LUMBARD INVESTMENT COUNSELING

INSIGHT

Nasdaq Composite 1,920.01 * Dow Jones Industrial 9,941.97 * 10 year U.S. Treasury bond 4.74%

DIAMONDS IN THE COAL BIN

The earnings of hundreds—perhaps thousands—of companies are hugely overstated. This is an era of shady pension accounting, stock options, recurring "non-recurring" writeoffs, and massive one-time writeoffs—willfully ignored by Wall Street—that boost future earnings. Not to mention the huge earnings boost that hundreds of companies got by cutting their taxes to zero . . .

How exciting, then, to discover an entire industry that *understates* its earnings. By a lot. The earnings of America's local telephone companies are massively understated, because these firms are deducting excessively-large amounts of money for depreciation and amortization. That is, they are recording huge, theoretical expenses that "set aside" great piles of money for future purchases of overpriced switching equipment that will never occur.

Yes, the business is shrinking, and that's another big reason why the stocks are so cheap. Customers are dropping their second lines—and sometimes even their first lines—in favor of cellular service, and they're dropping their dial-up Internet connections in favor of cable modems or DSL. But investors should notice that all the Baby Bells are in the cellular business, so the losses are much less significant than they might appear to be. And now that the Bells no longer have to rent out their DSL lines to competitors, they're expanding that service at a rapid clip.

In fact, investment-advisory board member Paul Wright predicts that five years from now DSL will be delivering more megabits to homes than cable modems will. He points out that the newest generation of DSL—already rolling out in South Korea, Canada, and Italy—delivers *22 to 24 megabits per second*, on "twisted-pair" copper wire. If you're wondering whether you ought to be impressed, cable-modem service offers "up to" 3 megabits.

It won't be long before the new technology is put in service here, allowing telephone customers to browse on-line for movies or sports, and then watch them on HDTV. This is a big problem for the cable companies, because they can't offer their own customers more than 3 megabits without seeing millions of them drop their premium-channel packages. In the very near future web sites will begin offering any programming you want, à la carte, whenever you want it.

The DSL story might well drive these stocks upward, but Paul would hasten to add that it's really just frosting on the cake. In the near term the companies will grow—or at least resist the shrinkage that most investors expect—because of "bundling". The Baby Bells were barred from offering long-distance service until quite recently, but now that they have it they're taking market share from the long-distance phone companies by offering "bundles" of local, long-distance, and cellular service. All on one bill, with special pricing that often includes DSL and even satellite TV. Voice Over Internet Protocol? You'll be getting it from your plain 'ol telephone provider.

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The annual report of CVS (the drugstore chain) claims that 2/3 of all the people in world history who managed to live past the age of 65 are alive today.

Diamonds… *(continued from page 1)*

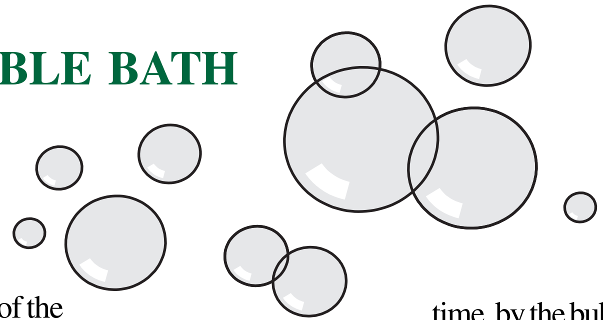
We own shares of Bell South (BLS - $25) and SBC ($24), but the opportunities extend beyond the Baby Bells. Century Telephone (CTL - $29), a small rural telephone provider, sells for less than ten times its "true" earnings—which means that management has the ability to pay dividends of more than 10%. They only pay out a small fraction of that now, but the dividend is rising; and the company is buying back its own stock at a clip that will cause solid growth in earnings per share, even if their business shrinks.

Free Cash Flow, Bundling, Cellular, Long Distance, VOIP, and DSL. It's a lot to keep track of. But all you have to remember is that the stocks are cheap, and that their earnings will rise in the year ahead. Boring stocks are best.

