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Semper Augustus Investments Group, LLC is an independent SEC registered investment advisor. The firm claims compliance with the Global Investment Performance Standards (GIPS).

At the time of this letter, Semper Augustus had not claimed compliance. Any references to performance in this letter is as it was presented at the time of publication. Do not rely on performance or performance language contained herein. The SEC introduced a new “marketing rule” effective in November 2022, after this letter was written. One aspect of the new rule alters the way composite returns are calculated which is a different method than prescribed under GIPS. Specifically, the SEC began requiring non-fee paying accounts to impute a management fee for the net fee presentation. As such, SAI has revised its net fee presentation to include a model management fee in the net fee calculations for accounts that do not pay an advisory fee which include employees and certain family members of SAI.

The firm maintains a complete list and description of composites, which is available upon request. Policies for valuing investments, calculating performance, and preparing GIPS reports are available upon request. A copy of Semper Augustus Investments Group LLC’s Fundamental Intrinsic Value Equity composite can be obtained by contacting Semper Augustus at (303) 893-1214 or at csc@semperaugustus.com. GIPS® is a registered trademark of CFA Institute. CFA Institute does not endorse or promote this organization, nor does it warrant the accuracy or quality of the content contained herein.



SEMPER AUGUSTUS

Investments Group LLC

2003 Year End Client Letter

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Clients and Friends:

The closing of our fifth year as a “going concern” presents a good opportunity for reflection. It also affords us the opportunity to extend our warmest thanks to our clients for your ongoing confidence, trust and support. All of you have unique circumstances and objectives, though we recognize a common thread in our dealings with each of you. Beyond our charge to generate the highest investment results while accepting minimal risk, we recognize an implicit need for fair and honest treatment. With the corruption of ethics so seemingly pervasive in the investment arena and in the management suite today, our mission is to treat each of you as we demand treatment as shareholders. We derive great satisfaction from considering most of you friends as well as clients. These sentiments extend to our purveyors of research, brokerage and custodial services. Certain contemporaries and pundits fit the bill as well. Your suggestions and criticisms are indispensable. Being able to work with people we like, admire and trust makes the effort we put into our profession worthwhile. By that standard we are immensely successful.

While our investment results over the past five years have been quite satisfactory, certain aspects of our results and our approach to the capital markets require introspection.

The following table updates our composite performance (average client returns) for each of the past five years. The bottom portion of the table presents our cumulative results, reflected as both average annual gain and cumulative overall gain. The results for our equity securities only and for our average full portfolio are compared to the results of the total return from the S&P 500:

Semper Augustus' Investment Performance vs. the S&P 500
Annual Percentage Change

Year	SAI Equity Only (1)	SAI Full Portfolio (2)	S&P 500 Total Return (3)	Relative Results (1)-(3) (2)-(3)	
1999	25.8%	9.9%	21.0%	4.8%	(11.1%)
2000	33.6	21.2	(9.0)	42.6	30.2
2001	22.6	15.8	(11.8)	34.4	27.6
2002	(21.0)	(9.1)	(22.1)	1.1	13.0
2003	38.7	13.5	28.7	10.0	(15.2)
Average Annual Gain (1999-2003)	17.7%	9.7%	(0.6%)	18.3%	10.3%
Overall Gain (1999-2003)	125.8%	59.1%	(2.8%)	128.6%	61.9%

Notes: SAI results are gross of management fees and taxes, but inclusive of trading costs and commissions paid. SAI published fee of 1.25% would reduce the annual return by 1.25% per year (average annual and overall gain for the full portfolio would have been 8.5% and 50.2%, respectively, for the five-year period presented). SAI has clients that pay less than the standard fee and certain performance accounts may pay more than the standard fee.

The S&P 500 returns are gross of any fees required to replicate the index and are also pre-tax. The index is theoretically passive (unmanaged) but in reality, replication requires trading costs and some management fees.

Please refer to the entire performance disclosure located at the end of this letter.

In last year's letter we echoed Warren Buffett's sentiment regarding the way we gauge investment success at Semper Augustus. His philosophy bears repeating:

"Whether we do a good job or a poor job is to be measured against the general experience in securities. We initially used the Dow Jones Industrials as our benchmark but shifted to the S&P 500 when that index became more widely used. Some people disagree with our focus on relative figures arguing that 'you can't eat relative performance.' But if you expect--as Charlie Munger, Berkshire's Vice Chairman, and I do--that owning the S&P 500 will produce reasonably satisfactory results over time, it follows that, for long-term investors, gaining small advantages annually over that index *must* prove rewarding. Just as you can eat well throughout the year if you own a profitable, but highly seasonal, business such as See's (which loses considerable money during summer months) so, too, can you regularly feast on investment returns that beat the averages, however variable the absolute numbers may be."

