

# REVIEW & OUTLOOK

**INSIDE THIS ISSUE:**

<i>The Economy - The Week In Review</i>	1
<i>Investment Strategy</i>	1
<i>Economic Forecasts</i>	2
<i>Stock Market Valuation</i>	3
<i>Stock Highlight: Jones Apparel Group</i>	4
<i>Focus List</i>	5
<i>Model Portfolio</i>	6
<i>Sector Allocation</i>	7
<i>Technical Research Focus List</i>	11

**INDEXES**

(Close as of: 6/8/01)

DJIA:	10977.00
S&P 500:	1264.96
NASDAQ:	2215.10
S&P 400:	531.61
S&P 600:	231.04



## THE ECONOMY - The Week In Review

June 4, 2001—The economic reports of the past couple of weeks show that while the economy is far from robust; the economy's weakening trend may actually be leveling off. The reports discussed below are mixed as to the current state of the economy. This may be a result of the economy reaching a turning point whereby some reports would be expected to reflect the past weakness and others would show the beginning of a recovery.

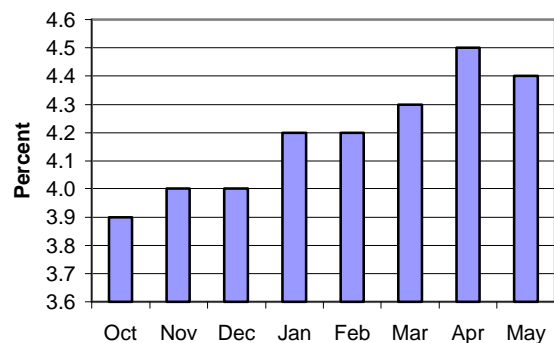
**Selected Economic Reports**

Source: Federal Reserve

The Labor Department reported that only 19,000 jobs were lost in May, a relative modest number. Employment in the services sector actually rose. The unemployment rate fell to 4.4% in May from 4.5% in April. Total hours worked in May were the same as April due to the workweek lengthening from 34.2 to 34.3 hours.

Automobile sales declined 3.1% in May

**Unemployment Rate**



from the year-earlier period. Despite the decline, the industry remains on track for its third of fourth best year ever.

The manufacturing sector remains in a slump. The index of manufacturing activity from the National Association of Purchasing Management declined to 42.1 from 43.2 in May. A reading below

*(Continued on page 2)*

## INVESTMENT STRATEGY

### Relative Strength: The Belle of Technical Analysis

*Relative Strength* is one of the oldest and most important of the tools of technical analysis. It is used in one form or another by just about all technical analysts, regardless of their particular technical analysis discipline. And in many of the disciplines, it occupies center stage.

**What is Relative Strength?**

Relative strength measures the price performance of a stock, industry or sector against some benchmark, usually an index such as the S&P 500. If a stock rose in price 15% over a given period,

*(Continued on page 8)*

## THE ECONOMY - The Week In Review

(Continued from page 1)

50 indicates the sector is contracting. Separately, the Commerce Department reported that new orders for durable goods fell a seasonally adjusted 5% in April, led by declines in computers and electronic products.

Construction spending rose 0.3% in April. It has risen six months in a row. It was also reported that the value of new construction contracts increased 3% in April.

The housing sector is showing signs of moderating. The National Association of Realtors reported that sales of existing homes fell 4.2% in April. The Commerce Department reported that sales of new

homes fell 9.5% in April. But despite these negative reports, the housing sector is still at historically high levels.

Consumer confidence and spending are healthy - but fragile. The Conference Board's consumer-confidence index rose from 109.9 in April to 115.5 in May. The University of Michigan's consumer-sentiment index rose from 88.4 in April to 92 in May. At the same time, though, consumers voiced concerns about the ability to find jobs. Without a strong job market, consumer confidence cannot remain at high levels for long. The Commerce Department reported that spending and personal income rose 0.4% and 0.3%, respectively, in April. The growth in spending was in nondurable goods

(Continued on page 8)