Investment banking plays an important role in our economy; bringing private companies into the public markets, and giving them access to capital that allows them to grow and create jobs.

Now that we've got that out of the way, let us add that investors should approach investment bankers the way they would approach a sexually-transmitted disease. If a company's CEO is selling shares of stock, he thinks that the price is high. It doesn't matter whether you're buying company shares or his personal shares; either way you're buying at a price that an *insider* with *inside information* finds pleasing.

THE BUBBLE BATH



Mary Meeker, queen of the Internet-stock bubble, is back. But she's touting a different group of stocks; in 2004 it's the *Chinese* Internet stocks. Happy Hour is fading on the world's markets, but—four years after the peak of the millennium bubble—you can still see tiny bubbles in every half-full rose-colored glass.

This has been an extraordinary era of bubbles. The irrational exuberance of the Japanese stock and real-estate markets peaked way back in 1989, but in the grand sweep of history they happened yesterday. They certainly should have been fresh in the minds of investors as our millennial market mania gained steam, but the Japanese experience—a "high tech" bubble very similar to ours—apparently didn't even make an impression on our monetary maven Alan Greenspan. In the fall of 1998 he shrugged off his own 1996 admonition about "irrational exuberance", and printed up a mess of money in response to the bursting of the Southeast Asian currency bubble. Then he kept the pedal to the metal to ensure that our economy would be OK when all the world's computers blew up in the first moments of January 1, 2000.

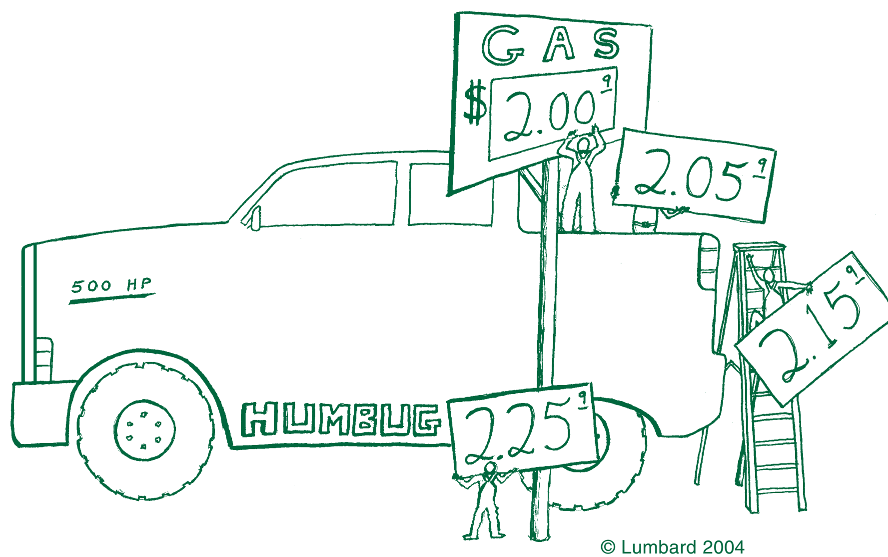
We were all pleased and proud of the way our PCs and mainframes clung tenaciously to survival throughout—and beyond**!**—the drunken revelry of that new year. The bubble in the stock market soon fizzled out—followed, in time, by the bubble in the wildly-overpriced U.S. dollar—but the party resumed in 2003, with many of the big technology stocks rising 100%. The same ol' big technology stocks, pushed by the same ol' easy-money stimulus from the Fed . . . . this time all the world's markets joined in, with gains of more than 100% throughout the developing world. A 100% improvement in Third-World prospects in just one year!

Now interest rates are rising, and Greenspan will soon take his foot off the gas. There will be less money swirling around Wall Street. China—new linchpin of the world economy, or at least the global media machine—has already raised interest rates in an effort to cool overheated growth and torrid markets.

