Brookstreet Securities Corporation

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REVIEW & OUTLOOK

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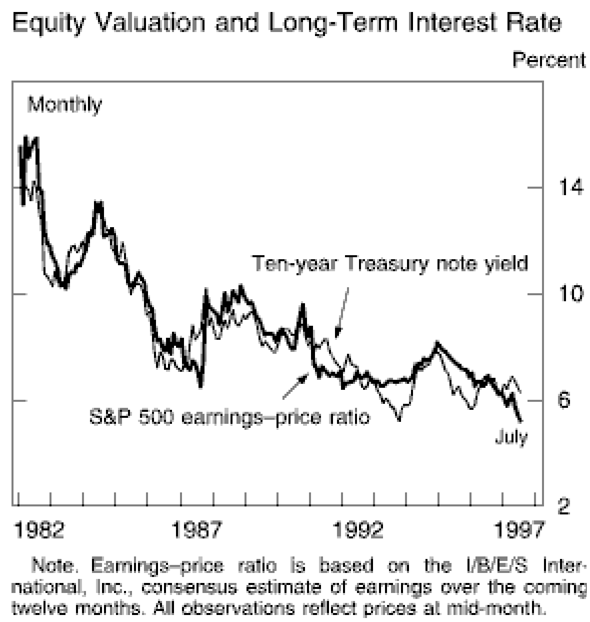
INDEXES

(Close as of: 8/10/01)

DJIA:	10416.25
S&P 500:	1190.16
NASDAQ:	1956.47
S&P 400:	498.54
S&P 600:	224.24

STOCK MARKET VALUATION MODELS



Source: Federal Reserve

Our approach to investment analysis and portfolio management involves the use of fundamental research, quantitative models, technical research and portfolio optimization models to analyze individual securities and to construct portfolios that balance risk and reward.

But apart from the use of extensive research and modeling, it is important to realize that each company is a part of the overall market for publicly traded equity securities (i.e., the stock market). Accordingly, it is useful to understand if the stock market is overvalued, undervalued or fairly valued. We have developed proprietary *market valuation models* to estimate the valuation of the overall stock market as represented by the S&P 500. The primary elements of the market valuation models are described below.

The Chicago Models

The *Chicago models*, so named because we developed them in that city a few years ago, are based on a valuation model originally proposed and used by Benjamin Graham. Benjamin Graham, for those who are not familiar with him, was a financial theorist, writer, and teacher who is generally credited with laying the foundation for much of modern day securities analysis. One of Professor

(Continued on page 2)

ECONOMICS 1-2-3

August 10, 2001

Understanding the economy may best be accomplished by keeping the analysis simple. I was inspired to this way of thinking by an article I read recently in the Wall Street Journal written by David Wessel (Wessel, David. “Economic Forecasting In Three Steps.” The Wall Street Journal 19 July 2001:A1). In his article, Mr. Wessel makes the point that: “Economic forecasting can be complex or simple. Complex isn’t always more accurate.”

I don’t believe that we are going to put the practitioners of the dismal science

(Continued on page 6)

STOCK MARKET VALUATION MODELS (CONTINUED)

(Continued from page 1)

Graham's students was the renowned investor Warren Buffett, who studied under Graham while a student at Columbia University.

The Basic Chicago Model

The basic *Chicago Model* has several components. The main component of the Chicago model is based upon following variables:

value is a function of [(eps, g)/i]

where:

eps = earnings per share

g = estimated growth in eps

i = AAA bond yield

By observing the relationship of value being a function of *[(eps, g)/i]*, it is easy to see how the variables interact to approximate the way the market looks at value. With *eps* and *g* in the numerator, one can see that if either or both of these variables increases, the numerator becomes a larger number and hence the market's value should increase. If on the other hand interest rates increase, the denominator becomes larger and the market's value should decrease. This is

(Continued on page 6)

"It is easy to see how the variables interact to approximate the way the market looks at value. "