### ECONOMIC FORECASTS

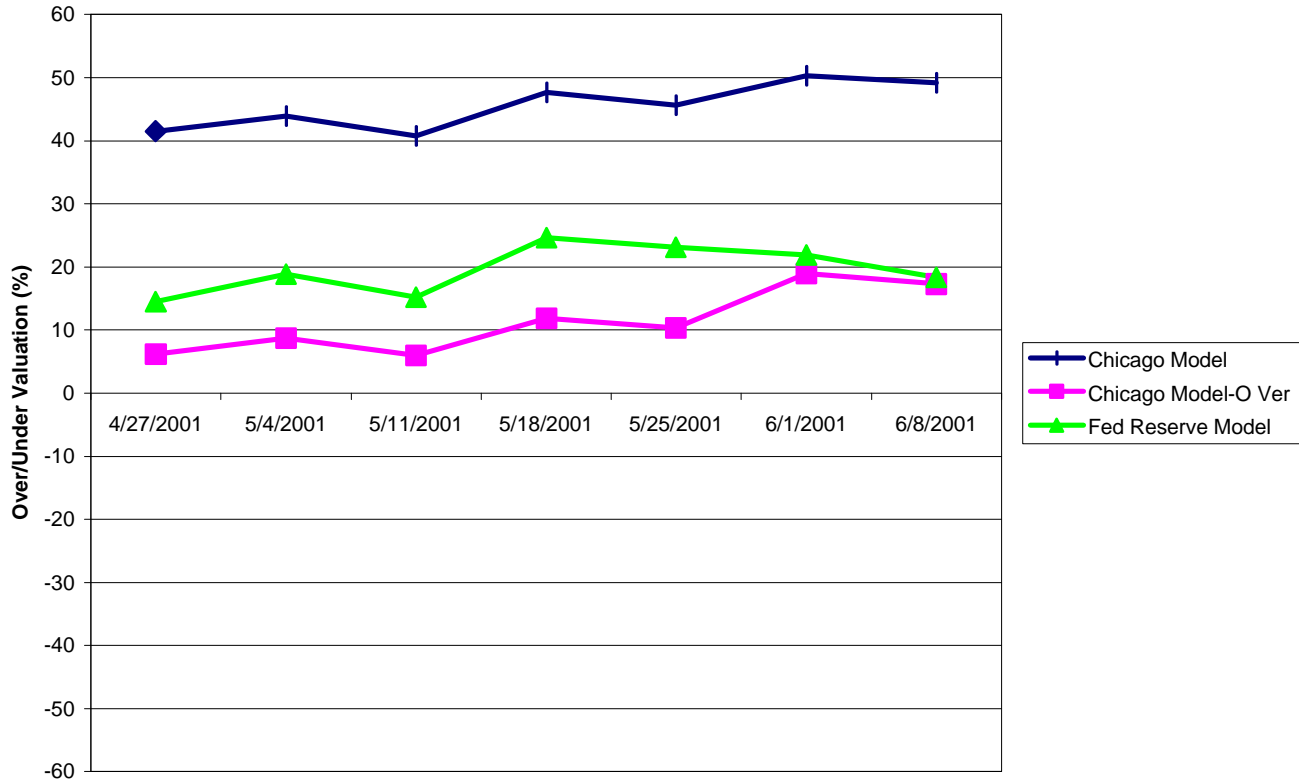
(As of June 11, 2001)

*“Consumer confidence  
and spending are  
healthy—but fragile.”*

<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	3.0
GDP Price Index	2.0	1.3	1.5	2.1	2.3	2.1
Gross Domestic Product (GDP)	6.5	5.7	5.8	7.1	4.2	5.1
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	4.0	4.1
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

## STOCK MARKET VALUATION (AS OF JUNE 8, 2001)

S&amp;P 500 Valuation



At the present time (June 8, 2001), we believe the stock market, as represented by the S&P 500, is overvalued by about 18%. This is down from an estimated overvaluation of about 22% 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 17.3% and 18.3%, 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 49.2%.

While we do not necessarily believe that the market is overvalued by 49.2%, 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 18%.

