STRATEGIES, TRENDS AND NEWS FOR TODAY'S INVESTORS Summer 2003

LUMBARD INVESTMENT COUNSELING

INSIGHT

Nasdaq Composite 1,541.40 * Dow Jones Industrial 8726.73 * 30 year U.S. Treasury bond 4.64%

A THOUSAND POINTS OF DARKNESS

One of the most irrational ideas that cropped up in the exuberant Nineties was the notion that you could get rich by hitching your wagon to a greedy, amoral, egomaniacal star. That bubble burst more than three years ago: a thousand lies have since been exposed, and dozens of evil CEOs have been thrown out into the street—or, all too often, chauffered out through the gates with a truckload of unmarked $100 bills.

Still, the surprise is that there has been so little passion. A few shareholders have stood up in annual meetings to rail at management, and a larger number have "voted with their feet" and sold their shares of individual companies. Most of us have watched with satisfaction as the government hauled the worst miscreants into court. But we're not talking about a few bad apples here. We're talking about an entire generation of selfish, amoral chief executive officers, and a widespread culture of disinformation and abuse.

This isn't happening at every company; it isn't even happening at half the publicly-traded companies. But the notion of what is normal and acceptable has been stretched and changed, for all. It's a rare corporation, today, that is truly run for the benefit of the shareholders.

The SEC and the Federal Accounting Standards Board and small groups of activist investors continue to battle this many-headed Hydra. But, like the Hydra of lore, this monster can't be defeated by just lopping off a couple of heads. We have to slay the beast. The small steps taken so far – an evolutionary process – will be replaced, somehow, with a revolution.

Millions will finally exclaim "The markets are rigged! Wall Street analysts and investment bankers are lying to me, and the specialists on the New York Stock Exchange have their hands in the cookie jar. The CEOs of my companies are lying to me, and raking off a big chunk of the profits that are supposed to belong to the shareholders. Why would anybody want to own stocks?"

It's frankly astonishing that these words are rarely spoken, at a time when a new scandal is revealed every day. The reason is that so many investors promised themselves that they would hang tough during bear markets, and keep their eyes focused on the long term. Yes, stocks offer one of the very best ways to build wealth, over the course of decades; but it's also true that big bear markets continue until all the believers have been disillusioned and stocks are truly cheap.

When will we see the bottom? The market is still whipping up and down, trying to crush the day traders and hedge funds (see "Say Goodnight to the Day Traders" in our Autumn 2002 issue); so you can be sure that every high will be surprisingly high. But when the bottom finally comes, practically everybody will be saying that it's a bad idea to own stocks. Your friends won't just tell you that the markets are rigged; they'll tell you, with great passion, that you are a fool for believing in stocks. They'll also point out, quite sensibly, that a bank savings account never

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> "I didn't get here by listening to people"
>
> – a retort from a CEO to one of his advisers, as chronicled in that adviser's book "The Productive Narcissist."

A Thousand... *(continued from page 1)*

shrinks, and that it grows every time you put money into it. "If you want faster savings growth, just save more." Then they'll remind you that the Dow Jones Industrials went nowhere from 1966 to 1982, and they'll trot out statistics showing that—in the long term—the investors who gained the most were those who lost the least during bad years.

And that's when you buy with gusto, if you can summon up any gusto while holding your nose and repressing your gag reflex. You'll have to invest with your head rather than your heart. The great John Templeton says that you should "buy at the point of maximum pessimism" when investing in individual stocks or in entire stock markets. By definition, it's a *very* hard thing to do.

We have once again reduced our common-stock holdings, but we would never eliminate them. Diversification sharply reduces risk while causing a negligible reduction in your returns. It's the only free lunch in investing.

"Buy at the point of maximum pessimism"
– Sir John Templeton

Revolutions are never pretty. There is more anger and disillusionment ahead, and we can only hope that any future decline will be swift and severe, rather than slow and excruciating. We can also hope that investors will continue to focus on shareholder rights, and demand solid dividends from the stocks they keep. This is a good time to be conservative, and think hard about your overall strategy and each of your holdings.

BELLWETHER CISCO

Cisco, like other "blue chip" tech companies, has been playing accounting games to fatten its earnings. One favorite trick, recently copied by Intel, is to declare that an entire warehouse full of new products is worthless. That causes a big loss, but Wall Street ignores the loss as a "one time", non-recurring event. Then the company discovers that—happy days**!!**—the products can be sold after all. They become pure-profit goods that have no cost.