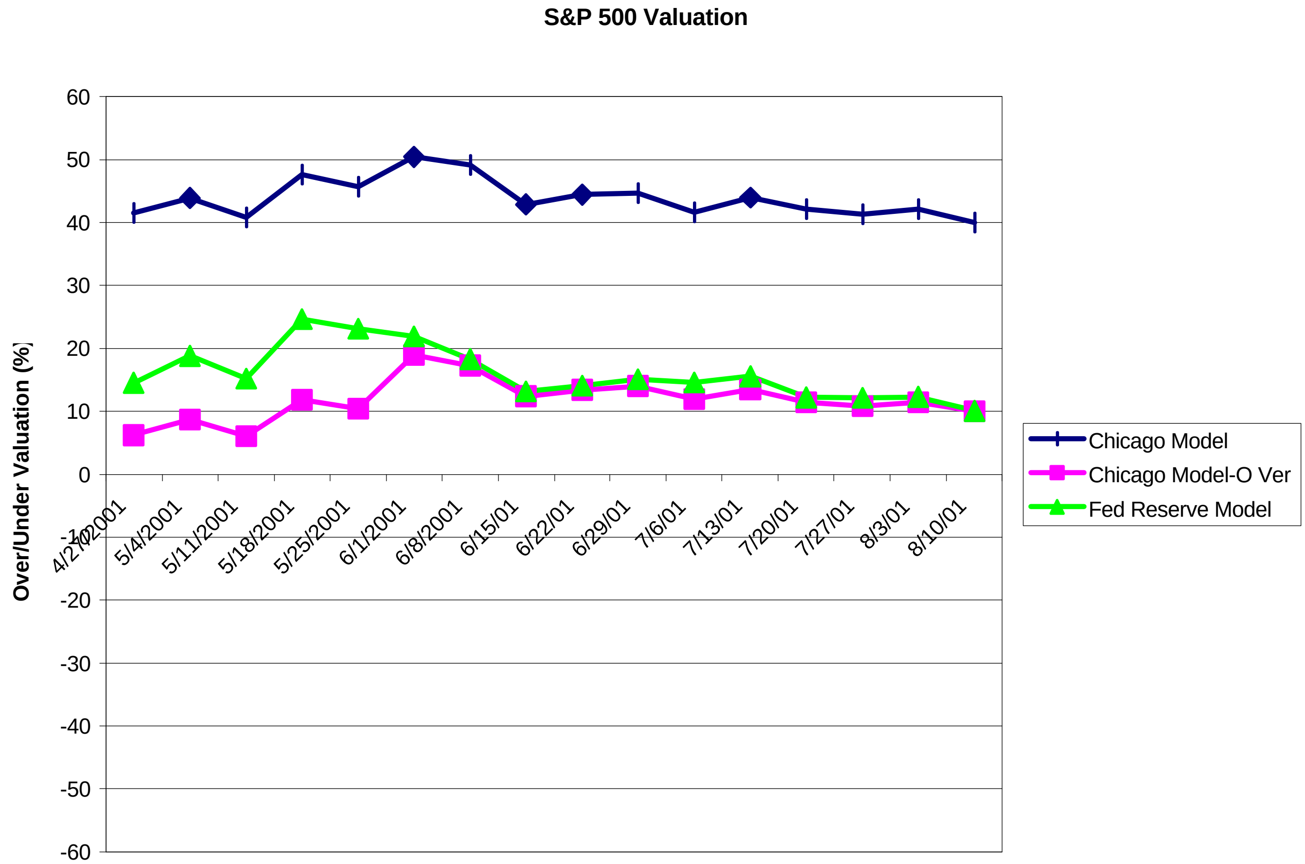
ECONOMIC FORECASTS

(As of August 10, 2001)

	Actual				Forecasts	
ECONOMIC FACTOR	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**
Percent Change						
Real GDP	4.4	4.4	4.2	5.0	1.6	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	3.9	5.1
Consumer Price Index (CPI)	2.3	1.5	2.2	3.4	3.0	2.5
Variables In Levels						
Unemployment Rate	5.0	4.5	4.2	4.0	4.9	5.0
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 AUGUST 10, 2001)



At the present time (August 10, 2001) , we believe the stock market, as represented by the S&P 500, is <u>overvalued by about 10%</u>. This is down from an estimated overvaluation of about 12% 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 10.0% and 10.1%, 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 40.0%.