## STOCK HIGHLIGHT: JONES APPAREL GROUP, INC.

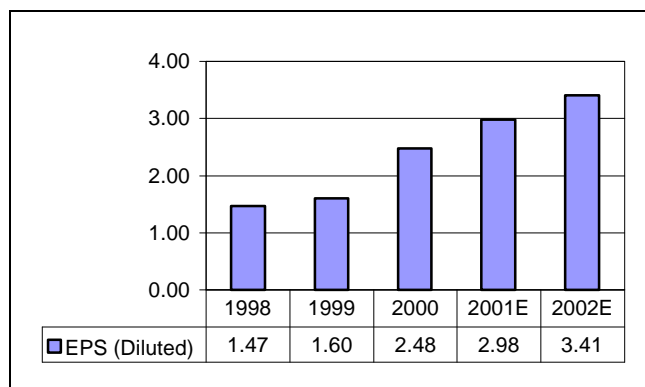
Price (6/11/01):	\$42.84	Beta:	1.14
52-Week Range:	\$21.2500 to \$47.4300	Shares O/S (Basic):	120.9 million
Dividend:	None.	Market Capitalization:	\$5.18 billion
Dividend Yield:	n/a	Fiscal Year End:	December
EPS:	\$2.65	Industry:	Apparel/Accessories
EPS Growth (5yr):	32.8%	Float:	85.8 million
Avg. Daily Vol.	1,092,545	ROA (3/01):	10.62%
P/E (Basic ttm.):	16.17	ROE (3/01):	23.77%
P/B (4/01):	3.31	P/E/G	0.95
P/S (3/01):	1.29	P/E/G (2001E EPS):	0.85
Profit Margin (3/01):	7.9%	5Yr Est EPS Growth:	17%
Current Ratio (4/01):	2.20	Symbol:	JNY
Debt/Equity (4/01):	0.79	Exchange:	NYSE

### BUSINESS

(Source: Jones Apparel Group, Inc.)

Jones Apparel Group, Inc. ([www.jny.com](http://www.jny.com)) is a leading designer and marketer of branded apparel, footwear and accessories. The Company's nationally recognized brands include: Jones New York; Lauren by Ralph Lauren, Ralph by Ralph Lauren, and Polo Jeans Company, which are licensed from Polo Ralph Lauren Corporation; Evan-Picone, Rena Rowan, Todd Oldham, Nine West, Easy Spirit, Enzo Angiolini, Bandolino, Napier and Judith Jack. The Company also markets costume jewelry under the Tommy Hilfiger brand licensed from Tommy Hilfiger Corporation, and the Givenchy brand licensed from Givenchy Corporation. Celebrating more than 30 years of service, the Company has built a reputation for excellence in product quality and value, and in operational execution.

### Diluted Earnings Per Share



FOCUS LIST - 6/11/01

(data as of 4/2/01)

Company	Symbol	Price 3/23/01	Current FY EPS Est	P/E Est Crnt FY	5 Yr.		PEG Ratio	Div (Ind.)	Beta	Sector	Mkt Cap (millions)
					EPS g 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	
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	
<b>Additions - 4/2/01</b>		<b>Price</b>									
Sunrise Assisted Living	SNRZ	19.69	1.89	10.4	20.8	0.5	0.00	0.43	Health Care	425.2	
<b>Deletions -4/2/01</b>											
AmeriSource Health Corp.	AAS	49.05	2.27	21.6	17.7	1.2	0.00	-0.03	Health Care	2579.0	
<b>Deletions -6/11/01</b>		<b>Price</b>									
Esterline Technologies	ESL	22.31	n/a	n/a	n/a	n/a	n/a	n/a	Capital Goods	n/a	