It's hard to know how far this correction will go. But it seems clear that there will at last be some real bargains available in the markets. There haven't been bargains anywhere, in any market or asset class, for a long time; and that is not a normal state of affairs. We don't know what "the market" is going to do, but we do know that *some* stocks and bonds are going to decline a great deal. Investors with cash will see some terrific opportunities in the year ahead.

FAVORITE STOCKS

Our favorite stock of the last few years—big dividends, few heartaches, and sizable holdings—has been Healthcare Realty Trust (HR - $33). It's a real-estate investment trust that owns medical office buildings, outpatient-surgery centers, and other health care properties in 30 states. Bart Starr (who had the misfortune to play in the low-salary days of the NFL) is the head of a division that manages properties. We've owned the stock for a decade—starting with a small REIT that was acquired by Healthcare Realty—and in that time the company has always paid large and growing dividends that responded to steady growth in earnings and Funds From Operations.



Optimists say that higher gas prices will cause less consumer spending on other items, leading to a slower economy . . . . . low inflation . . . . . low interest rates . . . . . and rising markets ???

In fact, the only bad spell for the stock had nothing to do with earnings or management. In 1998 investors started selling the shares because they weren't high tech, and continued selling because they had performed poorly . . . By late 1999 the shares had fallen so far that the dividend yield had climbed to 15%—*a fifteen percent yield!* We added to our holdings and collected the huge dividends. Within two years the stock had doubled.

Our *hottest* stock of the last year or two is one that had caused some serious heartache. We first became involved with Elan Pharmaceuticals (ELN - $21) when it acquired our shares of Neurex, and stayed with it because we liked its "drug-delivery" business—which received cash and royalties for helping pharmaceutical companies create time-release versions of their drugs. Elan's earnings seemed a bit too high for a company with large R&D expenses, but we chalked that up to the up-front payments generated by the drug delivery business. And the shares were climbing inexorably as the company reported success in clinical trials.

Allegations of poor accounting practices began to surface. The stock began to fall, and we corresponded with the CEO by e-mail—helping to persuade him to reveal the details of some undisclosed partnerships. "Tell me how you feel about this on Monday", he wrote. On Monday the stock collapsed (we never attempted to locate the CEO to deliver a response) and soon it had fallen all the way to a dollar. Still, it was clear that the company was earning real revenues and that it had the rare ability to win FDA approvals. The research programs seemed strong—even exciting—and there was lots of room to cut expenses by jettisoning unnecessary research expenditures. We bought more shares at $1.55. You can buy 20 times as many shares at $1.50 as you can at $30, so we bought a lot.

It doesn't always pay to sell your losers. We sold half our holdings at $6—a 300% gain—and the remaining shares became what Peter Lynch likes to call a "ten bagger", powered by the success of Antegren, a treatment for Multiple Sclerosis and Crohn's disease. Investors are also reawakening to the potential for a drug for chronic pain developed by (our original holding) Neurex, and a vaccine for Alzheimer's disease that Elan is developing with the help of Wyeth Labs.

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John Lumbard, CFA
Photo by Rick Balboni

The millions of Baby Boomers in the workforce have swelled the ranks at all levels—especially management, because the 'Boomers are at just the right age. The result is an unusually-high level of competition for jobs in top management. To put it another way, there's a lot of supply, but not much demand. So you'd think that CEO salaries would be *declining* . . . . .

Here's an idea; let's replace stock awards and stock options with a system in which shareholders give part of their shares to the company each year, for distribution to the CEO and other employees. To match the generosity of today's option programs, a shareholder with 1,000 shares of stock would be asked to give up 25 shares each year.

Sounds unreasonable? There's precious little difference between a plan that takes shares away from shareholders and one that dilutes their holdings by issuing additional shares, or issuing options to buy shares cheaply. Either way, the employees get a chunk of the business. And the shareholders give up a chunk of the business.

If you would like to learn more about our excellent performance record, fees, custody arrangements, or other details, please visit our web site, www.lumbard.com. Or, call Jan at (800) Lumbard and ask for a packet of our literature.