Even with the help of accounting games (also see page 6), Cisco's earnings for this year will be no greater than the 50 cents per share they say they earned three years ago. The stock is selling at 33 times those earnings, and it's selling at more than 6 times the company's *revenues* of $2.70 per share (which have declined significantly during the last two years).

But Cisco has *ten billion dollars in cash!!* Surely a company with that kind of cash has been rolling up some real, honest-to-goodness profits. Yes?

Unfortunately, that ten billion dollars is only $1.40 per share, and Cisco acquired a good part of the cash by selling shares of its stock—mostly to participants in the company's stock options giveaway. In the last five years Cisco raised $3.1 billion by selling shares, and it also brought in some cash by using its stock to purchase smaller companies that arrived at headquarters with a load of designer furniture and a Wells Fargo truck full of dollar bills. Cisco now has 7.3 billion shares of stock, up from 6.3 billion shares in 1998. If the company had been able to sell the extra billion shares at today's price of $16.50, the company would have sixteen billion dollars rather than a mere ten.

If only they had sold a billion shares when the stock was at $80 . . . .

"We went from 'greed is good' being said as a joke, to people thinking that 'greed is good' was a fundamental fact."

– Paul Volcker, talking about Corporate Responsibility in the Nineties.

The Greatest Headline of 2003

Associated Press, May 13:

Iraqi Soldiers March to Demand Back Pay

Lumbard Investment Counseling's
"Investment in Continuing Education" Series

July:	"Money Without Mildew: The Right Way to Bury Currency in Your Backyard."
August:	"Learning the Language of Business: Optimism, Obfuscation, and Hype."
September:	"Overcoming Peace of Mind."
October:	"Tax Shelters for the Indigent."
November:	"Use Low-Cost Stock for Charitable Donations to Deserving CEOs!"
December:	"Gift Ideas for Your Favorite Investment Banker."

THE HUNT FOR VALUE

The Fed has been printing money as fast as it can ("We have a printing press" says one official at the New York Fed), and the unsurprising result is that there's a lot of money around. Since the stock-market bubble burst, the amount of money sloshing around in our economy has increased by more than 25%. Borrowers find it easy to get lots of money at low cost—that is, low interest rates—and that means more borrowing and more spending.

On the other side of the fence, investors are disgusted with the low rates they are getting on money-market funds and Treasury bills, so they're moving into long-term bonds and stocks and real estate and home mortgages and hedge funds and everyotherdamnthing.

What's really popular are investments that seem "safe" but also wiggle their hips seductively, and whisper that investors just might *hit the jackpot* if the stars align and the planets collide. On May 1 Duke Energy (an electric utility in North Carolina) sold $700 million worth of 20 year bonds that pay just 1.75%. *Twenty year bonds at 1.75%!!*

Now, the bonds are rated A-minus, which sounds pretty good at a time when a lot of blue-chip companies have gone bankrupt. And buyers can convert their bonds to shares of the company's stock, any time they want. But they'll lose money on the conversion unless the stock goes up 40%.

If they really think the stock can go up 40%, why not buy the shares and get the whole 40%? They'll also get a dividend yield of 6.5% while they're waiting. But risk is in the eye of the beholder; Duke Energy stock seems risky because its earnings have declined, the stock price has declined, and there are fears that the company might have to reduce the dividend. Of course, a 50% cut in the dividend would still leave common stock investors with a yield that's 85% higher than the yield on the bonds. And these knuckleheads never stopped to think that the bonds can go down in price. They *will* go down, and stay down, until Duke's stock has appreciated 45%.

Americans are a bit nutty when it comes to safety. All over the country travelers are avoiding airplanes because of fears about terrorists, but happily climbing into their "safe" SUVs and driving at high speed through snowstorms. The rest of us get stuck in traffic jams on the way to the airport, waiting for road crews to pull all the overturned SUVs and pick-up trucks out of the ditch. We bought shares of Duke in February, when the situation looked scarier and the stock was even cheaper than it is today. We got a dividend yield of 7.8%.

Value investors buy when no one else is buying. We also purchased some shares of Korea Electric Power, during the height of the crises in North

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During the Eighties and early Nineties it was gospel that the long-term (60 or 70 year) average return offered by common stocks was 10%. As the market moved higher you heard investors assert that the number was now 11%, and then 12% or more. In fact, by 1999 the 10-year average return on common-stock mutual funds had soared to 15.6%!