While we do not necessarily believe that the market is overvalued by 40.0%, 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 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.

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 10%.

The workings of these models is discussed in a feature article in this issue of the Review & Outlook entitled, "Stock Market Valuation Models." (please see page 1).

STOCK HIGHLIGHT:
LINCARE HOLDINGS, INC.

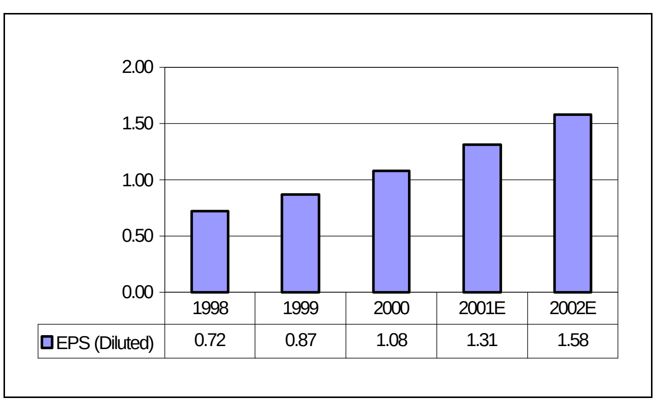
Price (8/10/01):	$28.56	Beta:	0.28
52-Week Range:	$11.5625 to $34.3900	Shares O/S (Basic):	107.7 million
Dividend:	None.	Market Capitalization:	$3.08 billion
Dividend Yield:	n/a	Fiscal Year End:	December
EPS:	$1.18	Industry:	Healthcare Facilities
EPS Growth (5yr):	19.1%	Float:	81.8 million
Avg. Daily Vol.	778,000	ROA (6/01):	14.40%
P/E (Basic ttm.):	24.20	ROE (6/01):	22.01%
P/B (6/01):	4.60	P/E/G	1.15
P/S (6/01):	4.06	P/E/G (2001E EPS):	1.04
Profit Margin (6/01):	16.8%	5Yr Est EPS Growth:	21%
Current Ratio (6/01):	2.10	Symbol:	LNCR
Debt/Equity (6/01):	0.27	Exchange:	NasdaqNM

BUSINESS
(Source: Lincare Holdings Inc.)

Lincare Holdings Inc. and subsidiaries is one of the nation's largest providers of oxygen and other respiratory therapy services to patients in the home. The Company's customers typically suffer from chronic obstructive pulmonary disease (COPD), such as emphysema, chronic bronchitis or asthma, and require supplemental oxygen or other respiratory therapy services in order to alleviate the symptoms and discomfort of respiratory dysfunction. Lincare currently serves over 275,000 customers in 44 states through 510 operating centers.

For technical analysis information on LNCR, please see the Brookstreet Technical Research Focus List which may be accessed from the Brookstreet website by following the links to Research, Dorsey Wright & Associates, View and Edit Portfolio, Brookstreet Technical Focus List.

LNCR—Diluted Earnings Per Share



(data as of 8/3/01)

