Sector	Mkt Cap (millions)
						Est Crnt FY	Est Crnt FY				
Anadarko Petroleum Corp.	APC	62.78	100.00	6278.00	6.79%	11.1	0.20	0.74	Energy	15676.9	
Applebee's Int'l, Inc.	APPB	35.69	100.00	3568.75	3.86%	13.1	0.11	0.53	Consumer Staples	864.3	
Arkansas Best Corporation	ABFS	15.75	200.00	3150.00	3.41%	5.6	0.00	0.83	Transportation	351.4	
Constellation Brands Inc.	STZ	71.75	100.00	7175.00	7.76%	13.8	0.00	0.88	Consumer Staples	1369.6	
Energen Corporation	EGN	35.30	200.00	7060.00	7.63%	15.3	0.68	0.26	Utilities	974.9	
Esterline Technologies	ESL	21.75	100.00	2175.00	2.35%	11.6	0.00	0.78	Capital Goods	407.9	
Fastenal Company	FAST	54.50	100.00	5450.00	5.89%	21.3	0.09	0.63	Basic Materials	2053.4	
Golden State Bancorp, Inc	GSB	27.88	100.00	2788.00	3.01%	10.4	0.40	0.91	Financial	3604.3	
Henry Schein, Inc.	HSIC	36.75	100.00	3675.00	3.97%	19.1	0.00	0.76	Health Care	1397.9	
Jones Apparel Group, Inc.	JNY	37.80	100.00	3780.00	4.09%	12.8	0.00	1.18	Consumer Cyclical	4444.8	
Lincare Holdings Inc.	LNCR	52.94	100.00	5293.75	5.72%	19.8	0.00	0.29	Health Care	2767.4	
MBNA Corporation	KRB	33.10	200.00	6620.00	7.16%	17.9	0.36	1.61	Financial	25732.3	
Philip Morris Companies	MO	47.45	100.00	4745.00	5.13%	11.7	2.12	0.24	Consumer Staples	96501.2	
Phillips Petroleum Co.	P	55.05	100.00	5505.00	5.95%	8.5	1.36	0.67	Energy	13880.7	
Robert Mondavi Corp.	MOND	44.81	100.00	4481.25	4.85%	15.1	0.00	1.05	Consumer Staples	738.3	
Soletron Corporation	SLR	19.01	200.00	3802.00	4.11%	21.1	0.00	1.98	Technology	13582.0	
Tellabs, Inc.	TLAB	40.69	100.00	4068.75	4.40%	19.4	0.00	1.95	Technology	18986.3	
Timberland Company	TBL	50.80	100.00	5080.00	5.49%	14.7	0.00	1.31	Consumer Cyclical	2044.4	
Toll Brothers, Inc.	TOL	38.50	100.00	3850.00	4.16%	8.2	0.00	0.34	Consumer Cyclical	1349.8	
<b>Total</b>				<b>92483.10</b>	<b>100.00%</b>						
<b>Additions - 4/2/01</b>											
Sunrise Assisted Living	SNRZ	19.69	200.00	3937.60	4.26%	10.4	0.00	0.43	Health Care	425.2	
<b>Deletions - 4/2/01</b>											
AmeriSource Health Corp.	AAS	49.05	100.00	n/a	n/a	n/a	n/a	n/a	Health Care	n/a	

## SECTOR ALLOCATION

March 22, 2001

Sector	% of S&P 1500 *	Portfolio Weight
Basic Materials	2.74%	Underweight
Capital Goods	8.78%	Neutral
Communication Services	5.60%	Underweight
Consumer Cyclicals	9.26%	Neutral
Consumer Staples	12.66%	Neutral
Energy	7.09%	Overweight
Financial	17.14%	Neutral
Health Care	12.76%	Overweight
Technology	18.76%	Neutral
Transportation	0.85%	Neutral
Utilities	4.37%	Neutral
Total S&P 1500	100.0%	

\* Data as of March 16, 2001

Our **sector allocation strategy** is based on a quantitative analysis of over 100 industries in the 11 economic sectors listed above.

Many years of experience has taught us that over the long-term, most investors should maintain some investment exposure to each of these 11 sectors. However, in the short-run, some sectors can be expected to perform better than others. Accordingly, the ratings of **Overweight**, **Neutral** and **Underweight** that we have assigned to each of the sectors above represent our assessment of the expected relative market performance of each of the sectors over the next year.

When constructing a portfolio, it is suggested that an investor invest in each of the

sectors, but *overweight* those sectors that have the best prospects and *underweight* those sectors that have the least favorable prospects.

It should be noted that these ratings are for broad sector groupings which are composed of many different industries and thousands of individual stocks. Therefore, a careful analysis should be made of such factors as valuation, financial strength and growth characteristics for each industry and individual stock in which the investor plans to invest. In other words, not every industry or stock in a chosen sector has the same expected attributes as the sector as a whole might have. It is important to be selective in choosing individual investments.