"Liquidity is pretty terrible, which is indicative of a market that has no clear longer-term directional bias"

—A portfolio manager at a hedge fund, as quoted in the Wall Street Journal.

Translation: "We don't know whether to buy or sell."

From the web site of Korea Electric Power:

"Publicly owned companies around the world, utilities in particular, tend to have a reputation as poorly run, money-losing operations that are kept afloat by a government's generosity, providing them little incentive to improve. The nation's electricity provider, Korea Electric Power Corp, is bucking the trend."

BELIEVE IT OR NOT

In the 1970s and early 1980s, 6% unemployment was the official "full employment" goal of the U.S. government.

Whip Inflation Now

—A lapel button issued by the Ford administration

YOU'LL NEVER GO BROKE TAKING PROFITS

Why hold cash in a money market fund? Because nobody else wants to. Buy stocks when nobody wants stocks, bonds when nobody wants bonds, and money-market fund shares when they're way out of style.

$$$$$$

When you sell a stock or a bond, don't be in a hurry to replace it. If you rush right out looking for another security, you're probably not going to do enough homework, and you'll pay too much. Better bargains in stocks, bonds, and other investments will turn up before long.

Give us a call at 1(800) Lumbard. **Not** (800) Lombard**!** (800) **Lumbard.**
That's (800) 586-2273.

BORING STOCKS ARE BEST

Over the course of the last 84 years, the yield on the stocks in the Dow Jones Industrials has averaged 4.3%. Today stock prices are high and dividend payouts are low, so the Dow's yield is only 2.3%. Even so, that's almost twice what the average stock pays in the rest of the market.

The new tax law gave companies a big incentive to raise their dividends, or start paying them for the first time. Now, shareholders pay a maximum tax rate of 15% on dividends, so no one can argue that the double taxation of corporate profits is a reason not to give a portion of those profits to the owners of the company.

Unfortunately, few companies have taken the opportunity. Microsoft is a trophy name that made the switch, and it's worth noting that they also decided to expense options—that is, the company is now accounting for stock options in an open and honest manner. Cisco Systems, on the other hand, still hasn't paid any dividends and it still doesn't expense its stock options.

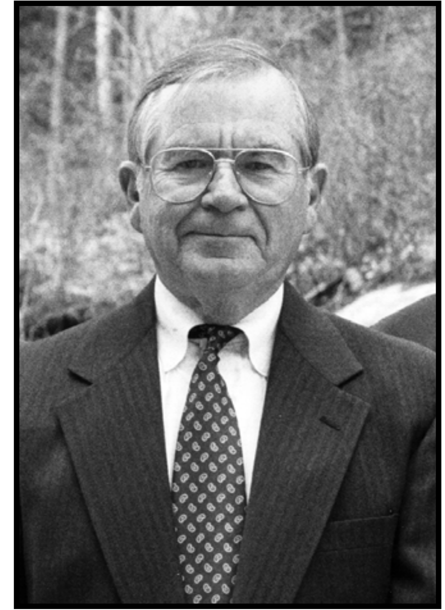
Companies without dividends insist that they return cash to shareholders when they buy back shares of their own stock, but that doesn't do any good unless they buy more shares than they issue. These days it's very common to see announcements about the large number of shares that companies are planning to buy back, but you later learn that they only bought enough to offset all the new shares that were given to the CEO and other employees via stock options. The result is that these buybacks only put cash in the hands of investors who sell their shares. Why should they receive better treatment than loyal shareholders who are in for the long term?

Dividends offer more than just a cash return. They reduce the risk of your investment portfolio because they can be viewed, at the darkest of times, as a return of part of your original investment. And they give other investors a reason to buy in and stop a stock from falling further. When a stock with a 4% dividend yield declines 25%, the yield rises to 5%. At 5%, people sit up and take notice.