From the standpoint of returns generated only by our stocks, 2003 was another good year for us. In fact, in absolute terms, the year was our best ever. For the fifth consecutive year, our stocks outdistanced the S&P 500, gaining 38.7% versus 28.7% for the index. In terms of our average portfolio results, inclusive of cash equivalents and fixed income, the year was the worst we have experienced in relative terms to the index. Our 13.5% gain for the year trailed the S&P 500 by 15.2%. While we still enjoy an 18.3% annual advantage with our stocks versus the index and a 10.3% annual margin for our composite portfolio over the past five years, our average annual margin was even wider at the end of 2002, at 19.7% and 15.5% respectively over four years.

To put our results in perspective, Buffett has grown the book value per share at Berkshire at a staggering clip of 22.2% over 39 years; an unbelievable 11.8% annualized advantage versus the S&P 500's 10.4% annual gain. In one short year, we saw our annual advantage versus the index decline from 15.5% to 10.3%. Buffett can see the equity of his company drop by nearly 99% and still maintain an advantage versus the index. We would lose our annual advantage with relative underperformance of 38.9% and 57.0% for our stocks only. In baseball terms, it's a long way from single A to The Show.

Even though our 38.7% equity return was a market beater again, it was not a "stock-pickers" year. We made this point with clients during the second half of the year and were pleased to see the sentiment shared by Bill Nygren, manager of two Oakmark funds and one of the best stock-pickers around. In the August 11, 2003 edition of Outstanding Investor Digest, Nygren stated, "I have to laugh every time I hear someone come on CNBC and say they think we're *now* entering a stock-picker's market. If what we've been through over the last three years hasn't been a stock-picker's market, then I don't know what is." Amen.

Asset allocation largely drove results in 2003. Being in the stock market in general was more important than which stocks you were in. Our good showing in stocks was insufficient to overcome our very conservative and very pre-meditated decision to not be more fully invested. Unlike 2002, when our heavy allocation to fixed income and cash equivalents helped our total result, just the opposite occurred in 2003.

Put another way, the last two years have been akin to "kissing your sister," both for our results and for the index. What was lost in 2002 was regained in 2003. Our 9.1% average decline in 2002 saw our investment portfolios fall to 90.9 cents on the dollar. Regaining 13.5% in 2003 allowed us to grow to 103.2 cents on the dollar, slightly more than we could have earned in US Treasury bills over the two-year period. Had we been fully invested in our stocks instead of holding big fixed income and cash equivalent positions, we would have lost 21.0% in 2002 and gained 38.7% last year, producing a cumulative gain of 9.6%. The difference, while somewhat better, would have been done with much higher volatility. The S&P 500, meanwhile, dropping 22.1% in 2002 and gaining 28.7% last year, would have finished a mere whisker over flat, first falling to 77.9 cents on the dollar then rising to 100.3 cents on the dollar. The good news is that by losing less in 2002, our two-year numbers still outdistance the index.

"O.K. fellas," you might say, "Wouldn't it have been intelligent to have bought more stocks at the market lows? After all, you had two cracks at it -- in October of 2002 and last March." Absolutely, we respond. Unfortunately, the lows during those periods did not represent lows for the kinds of stocks we buy. In fact, as can be derived from our annual results, our stocks had already advanced considerably from their lows in 1999 and 2000.

Even during 2002, the only year we posted negative returns, most of our stocks did not decline nearly as much as our average equity result. Huh? Recall we had a couple disasters in 2002 (certainly not worth repeating, neither in

this letter nor in practice!). In reality, despite the bubble in tech, telecom, internet and in certain large capitalization stocks, the prices of many outstanding businesses sold for immensely reasonable prices. Many traded at bear market low type prices. The market was indeed two-tiered at the market peak in March 2000. Many stocks were extremely undervalued and many were conversely overvalued. The discrepancy rivaled and ultimately exceeded prior such occurrences, in the late 1920's and early 1970's, during the heyday of the "Nifty Fifty." Please refer to past letters discussing the tiering in the market in the late 1990's and early 2000.