FOCUS LIST - 8/10/01

Company	Symbol	Price 8/3/01	Current FY EPS Est	P/E Est Crr FY	5 Yr. EPS g Est %	PEG Ratio	Div (Ind.)	Beta	Sector	Mkt Cap (millions)
Anadarko Petroleum Corp.	APC	56.01	5.60	10.0	23.2	0.4	0.20	0.75	06 - Energy	14037.7
Applebee's Int'l, Inc.	APPB	30.34	1.84	16.5	14.6	1.1	0.07	0.45	09 - Services	1118.5
Canadian National Railway	CNI	45.65	4.84	9.4	12.8	0.7	0.49	0.78	11 - Transportation	8764.8
Constellation Brands Inc.	STZ	43.55	3.04	14.3	15.8	0.9	0.00	0.70	05 - Consumer Non-Cyclical	1833.6
D.R. Horton Inc.	DHI	26.42	3.28	8.1	14.8	0.5	0.20	1.11	02 - Capital Goods	1997.4
Energen Corporation	EGN	25.50	2.31	11.0	11.0	1.0	0.68	0.17	12 - Utilities	788.0
Golden State Bancorp, Inc	GSB	33.46	2.81	11.9	9.9	1.2	0.40	0.86	07 - Financial	4519.0
Henry Schein, Inc.	HSIC	35.21	1.93	18.2	16.3	1.1	0.00	0.57	08 - Health Care	1491.6
Jones Apparel Group, Inc.	JNY	34.15	2.72	12.6	17.4	0.7	0.00	1.13	04 - Consumer Cyclical	4224.2
Kimberly-Clark Corp.	KMB	61.10	3.39	18.0	11.4	1.6	1.12	0.53	01 - Basic Materials	32517.6
Lincare Holdings Inc.	LNCR	31.28	1.32	23.7	22.0	1.1	0.00	0.30	08 - Health Care	3368.5
MBNA Corporation	KRB	37.00	1.88	19.7	20.0	1.0	0.36	1.54	07 - Financial	31515.9
Philip Morris Companies	MO	45.17	4.05	11.2	10.7	1.0	2.12	0.26	05 - Consumer Non-Cyclical	99358.6
Phillips Petroleum Co.	P	56.66	6.93	8.2	8.2	1.0	1.36	0.67	06 - Energy	14490.8
Republic Services, Inc.	RSG	20.00	1.35	14.8	12.8	1.2	0.00	0.56	09 - Services	3413.0
Solectron Corporation	SLR	18.55	0.78	23.8	28.7	0.8	0.00	2.18	10 - Technology	12181.9
Sunrise Assisted Living	SRZ	30.18	1.94	15.6	25.0	0.6	0.00	0.52	08 - Health Care	652.8
Tasty Baking Company	TBC	19.62	1.15	17.1	10.0	1.7	0.48	-0.29	05 - Consumer Non-Cyclical	156.5
Toll Brothers, Inc.	TOL	38.40	4.99	7.7	15.0	0.5	0.00	0.20	02 - Capital Goods	1381.2
Universal Corporation	UVV	38.52	4.12	9.3	n/a	n/a	1.28	-0.12	05 - Consumer Non-Cyclical	1051.5
Washington Mutual Inc.	WM	40.51	3.55	11.4	12.4	0.9	0.88	0.64	07 - Financial	35582.6

STOCK MARKET VALUATION MODELS (Continued)

(Continued from page 2)

a dynamic relationship with each of these three variables constantly changing and giving rise to a constantly changing market value.

The expression of value in this relationship is useful for a couple of reasons. First, it makes intuitive sense. Second, it allows us to mathematically compute an approximate value for the market.

It should be noted that the same valuation model can be used for valuing individual stocks as well as the entire market. In fact, this valuation model is one of several that we use in our individual stock valuation analysis.

In addition to the main component described above, the other components of the basic Chicago Model include historical Price-to-earnings ratios, dividend yields, and other factors.

Chicago Model - O Version

The *Chicago Model - O Version* is a variation of the basic Chicago Model described above. This version of the model focuses on the most aggressive assumptions and variables used in the Chicago Model. When compared to the basic Chicago Model, its aggressive assumptions usually produce a valuation that is closer to the actual market value of an index when that index is overvalued.

RELATIONSHIP BETWEEN TREASURY YIELD AND EARNINGS YIELD ON S&P 500

Federal Reserve Model

Federal Reserve Chairman Alan Greenspan often looks at the relationship between the yield of the 10-year Treasury note and the earnings yield of the S&P 500 in making a determination as to whether the stock market is overvalued or undervalued.

Evidence of this first appeared in the Monetary Policy Report to the Congress in July of 1997. In this report, Mr. Greenspan observed that "…the ratio of prices in the S&P 500 to consensus estimates of earnings over the coming twelve months has risen further from levels that were already unusually high." Mr. Greenspan goes on to say that "changes

(Continued on page 9)

"Changes in this ratio [the ratio of prices in the S&P 500 to consensus earnings estimates] have often been inversely related to changes in long-term Treasury yields..."