Three short years later, at the end of 2002, the 10-year average return on stock funds had dwindled to 7.65%. And it's sure to go a lot lower, because seven years from now we'll be comparing the stock prices of 2009 to the stock prices of 1999.

At Lumbard Investment Counseling our performance record has been quite different. We got wind of the accounting debacle early, and as a result our portfolios were *down* in mid-1999, and again in mid-2000; but since then we've posted solid positive returns that have kept our 13-year average (for stocks, bonds, cash, and other investments) above 10%. These performance numbers (which can be found at www.lumbard.com) have been compiled by our custodian banks, but two caveats are in order. Our custodians have not measured all accounts, but only those larger than $550,000. And the figures need to be adjusted downward to reflect the impact of our fees, which vary according to the size of the account.

Happily, the effect of fees can be seen in the performance of a small account that joined us several months after we launched this firm. In October of 1990 the account was valued at $100,000, and since then it has always paid a 1% fee. There have been no other additions or withdrawals. This "growth" portfolio, and other euro-bond-laden accounts like it, significantly under-performed our measured accounts in 1999 and early 2000, but also rebounded more quickly. On April 30, 2003 it was valued at $285,094, up from $268,904 at the end of 2002.

NOT (800) LOMBARD! (800) LUMBARD

If you think that bonds are boring, consider this. In April of 2000 we bought a large block of European Investment Bank bonds—zero coupon bonds maturing in 2026. It wasn't our very best purchase of euro-denominated bonds, because the euro, at that time, was worth 96 cents. Nevertheless, we realized a gain as the euro went to $1.08, and we realized a gain on the bonds (as interest rates declined in Europe), and we received a lot of "imputed interest" from the natural appreciation of a 0% bond. We recorded a 65% profit in January.

John Lumbard, CFA

Photo by Rick Balboni

PROXY VOTES

It's annual report season, and every day our post office box has been stuffed with annual reports and proxy statements and proxy cards. The fun thing about this year is that most of the proxy cards include a vote on a proposal from an unhappy shareholder, who wants to put a lid on executive compensation, stock options, or some other egregious practice.

Management has a huge advantage in these contests. It's very, very difficult to ram through a proposal against the wishes of the CEO and his buddies on the board, most of whom are lifetime members of the CEO union. So follow our simple rule: when in doubt, always vote against management. If you want to express your support for a CEO, send him flowers. Or a bulletproof vest.

John Convery, CFA

REAL COMPANIES

Investors have been deceived by investment bankers, and analysts, and CEOs, and auditors. But in most cases they allowed themselves to be deceived, and some practiced self deception. They wanted to "get rich quick" rather than exercise patience and prudence and invest for the long term.

Long term investing is not about getting rich quick, or making a killing on stocks that you bought on Monday and sold on Friday. What you want to do is invest in real companies that produce real earnings and real dividends and solid dividend growth. As the dividends grow, the stocks will grow along with them, and if you can afford to reinvest your dividends they will grow geometrically. Most of the stock-market returns of the last 200 years came from the compound growth of dividends that averaged 4.9% per year.

A real company is a company that produces a product or a service that the world needs. Real companies have shown, over the course of years, that they can hang on to their customers – and bring in new customers – while earning a reasonable profit on the goods and services they sell. A real company invests in new technology and stays current with its customer needs, but it focuses on the customer rather than on technology. It doesn't trade on the hope that losses will finally turn to profits when its latest and greatest widget finally hits the market.

Technology startups and other stocks that trade on hope fall in a category that we used to call "story" stocks. Sometimes the story can be very good, and there's no harm—and possibly real benefit—in investing part of your portfolio in companies that have no earnings but seem to have a great future. The trouble with story stocks is that it's easy to get carried away with the possibility of success, and forget about the possibility of failure. In a bull market investors are willing to pay ridiculous prices for startups and other story stocks, and the predictable result is that they lose most of their money.

In a normal market fraudulent companies wouldn't even be worth mentioning, but in the late 1990s there was fraud under every rock you turned over. Judging from the latest round of financial reports there is still a problem, and it's still focused on the most-popular companies. The ones that receive the most "buy" recommendations from Wall Street.