**MODEL PORTFOLIO**  
**6/11/01**

(data as of 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	6.95%	11.1	0.20	0.74	Energy	15676.9	
Applebee's Int'l, Inc.	APPB	35.69	100.00	3568.75	3.95%	13.1	0.11	0.53	Consumer Staples	864.3	
Arkansas Best Corporation	ABFS	15.75	200.00	3150.00	3.49%	5.6	0.00	0.83	Transportation	351.4	
Constellation Brands Inc.	STZ	71.75	100.00	7175.00	7.95%	13.8	0.00	0.88	Consumer Staples	1369.6	
Energen Corporation	EGN	35.30	200.00	7060.00	7.82%	15.3	0.68	0.26	Utilities	974.9	
Fastenal Company	FAST	54.50	100.00	5450.00	6.03%	21.3	0.09	0.63	Basic Materials	2053.4	
Golden State Bancorp, Inc	GSB	27.88	100.00	2788.00	3.09%	10.4	0.40	0.91	Financial	3604.3	
Henry Schein, Inc.	HSIC	36.75	100.00	3675.00	4.07%	19.1	0.00	0.76	Health Care	1397.9	
Jones Apparel Group, Inc.	JNY	37.80	100.00	3780.00	4.19%	12.8	0.00	1.18	Consumer Cyclicals	4444.8	
Lincare Holdings Inc.	LNCR	52.94	100.00	5293.75	5.86%	19.8	0.00	0.29	Health Care	2767.4	
MBNA Corporation	KRB	33.10	200.00	6620.00	7.33%	17.9	0.36	1.61	Financial	25732.3	
Philip Morris Companies	MO	47.45	100.00	4745.00	5.25%	11.7	2.12	0.24	Consumer Staples	96501.2	
Phillips Petroleum Co.	P	55.05	100.00	5505.00	6.10%	8.5	1.36	0.67	Energy	13880.7	
Robert Mondavi Corp.	MOND	44.81	100.00	4481.25	4.96%	15.1	0.00	1.05	Consumer Staples	738.3	
Soletron Corporation	SLR	19.01	200.00	3802.00	4.21%	21.1	0.00	1.98	Technology	13582.0	
Tellabs, Inc.	TLAB	40.69	100.00	4068.75	4.51%	19.4	0.00	1.95	Technology	18986.3	
Timberland Company	TBL	50.80	100.00	5080.00	5.63%	14.7	0.00	1.31	Consumer Cyclicals	2044.4	
Toll Brothers, Inc.	TOL	38.50	100.00	3850.00	4.26%	8.2	0.00	0.34	Consumer Cyclicals	1349.8	
<b>Total</b>				<b>90308.10</b>	<b>100.00%</b>						
<b>Additions - 4/2/01</b>											
Sunrise Assisted Living	SNRZ	19.69	200.00	3937.60	4.36%	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	
<b>Deletions - 6/11/01</b>											
Esterline Technologies	ESL	22.31	100.00	n/a	n/a	n/a	n/a	n/a	Capital Goods	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 Cyclical	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)*

and services while spending on durable goods actually declined 0.6%.

### The Outlook

We believe that the current quarter will not be a very strong one. Capital spending and corporate profits have been declining and there are many downside risks to consumer and business spending. The Bureau of Economic Analysis reported that pretax margins for nonfinancial corporations slipped to 10% in the first quarter from 10.5% in the fourth quarter of 2000. The Commerce Department has revised first quarter GDP growth down to 1.3% from the 2.0% growth rate it had reported earlier.

The second half of this year is expected to rebound, however. The Fed has been very accommodative with its interest rate policy, giving the economy five one-half percentage point interest rate cuts since January. Congress has passed the \$1.35 trillion package of tax cuts. These two things alone should give a tremendous boost to the economy – and that boost is expected to start taking hold in the second half.

Some economists, however, are voicing concern about possible inflationary pressures. With all of the monetary stimulus now in the works, and not much slack in the labor markets, inflation becomes a very real threat.

*“Some economists, however, are voicing concern about possible inflationary pressures.”*

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

Consumer spending has held up reasonably well so far, and that is vitally important to the recovery. Consumer spending accounts for about two-thirds of economic activity. For the U.S. to have a strong economic recovery, it will be necessary to continue having rising consumer confidence, income and spending.

Our current forecasts for a number of economic factors, which have been recently revised, are shown on page 2.

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## INVESTMENT STRATEGY (Continued)

*(Continued from page 1)*

that might sound like good performance. But if the market was up 30% over the same period, that would actually be pretty weak performance. Conversely, if a stock drops 5% when the market has dropped 20%, that would be pretty strong performance. It is this relative performance that the relative strength calculation is trying to capture.

strength, for it to be useful as an investment tool, is that the relative strength will persist. If it doesn't persist, all you are doing is looking at what has happened with no indication of what will happen in the future. It would be akin to looking in the rearview mirror as you are driving down the highway – the view might be nice but you have no idea of what is up ahead.

The underlying premise of relative

*(Continued on page 9)*



## INVESTMENT STRATEGY (Continued)

(Continued from page 8)

### How Relative Strength Is Calculated

There are several ways to calculate relative strength. We'll discuss two ways below.

#### Method 1

The most basic relative strength calculation is to divide the stock price by the index value,

$$\text{Relative Strength} = \frac{\text{Stock Price}}{\text{Index Value}}$$

For example, if XYZ stock is trading at \$50 and the S&P 500 is at 1250, the relative strength ratio is .04. If the stock

advances to \$70 and the S&P 500 goes to 1400, the new ratio is .05. The relative strength has improved – this would make sense as the stock has risen 40% while the S&P 500 index has only risen 12%.