Bonds, so often ignored at the turn of the century, are the ultimate "cash payout" investments. They are often associated with low returns, but in the last couple of years past we've been able to find several solid bonds that paid good interest and also offered a potential for gain. A bond selling at 50% of its par value will eventually double, if the company stays healthy until the bond matures.

The best strategy is to continue investing in stocks and bonds that have a tangible cash return, or at least a very clear road map for getting there. Slow and steady wins the race.

John Convery, a member of our investment advisory board for 14 years, manages portfolios for his own clients under the SEC registration of Lumbard Investment Counseling.



John Convery, CFA

"Earnings are opinion. Cash is a fact."
– An investors' adage from the 1890s

As a general rule, it's a bad idea to invest on the basis of a story about a shortage of a commodity such as oil or copper or wheat. Consumers will, in time, find ways to consume less, and producers will find ways to produce more. Worst of all, you'll find that you paid too much for the stock you bought, because everybody else was singing the same song.

It's far better to buy the stocks of deeply-depressed companies that have been suffering the effects of glut. You'll buy at a can't-lose price, and some day—somehow—that glut will disappear.

HOPE

On June 30, the responsibility for governing Iraq will be handed over to the Iraqi people. Iraqis won't just have responsibility for their government; they'll also have responsibility for providing jobs, clean water, electricity, sewage treatment, oil production, food, shelter, police protection . . . The revelations of Abu Ghraib have been disturbing, but Iraqis would do well to pay more attention to images that hold clues to the future of their country. Images such as the one of Iraqis throwing rocks at British and American soldiers because they failed to stop Iraqi car bombers from killing Iraqis.

It's going to be difficult to sew together a nation from three independent, cohesive, and geographically-separated ethnic groups—especially when one of those ethnic groups can democratically bludgeon the others by exercising 60% of the votes. But the biggest challenge, by far, is that the Iraqi people are not stepping up to take responsibility and build their own future.

Surely, there are many good men and women working behind the scenes, who we never hear about—just as there are legions of courageous and principled American and British servicemen who have been ignored by the international press. But there can be no doubt that there are large numbers of Iraqis who are so focused on driving out the invaders that they can't see beyond the fast-approaching day when the Yankees go home. And there are even larger numbers of Iraqis who expect others—the Americans, the British, Saddam Hussein, a new oil-rich government—to provide them with everything they need or want.

The only good solution is a complete withdrawal on June 30, because it would force Iraqis to come face to face with their new reality. Yes, there should be a small contingent of UN troops parked out in the desert; and yes, there might come a time when we'll need to go back in to protect the Kurds. But we've done all that we can do. The only reason to stay until June 30 is that we need to demonstrate to would-be terrorists and to the world that we will do what we say we will do.

This is not to say that we failed. It is utterly remarkable that there have not been any terrorist events in this country since 9/11, and the reason seems clear; the terrorists were all drawn to Iraq. We might not have found much in the way of weapons of mass destruction, but we removed the man who used them—*used them up*, apparently—in gassing the Iranians, the Kurds, and the Shiites. And we demonstrated that American foreign policy cannot be shaped and redirected by terrorist attacks.

There's still a chance that Iraq will provide the Arab world with an example of a functioning democracy, free markets, and the kind of individual rights and liberty that we have here. But it's not going to happen unless millions of people—in Iraq, in the United States, in Europe, and throughout the Middle East—pull together to make it happen. At the moment too many of those people, here and abroad, have a vested interest in seeing Iraq fail.

– John Lumbard, CFA

Everybody is calling for drug-price controls (or access to price-controlled Canadian drugs). But hardly anybody is talking about the obvious alternative of buying generic pharmaceuticals. Name a big-selling, famous, can't-do-without-it drug from the early 1990s's, and you'll find that it's already off patent . . . . or the patent is just about to expire. Were you really that unhappy with 1990s medicine?

The big drug firms are finding it hard to discover profitable new drugs, despite multi-billion-dollar research budgets. We've seen a bit more success in some corners of the biotech industry, but the biotech industry—as a whole—has run up more than $40 billion in cumulative losses . . .