## THE ECONOMY - The Week In Review (Continued)

(Continued from page 2)

Inflation concerns eased a bit with the release of the April CPI number, which rose 0.3%. This followed a 0.1% rise in March.

Housing starts rose 1.5% in April. They had declined 2.3% in March. The housing sector has been considered one of the stronger sectors during this economic slowdown.

And finally, the Conference Board's index of leading economic indicators rose 0.1% in April. It had fallen in the previous two months.

### Economic Forecasts

The Economic Forecasts table on page 2 shows our forecasts for a number of economic factors.

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## INVESTMENT STRATEGY (Continued)

(Continued from page 1)

regarded as one of the great investors of our time, is responsible for convincing Warren Buffett to follow the course of paying a little more for excellent businesses instead of pursuing the Ben Graham approach of buying anything as long as you can get it at a steep enough discount. The Munger approach is

largely responsible for making Warren Buffett and Charlie Munger two of the most successful investors of all time.

Reflecting back on some of the past Wesco meetings that I have attended, I was reminded of an important point that Munger often brings up in his various writings and speeches. The point he makes is this: **most of Berkshire Hatha-**

*“...most of Berkshire Hathaway’s billions of dollars were made with just a handful, perhaps ten or so, of great insights”*

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## INVESTMENT STRATEGY (Continued)

**way’s billions of dollars were made with just a handful, perhaps ten or so, of great insights.**

### JUST A HANDFUL OF GREAT IDEAS?

While it would be nice to have thousands of great investment ideas in a lifetime, all of which worked perfectly, that is not the possible for most humans – even for very savvy and successful investors like

Charlie Munger and Warren Buffett. And if someone did have that many great ideas, it would be impossible to keep up with all of those investments.

Munger and Buffett maintain that it is better to thoroughly research and understand a few companies and the management teams that run them; and to limit one’s investments to the best of these.

(Continued on page 9)



## INVESTMENT STRATEGY (Continued)

(Continued from page 8)

It is not enough, however, to find really great companies with talented management teams. There are, in fact, a lot of companies that meet this criteria. The other part of the investment equation is to find those great companies or investment situations that can be had for a bargain – that is that are somehow mispriced. Munger maintains that you don't find many of those in a lifetime. But when you do, you have to recognize it and load up on that investment. It's that simple!

Here's how Warren Buffett looks at it. He suggests that an investor pretend that he/she has a punch card with only twenty boxes on it. Each time the inves-

tor makes an investment decision, he/she punches one of the boxes. When all twenty boxes have been punched, the investor is done! That investor can never make an investment again for the rest of his/her life. Now how do you suppose an investor might look at a potential investment if he/she could only make twenty investments in his/her entire life? Do you think the investor might give that investment some due consideration? That's what Buffett would suggest.

Two other legendary investors who advocated the same or similar approaches were John Maynard Keynes and Philip Fisher. The economist John Maynard Keynes believed that investors should own a concentrated portfolio that they could understand well. Besides being a

### FISHER AND KEYNES

great economist, he was also a very successful investor. Philip Fisher was a successful California money manager and was a contemporary of Benjamin Graham. Warren Buffett once described himself as being 15 percent Philip Fisher and 85 percent Benjamin Graham. Buffett learned several things from Fisher including these two important lessons:

1. The quality of the company and

its management can make a big difference in investment results. And to really understand the quality of the company, an investor has to do a lot of investigation.

2. Don't put too much emphasis on diversification. Some diversification is good; but not understanding each company in which one

*“When all twenty boxes have been punched, the investor is done!”*

### THE SECRET TO INVESTMENT SUCCESS

makes an investment can be more risky than a strategy of limited diversification.

Peter Lynch, who coined the term “deworsification” to describe the negative aspects of diversification, has said that the number of stocks an investor should hold in his/her portfolio is the number of stocks that have passed all of the hurdles of research and in which the investor has an edge. How many stocks is

that? It could be one or a dozen stocks (although he does go on to say that it wouldn't be safe to own just one stock).

#### SECRET TO INVESTMENT SUCCESS

This approach can perhaps best be summed up this way: The secret to investment success is to find the really great investments that are somehow mispriced, load up on those investments,

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## INVESTMENT STRATEGY (Continued)

*(Continued from page 9)*

and plan to hold them over the long-term.

I'm not suggesting that this is the only approach to investing — or even the best approach — though it has worked pretty well for Munger, Buffett, Lynch, Fisher, Keynes and others.

Being less diversified in your portfolio can be scary at times and could ultimately lead to disastrous results if you are wrong. But despite this obvious drawback, I do think it is an approach worth considering.

*“The secret to investment success is to find the really great investments that are somehow mispriced, load up on those investments, and plan to hold them over the long-term.”*

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ates, View and Edit Portfolio, Brookstreet Technical Focus List.

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