



Value, Performance, & Service

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Letter to Clients - January 2002

We are pleased to present you with a year-end 2001 summary of your investment portfolio with Aldebaran Capital, LLC. You will note that your account had a relatively good year of performance. By maintaining our disciplined value-oriented approach, we were able to far outpace the market averages in 2001 (S&P 500 -11.8%, Dow Jones -8.5%, NASDAQ -22.5%.)

Since the technology bubble began to burst in early 2000, our firm's aggregate cumulative rate of return (net of fees) over the two-year period has been a positive 22%, versus -20% for the S&P 500 and -52% for the NASDAQ composite average. Needless to say, this has been a very unusual period. While we do not expect to outperform by such a wide margin in the future, we are optimistic in our abilities (over the long-term) to achieve above market rates of return. The investment environment we are likely to encounter for the foreseeable future is well suited to our strategy of selecting undervalued securities.

Five Years Since "Irrational Exuberance"

It was five years ago, in December 1996, when Federal Reserve Chairman Alan Greenspan delivered his infamous "Irrational Exuberance" speech. Greenspan was concerned that investors were becoming too complacent with risk in the securities markets. In addition, any rational investor who studied the data in late 1996, would have agreed that stock valuations were anything but cheap.

However, as it turned out, the stock market was just getting warmed up...and from 1997-1999 the S&P 500 rose 27.6% annually (more than doubling in value) and the NASDAQ soared an astounding 46.6% annually (more than tripling in value.) We all know what happened next. The market has spent the past two years, painfully for some investors, unwinding the bull market's speculative excesses.

This five-year span from 1996-2001, was an unparalleled time for the current generation of investors. The period can be dissected into two distinct market phases: The first three years (Phase 1, below) consisted of sharply rising stock prices resulting in a financial asset bubble, followed by (Phase 2, below) two years of agonizing decline.

	Aldebaran (net of fees)	S&P 500 Index	NASDAQ Index
Phase 1	(percentage returns)		
1997	37.6	33.4	21.6
1998	11.1	28.6	39.6
1999	<u>-1.1</u>	<u>21.0</u>	<u>85.6</u>
Cumulative	51.3	107.6	215.2
Avg. Annual	14.8	27.6	46.6

	Aldebaran (net of fees)	S&P 500 Index	NASDAQ Index
Phase 2 (percentage returns)			
2000	17.5	-9.1	-39.3
2001	<u>3.7</u>	<u>-11.9</u>	<u>-21.1</u>
Cumulative	21.9	-19.9	-52.1
Avg. Annual	10.4	-10.5	-30.8
Aggregate 5 Yr. Period 1997-2001 (percentage returns)			
Cumulative	84.4	66.2	51.1
Avg. Annual	13.0	10.7	8.6

A key observation from the above figures is that they display in stark detail the effect of compounding investment returns. The temptation might be to add up the annual returns and divide by 5 to arrive at the average annual rate of return. For example, this calculation on the NASDAQ for the 1997-2001 period would yield an apparent 17.3% annual rate of return $((21.6+39.6+85.6-39.3-21.1)/5)$. However, that figure is way off the correct calculation of 8.6% that incorporates the compounding effect of returns and which is calculated by the formula: $((1.216 \times 1.396 \times 1.856 \times 1.607 \times 1.789)^{1/5} - 1)$. This effect is similar to math that explains that if you have \$1 and lose 50%, resulting in \$.50, you now need a 100% return to get back to even $(.50 + .50)$, not a 50% return.

Another salient point is that while returns in our client portfolios did not match the meteoric market rise of 1997-1999, our investment philosophy rewarded us handsomely during the market rout the past two years. This illustrates a major benefit of value investing, one which we have communicated before. And that is - In times when the market is on a strong swing higher, we may tend to lag the market averages. However, during periods when the market is trading water or moving downward, we should outperform. And in the end we expect to post better than average results over the long-term. After all, in the story, the tortoise did beat the hare!

Wall Street Weak

When I sit down to write these letters, Ed always encourages me to be upbeat in our message. However, on the subject of our next topic my view is decidedly cynical. You will note our headline is a play-on-words of the venerable PBS show hosted by Louis Rukeyser. While I count myself as a viewer of the program, my enthusiasm for its content has waned. Over the bull market stretch of the late 1990s, the show's "panel of experts" became a sounding board for the technology bubble market. Aside from an occasional independently thinking guest, their advice was unanimous; "buy the highly-favored over-priced stocks throughout the market's rise *and* its subsequent fall."