ECONOMICS 1-2-3 (Continued)

(Continued from page 1)

out of business – nor do I believe we should. Good economic research adds much to our understanding of the economy and where it is headed. But as investment professionals, a broader and more simplistic view of the economy may provide a bit of important insight to us as we make our investment decisions.

Three Economic Factors

Mr. Wessel suggests this: "Boil the economy down to three factors: the spending consumers do; the investing businesses do in machinery, buildings, computers and software; and the vitality of the rest of the world."

Can it be that simple? To answer this question, I went back to my economic

(Continued on page 7)

ECONOMICS 1-2-3 (Continued)

(Continued from page 6)

textbooks from college (I was an economics major as an undergraduate at the University of California, Riverside. That, by the way, does not make me an economist!). What I found was quite surprising – and quite simple! Let's look at one of the most basic identities in macroeconomics, the product side measurement of Gross Domestic Product (GDP):

GDP = C + I + G + (X – M)

Where,

C = spending on consumer goods and services;
I = spending on investment goods;
G = spending on government goods and services; and
(X – M) = net exports, or exports (X) minus imports (M).

So, if we boil the economy down to the three factors that Mr. Wessel suggests, we may be capturing the majority of the factors in the computation of GDP.

But what about the government's spending on goods and services? This is noticeably absent from Mr. Wessel's analysis but is an important component in the calculation of GDP. The answer, I believe, is that government spending – barring a major change in fiscal policy - tends to be fairly stable from one year to the next. Therefore, if one is trying to figure out where the economy may be going, it is the more volatile components

WHERE IS THE ECONOMY HEADED NOW?

that produce change in the economy that should be analyzed.

Where Is The Economy Headed Now?

It was recently reported that a number of professional economic forecasters have just sharply reduced their estimates for the second-half of this year. Let us use our new found insight to see if we agree with this conclusion.

Consumer Spending

There are signs that the consumer has been faltering. Fed Chairman Alan Greenspan has expressed his concern that losses in stock wealth and a softer job market may lead to a reduction in consumer spending. The latest report

CONSUMER SPENDING

from The Conference Board may be confirming his fears, as it showed that its Consumer Confidence Index fell to a level of 116.5 in July from its pervious level of 118.9. When consumer confidence declines, people stop spending.

Nonfarm payrolls declined by 42,000 jobs in July, the third decline in four months. The unemployment rate, however, remained at 4.5% - which is an historically low rate.

In a sign that consumers may be reigning in debt-financed purchases, consumer credit declined by $1.5 billion in June from May. This was the first monthly decline since November 1997.

Consumer spending accounts for about two-thirds of U.S. economic activity. Any recovery in the economy will have to be largely driven by the consumer. A cou-

(Continued on page 8)

"What I found was surprising—and quite simple!"

ECONOMICS 1-2-3 (Continued)

(Continued from page 7)

ple of factors that might help the consumer lead a recovery are the tax cuts under way and declining energy prices.

Business Investment

Business investing has been in a slump and doesn't appear to be getting much better. The latest Fed "beige book" report showed continued weakness in manufacturing and suggests that improvement in corporate profit margins won't be coming soon.

The National Association of Purchasing Management's index of manufacturing activity declined to 43.6 in July from its previous level of 44.7. A reading less than 50 indicates that the manufacturing sector is contracting.

And in yet another sign that manufacturing remains weak, the Commerce Department reported that U.S. factory orders declined 2.4% in June.

Business investment accounts for about 15% of U.S. economic activity; but it is much more volatile than consumer spending and can drive the economy in or out of a recession.

Net Exports

We can't expect much help to come from the rest of the world. The economies of Europe, Asia and Latin America have been weakening.

IMPORT PRICES DECLINED

To make matters worse, import prices declined 1.6% in July, following a 0.4% decline in June. The July drop in import prices was the fifth decline in the past six months. A drop in import prices is good news for U.S. consumers who can buy goods at lower prices; but bad news for manufacturers who have to compete with these lower prices when their margins are already squeezed.