When evaluating relative strength using the basic calculation, it is the trend that is important. We are looking for improvements in the ratio. Referring to the example above, the ratio increased from .04 to .05. This indicates that relative strength is getting stronger.

The basic relative strength calculation is used by Dorsey Wright & Associates, a well-known provider of technical research. There are many variations of this basic calculation. Dorsey Wright, for

## PLOT ON A POINT & FIGURE CHART

example, takes the relative strength number resulting from the calculation and plots it on a point & figure chart similar to the way they would plot the stock's actual price. They can then interpret the relative strength using a point & figure type of methodology. For a discussion of how Dorsey Wright accomplishes this analysis, you can go to the Dorsey Wright website (which Brookstreet Mem-

bers can access from the Brookstreet website) or see Thomas J. Dorsey's book, "Point & Figure Charting: The Essential Application for Forecasting and Tracking Market Prices" (New York: Wiley).

#### Method 2

One variation is to divide the *perform-*

## USEFUL WITH FUNDAMENTAL ANALYSIS

ance of the stock by the *performance* of the index:

Relative Strength =

$$\frac{\text{Ending Stock Price/Beginning Stock Price}}{\text{Ending Index Value/Beginning Index Value}}$$

For example, using the numbers from the example above:

$$\text{Relative Strength} = \frac{(70/50)}{(1400/1250)} = 1.25$$

If you subtract 1.00 from the result, you get 0.25. This can be interpreted to mean that the stock did 25% better than the index during the period. As is the case with the basic relative strength calculation discussed in Method 1 above, it is the trend that is important.

*"...it is the trend that is important."*

(Continued on page 10)

## INVESTMENT STRATEGY (Continued)

(Continued from page 9)

### Fundamental Analysis and Relative Strength

Relative strength can be used on a stand-alone basis as a purely technical research tool. But it can also be used with fundamental analysis to possibly improve the timing of taking a position in a stock.

Contrarian investing attempts to find stocks that are fundamentally sound but are undervalued by the market for some reason, with the expectation that eventually the market will recognize and correct the mispricing. Contrarian investing takes patience, though, as it can take a long time for the market to see the value.

Relative strength may shorten the waiting period by identifying those stocks that have already begun to get some recognition.

A strategy that combines fundamental factors and relative strength was proposed by James P. O'Shaughnessy in his book entitled: "What Works On Wall Street: A Guide to the Best-Performing Investment Strategies of All Time" (McGraw-Hill). For example combining a low price-to-sales ratio with a high relative strength ratio could lead to higher risk adjusted returns than just using one of the ratios alone. The low price-to-sales ratio, a value screen, may prevent the paying of a high valuation for the stock; while the relative strength ratio increases the odds that the stock is be-

## COMBINING RATIOS

ing recognized by the market.

### Other Considerations

Studies on the validity and effectiveness of relative strength are mixed. The underlying premise is that relative strength tends to persist and can therefore be used as a tool to identify stocks that have a likelihood of continuing to advance in price. An investor has to accept this premise in order to justify the use of

this investment tool. There is no absolute assurance that this premise is correct.

Relative strength is essentially a trend-following technique. Trend following techniques have the disadvantage that they will often miss the tops and the bottoms of trends, as it usually takes awhile for the trend to become apparent. Accordingly, some of the gains are left on the table.

## TREND FOLLOWING TECHNIQUE

Stocks with strong relative strength are often priced at a premium in the market. And stocks that have been market leaders, as indicated by their strong relative strength, will often fall very quickly during market downturns as investors rotate out of hot sectors and out of stocks that are priced richly. Some studies have suggested that the best use of relative strength is in combination with various fundamental and/or value screens.

### Conclusion

Relative strength is a widely used technical research tool that may exhibit its best results when used in combination with fundamental and value screening analysis. As such, it may help to identify those fundamentally sound, value stocks that are starting to gain market recognition. This would be useful to contrarian investors as it may shorten their workout period on the stocks they have chosen for investment.

*"The underlying premise is that relative strength tends to persist..."*

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## BROOKSTREET TECHNICAL RESEARCH FOCUS LIST

The Brookstreet Research Services Department maintains a focus list based on technical research. We maintain this list as a portfolio with the Dorsey Wright Technical Research service. You can access the *Brookstreet Technical Research Focus List* by going to the Brookstreet web site and following the links to: Research, Dorsey Wright & Associ-

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

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