However, our beef is not with this TV program, but instead with the entire Wall Street network. The performance and general conduct of the investment industry and its highly paid professionals over the past several years has been abysmal. Perhaps it is time for a reprint edition of the Fred Schwed's famous book, Where Are the Customers' Yachts? Originally published in 1940, its theme is a familiar one some sixty years later, as the book examined the excesses of Wall Street and the conflicts that exist between the investment industry and their clients.

The Wall Street hype machine was in full gear during the late 1990s. Venture capitalists, in collusion with investment bankers, were floating the securities of dubious companies in the public markets and reaping huge sums of money in the process. The entire ruse was furthered by the cheerleading of Wall Street analysts and strategists, who promoted the investment value of these companies to the public with outlandish predictions of success (all

while their compensation was tied to their firms issuing these IPOs.) As stocks raced higher, gurus appeared on the scene. Goldman Sachs strategist Abbey Joseph Cohen would speak and the markets would move higher. Demographer Harry Dent theorized that the baby boom generation of 50-somethings, needing to save for retirement, would pour money into stocks keeping the market in an uptrend for the next two decades. Wall Street analysts became media stars, Henry Blodget (Merrill Lynch) and Mary Meeker (Morgan Stanley), vied for air time on CNBC. A mere mention of any technology stock by these “experts” sent the shares on a vertical path higher. Books appeared, Dow 36,000 advocated that stocks were as safe as bonds and that stocks were worth triple what they sold for at the market peak (of course the authors got rich, but the followers of their advice did poorly.)

In sum, Wall Street billed this New Economy as an era of wealth creation. But in the end, the result was a transfer of wealth from the investing public into the hands of the Wall Street network. In its aftermath, we invoke a variation on Winston Churchill’s speech delivered August 20, 1940, to the Royal Air Force: “Never in the field of American capitalism was so much taken, by so few, from so many.”

The Strategy Du Jour: Momentum Investing

And while these “sellers” of investment advice were touting the virtues of the new economy, on the other side the “buyers” were gobbling it up. Mutual fund managers, who many investors were entrusting money to for their investment experience and knowledge, began to stretch their investment mandates. Soon mutual funds with significantly different investment objectives began to look the same, stuffed with the favored stocks that were leading the charge. Warren Buffett refers to this phenomenon as the “institutional imperative”. Fund managers argued they could not afford to stay out of the game, even if the business valuations made no sense. Missing the return of the index or lagging competing funds for any length of time would mean, at the very least a withdrawal of assets, or worse, job termination. Therefore, in Wall Street’s eyes, it was critical that fund managers keep pace in the short-term.

As a consequence of this focus on near term results, momentum investing became the popular investment strategy. Momentum investing involves buying the stocks of companies that can each quarter exceed the Wall Street analysts’ earnings estimate. Companies that could beat that forecast by as little as 1 penny were rewarded with a soaring stock price, falling just 1 penny short was the kiss of death to your stock. Of course, it didn’t take long for corporate management to realize how important it was for them to “meet or beat the number” - and the game was on. Management, particularly of the “must own” technology companies would guide analysts towards an earnings number that they believed the company could achieve. Then on earnings announcement day like clockwork, the truly coveted companies would not only meet those forecasts, but also routinely exceed them. For the favored tech stocks, the actual release of their earnings became theater. CNBC would build the suspense, as investors waited with baited breath as the anticipated earnings release approached. Stocks would react immediately, positively or negatively, as the numbers were flashed on the screen. The whole charade was truly comical.

With such an emphasis on companies achieving their expected quarterly earnings, what began to happen next was predictable. Corporate management, keenly aware that the value of their stock price depended on these short-term figures, became “creative” in their ability to hit the earnings number. CEOs began to counsel investors on how to interpret their earnings press releases. Investors were instructed to ignore recurring “one-time” charges to earnings. Eventually, many press releases did not even report earnings under generally accepted accounting principles (GAAP.) Instead “pro forma” earnings reports became common, where companies left many expenses out of earnings and tweaked the numbers to present much a better picture. In the end, accounting at many companies became a form of fiction. So as the bull market peaked, many investors owned richly valued stocks whose underlying quality of earnings had deteriorated.