Conclusion

So, do we agree with the professional economic forecasters that have reduced their estimates for the second half of the year? The answer is yes! Faced with a weakening economy and an uncertain employment environment , consumer confidence has dropped off a little and consumers have been reigning in their debt-financed spending. These are indi-

COULD WE HAVE ANTICIPATED THE REVISION?

cations that consumer spending may weaken. Adding to the sluggish economy's problems are a deepening investment slump and a deterioration in other important world economies. All of this suggests that, indeed, the second half of the year may be slower than had previously been thought and that we are not likely to see a recovery in the economy until we see improvement in these three major economic factors.

Another important question to ask is this: "Could we have seen this revision in professional forecaster estimates coming?" I believe the answer is again, yes! There have been many signs over the past year that Wessel's three main areas of the economy were deteriorating. While the outlook for the consumer has been mixed, the problems in the manufacturing sector and business investment have been readily apparent. And if one were on the lookout for conditions in world economies, the weakening there has been visible too. At the very least, if we could not have seen the revision com-

(Continued on page 9)

"There have been many signs over the past year that Wessel's three main areas of the economy were deteriorating."

ECONOMICS 1-2-3 (Continued)

(Continued from page 8)

ing – we should have been alerted to use some caution in our outlook.

This brings up another point regarding the usefulness of this analysis. It can provide a useful check on what others are forecasting. By focusing on the most important variables in the economy, it may help us to organize and make sense of what we read daily in the press about the economy and to filter out some of the noise in the data.

What about the longer-term outlook for the economy? There are some extremely powerful economic forces in the pipeline that should eventually give a strong boost to the economy. These are: the Fed interest-rate cuts totaling 2.75 points so far this year (note: many forecasters expect a further quarter point cut when the Fed meets on August 21); the tax rebate; and the reversal in energy prices. There is usually a lag before economic stimuli take effect – so the second-half outlook may still be clouded – but eventually these powerful economic forces will give their boost.

Editor's Note: Our current forecasts for a number of economic factors are shown on page 2.

"...eventually these powerful economic forces will give their boost."

STOCK MARKET VALUATION MODELS (Continued)

(Continued from page 6)

in this ratio have often been inversely related to changes in long-term treasury yields…" The chart that we have reproduced from Mr. Greenspan's report and put on page 1 of our Review and Outlook shows this relationship (please turn to page 1).

Our *Federal Reserve Model* looks at the relationship between these two yields in valuing the S&P 500.

It is interesting to note that the Federal Reserve uses the I/B/E/S consensus earnings estimates over the coming twelve months (i.e., forward looking estimates), even though it has been observed that there is generally an upward bias in analysts' earnings estimates

FAIR VALUE LEVEL OF MARKET VALUATION

when taken as a whole. So one should keep in mind when using this model that the "fair-value" level of market valuation may be quite a bit lower than what the model is indicating. This is one reason that we use the basic Chicago Model in our analysis, even though the values that it computes tend to be quite a bit lower than the values computed by either the Chicago Model – O Version or the Federal Reserve Model.

Conclusion

One of the great things about financial modeling is that it allows us to examine and analyze our assumptions. The three models discussed 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. At the time of this writing, the *Chicago Model – O Version* and the *Federal Reserve Model* show overvaluations of

(Continued on page 10)

STOCK MARKET VALUATION MODELS (Continued)

(Continued from page 9)

10.0% and 10.1%, respectively. As we've discussed, the *Chicago Model – O Version* uses fairly aggressive assumptions (particularly the assumptions for earnings growth rates) and the *Federal Reserve Model* is biased upward by inflated earnings estimates. The basic *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 40.0%. While we do not necessarily believe that the market is overvalued by 40.0%, 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 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.

It should also be noted that although the models show an overvaluation or undervaluation for the market, the market can stay overvalued or undervalued for long periods of time. Eventually, however, overvaluation and undervaluation are corrected by a combination of changing interest rates, changing earnings expectations, and/or changing stock prices.

"...the market can stay overvalued or undervalued for long periods of time."

Brookstreet Securities Corporation

2361 Campus Drive, Suite 210
Irvine, CA 92612

Paul M. Wendee
Director of Research
Corporate: 800-268-2578
Research Department: 800-811-0232
Fax: 949-363-9672
Email: pwendee@mail.bkst.com

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