Real companies are not exciting. They sell electric power and banking services, food and drugs, gasoline and circuit-breaker boxes. But the economy is growing, our population is growing, and the revenues of these companies will grow along with them. If you can collect a dividend that's 4% this year, and growing to 5% and then 6%, your shares of stock are eventually going to go up. And if you buy them at a good enough price you'll get a "bonus" of 30% or 40% or 50% as the stock moves back to its fair value.

> "Worry is the misuse of your imagination."
> – Ed Foreman, Executive Development Systems

> The Dow Jones Industrial Average was at 6900 when Alan Greenspan made his famous comment about irrational exuberance.

The Hunt...continued from page 3

Korea and Iraq, because the price seemed absurdly low. And it seems clear that nobody wants to own "cash", so we've been building up our cash reserves.

It would be unwise to put all your investment dollars into Duke or Korea Electric Power, but a portfolio of 30 or 40 of these slightly-imperfect, deeply-discounted clearance sale items will far outperform a portfolio of the World's Greatest Companies. The best and brightest (and best-managed and safest) come with high expectations and high prices, and they are sure to bring you two or three—or perhaps ten—great heartaches. A portfolio of homely, wart-covered stocks will also bring you heartaches, and these will seem all the more painful because everybody told you precisely why and how the companies would stumble. But most of the homely stocks and bonds will exceed their modest expectations, while most of the gold-plated securities will fall short of the greatness that investors expect. It's really just as simple as that.

Tax Refunds!

There's good news for the shareholders of companies that have revealed accounting "irregularities" . . . . and then more irregularities, and "creative accounting", followed by the publication of a cookbook of new recipes for baking, roasting, boiling and broiling the books. These companies all overstated, or massively overstated, their earnings during the bubble years, so—guess what?—they paid more federal tax than they needed to. And now they want the money back.

THE GREAT GRAB-BAG GIVEAWAY

At large U.S. companies, stock equal to 16.3% of all the outstanding shares has been earmarked for employee options. That's not 16% of this year's earnings; it's 16% of *all future earnings*. And we're not talking about all the options the company has ever issued; we're talking about the options that are cueing up for the next two or three years.

So what's the whole picture? How bad is it really? Business Week offered an example of a company that, each year, grants its executives options equivalent to 3% of outstanding shares (according to Pearl Meyer & Partners, the average is now 2.6% per year). After ten years of good growth the executives cash in all their options, and the company buys back all the newly-issued stock in the open market. The result is that the executives get almost half of the additional profits earned during the ten years.

You won't see that on the financial statements. Bear, Stearns & Co. calculates that the $255 million profit reported by Siebel Systems in 2001 really should have been reported as a $467 million *loss*. Proper recognition of options also would have turned profits to losses at Hewlett Packard and Merrill Lynch, and Intel would have seen a $12 billion profit shrivel to $254 million. The impact on Cisco, Nortel, Lucent, AOL, Yahoo!, and Broadcom is no less significant, but none of these companies reported a profit in 2001—in each case, a big loss would have simply been bigger.

The footnotes to a company's annual report will tell you the number of options that it issues each year. They'll also give you a "true" earnings figure, that has been adjusted for the options expense that should have been taken. If you don't like to read footnotes, don't invest in high-technology or biotech companies.

John Lumbard, CFA

Performance Results:

The performance results presented below are for our "Benchmark Account", using January 1, 1998 as the date of inception. The performance results for the Benchmark Account are calculated by Lumbard & Kellner, LLC's current custodian, U.S. Bank (prior to 2004 State Street was the custodian). The account pays fees based on our firm's fee schedule from the 1990s (top rate of 1%), and the percentages shown are net of fees and expenses—that is, the returns shown would have been higher if fees had not been deducted. The performance results for the Benchmark Account include the reinvestment of dividends and other earnings, but there have not been any other additions or withdrawals since inception. The comparative indexes shown are the S&P 500 Composite Index, Dow Jones Industrial Average, NASDAQ Composite, Barclays U.S. Aggregate Bond Index, and the Citigroup 3 Mo T-Bill Index.

Actual returns for individual client portfolios managed by Lumbard & Kellner, LLC may vary and will not necessarily coincide exactly with the returns for the "Benchmark Account." Past performance of the "Benchmark Account" does not guarantee future results. No assurances or guarantees can be given or implied concerning future investment results for Lumbard & Kellner, LLC or any investment index. Future returns may differ significantly from the past due to materially different economic and market conditions and other factors. Investments within portfolios, and therefore, portfolios, involve risk and the possibility of loss, including a permanent loss of principal.

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