Sins of A Bull Market:

“You don’t know who’s been swimming naked until the tide goes out.”

This quip by Buffett has always been one of my favorites, and never has it rung more true than today. We now find our stock market atoning for the financial sins that multiplied over the “new era” bull market. As I write, the

business news is dominated by the Enron scandal. And while the Enron fiasco was outright corporate fraud, stocks in general are suffering from the shenanigans that played out on Wall Street over the last five years.

During the 1990s a shameful misallocation of capital by venture capitalists and investment bankers caused too much over-investment in things we can't use. There is excess capacity in fiber optics and computer storage, to name a few. Capital spending has dried to a standstill as sour investments financed with debt and overpriced equity have burdened corporate balance sheets. The use of stock options, at one time viewed as the golden goose of employee compensation, was abused by companies. Companies that relied on high stock prices for acquisitions are now confessing that they significantly overpaid for their purchases.

Another development we think has yet to be factored in by investors is the reversal in fortune for corporate pension plans. When stocks were rising, corporations did not have to contribute money to pensions because the rise in stock prices kept the plans fully funded. Many companies benefited from accounting rules that allowed them to report excess pension fund returns in their earnings statements. Now, that income boost will disappear and instead become a drag on future earnings.

Lastly, the September attacks have led to escalating insurance premiums along with added security costs. These unexpected "frictional" costs will act like a tax on future corporate earnings.

Unfortunately, as the tide from the 1990s bull market continues to recede, we would expect more unpleasant corporate exposures. Investors, weary after two years of plunging stocks, are hanging in there with fragile confidence in the market. While we have no idea what is in store for stock prices in the near term, we are cognizant of the fact that, much like a bull market pushes stock prices too high, the pendulum can swing the other way when investor pessimism invades.

Outlook: And Even Some Optimism

As we mark the five-year anniversary of irrational exuberance, consider a "Rip Van Winkle" investor who went to sleep after Greenspan's speech in December 1996. That person (oblivious to all that transpired in between) would have woken up in January 2002, glanced at the market averages, and calculated a respectable 10% annualized rate of return. This rational investor, having remembered Greenspan's warning, would probably think that 10% annually over five years was a pretty good outcome for a stock market that wasn't exactly cheap when he went to sleep. And lastly, this sleepy investor might conclude that a 10% annual return on a fully valued stock market five years ago, would probably mean that the stock market is not exactly undervalued today.

And that, we believe, is where we find ourselves here in the present. It may be hard to believe that after the pounding certain sectors of the stock market have experienced over the past two years, that the market isn't a screaming buy. Yet, when we look at the measures of valuation for the stock market in aggregate, this is the case. In fact, this is a testament to just how over-stretched valuations were at the peak of the market bubble.

Of course, though, this is not the sales pitch we are currently hearing from the same Wall Street experts who guided investors down the wrong path previously. While it appears the economy is on a slow path to reviving, it is doubtful that corporate earnings will rise fast enough to support the market returns that brokerage house strategists are predicting. Instead, we wouldn't be surprised to see positive signs for economic recovery, to be greeted by a struggling stock market. A re-valuation of stock prices is an unpleasant, but inevitable process brought on by the sins of the bull market.

As for our own cause, (this may surprise you) we are optimistic about operating in this type of environment. Uncertainty, and even some gloom, in the market will provide us with opportunities to make long term investments at attractive prices. In many of our portfolios, we have more cash on hand than we would like. But we won't buy something just for the sake of moving money. Preservation of capital has served us well over the past two years and we are conscious that the price we pay for owning a business (the act of buying stocks) will determine our results in the years to come. We also know that if we are patient and diligent, our research will inevitably lead us to a few attractive companies trading at prices significantly less than we feel the businesses are worth.

With all the silliness that transpired in the stock market over the past five years, we often looked at the market and viewed “the glass as half-empty.” Now we are beginning to see it as “half-full.” We look forward to working for you this year and will keep you informed of our progress. As always, please feel free to give Ed or me a call if you have any questions or would like to meet to discuss your account in more detail.
Sincerely,

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