During the subsequent "bear market," many of these imbalances worked themselves off. As the capitalization weighted averages declined (NASDAQ by nearly 80% and the S&P 500 by nearly 50%), the prices of many formerly neglected and oversold companies saw their shares advance, in many cases substantially. We certainly did not expect our stocks to advance as much as they did simultaneous to the indices being chopped by half or more, though we certainly aren't complaining.

By March of last year, when the S&P 500 traded closer to our appraisal of fair value than at any time since 1995, we liquidated many of our positions as they became fully valued, and in some cases, overvalued. We sold our position in Mylan Labs, for instance, which had nearly tripled in price, throughout early 2003. This was not the first time we had profitably sold our entire position in the terrific generic drug manufacturer. We hope to buy it back again. Lower.

We do need to constantly examine whether we should be in the business of asset allocation. Obviously, each client relationship we maintain is unique. At times, some investors should be more fully invested in stocks than others. The allocation we formulate over time is governed by a very individualized set of parameters. A portfolio in which we target a very high allocation to stocks is only 40% or so invested in stocks today. Likewise, a portfolio with a long-term target of roughly 50% in stocks (permanent fixed income position for balance) is only 20% or so invested in stocks today. In other words, we are less than half committed to stocks today than we would prefer. During 2003, we were a net seller of stocks, though we did initiate a handful of attractive new positions and added to some current ones. Over the long haul, we believe the stock market will afford us better prospects for higher returns than cash or fixed income.

Our conservative allocation away from common stocks is only slightly driven by our macroeconomic outlook. Clearly our biggest mistake to date, much more costly than the couple of bombs in 2002, was our reluctance to be more fully invested in the late 1990's and early 2000. We were gun shy from an allocation standpoint due to our recognition of the bubble in many stocks as well as from out of control capital spending. In fact, we named our company after the most inflated tulip bulb in 1637 Holland. Knowing the fallout of bubbles to be destructive, we kept the allocation to stocks down – not for a lack of good companies at good prices but because of our macro view. This decision, though we would likely make it again, has cost us dearly.

With the exception of our macro views during the last few years of the 1990's and in early 2000, the primary determinant of our allocation away from stocks is an inability to find good businesses trading at good prices. We wrote extensively about our process earlier so we won't bore you with the details in this year's letter. Suffice it to say, however, that the current market environment is the most brutal we have encountered. The prices of the vast majority of terrific companies are simply too high to justify purchase. The notion that a great company can be bought at any price simply makes no sense to us. We want to own companies trading at a discount to our appraised value of the company, the price at which a rational businessperson armed with sufficient data would pay for the entire company in a private transaction.

The climate for what we do well has changed for the worse over the past several years. There simply aren't enough great companies to buy at reasonable prices. Fortunately we generated satisfactory results over the past five years, both in absolute and relative terms, and have some relative cushion.

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AGNOSTICISM

Many equity market participants are “market agnostics.” These investors stay as fully invested in stocks as they can. Some are willing agnostics, and some are compulsory agnostics.

Compulsory agnostics are often equity mutual fund managers or institutional managers with a direct mandate to stay fully invested. These folks have a figurative gun pointed at their heads, and are fired upon for not being fully invested in stocks. Jeff Vinik was a compulsory agnostic until sensing the market overvalued as the helmsman of the Fidelity Magellan Fund in the early 1990’s. By 1994 he built a cash and bond position in the fund. Fidelity summarily fired Vinik for not being fully invested when his bonds declined and underperformed the stock market.

Many of our friends and contemporaries are compulsory agnostics. Managing institutional funds with consultants dictating the asset mix, these managers have no choice but to stay fully invested, committed to a style box for fear of being fired. “What if, as a small cap manager, I have a stock which grows enough to be a mid cap or a large cap,” they rhetorically lament. Naturally they sell it, even if the fundamentals of the company and the price dictate otherwise. No style-drifting allowed. So much for buy and hold. Our friends will outperform their “benchmarks” for some period of time and then watch the new money cascade in as the world chases performance. Rear-view mirror investing. They are forced, per their mandates, to immediately invest the inflows, even if reasonably priced ideas are nonexistent at the time. Conversely, following periods of underperformance, money abruptly flies out the door. Poor bastards, forced to sell what they would otherwise own, or even buy, to meet liquidity demands so the hot money can chase yesterday’s winners (this phenomenon explains the severely undervalued market for good companies at the broad market peak in March 2000).

**Armed with the Greek alphabet and statistical techniques
of a higher order, who can dispute the consultants' knowledge?**

Perhaps the consultants have it nailed. Perhaps, despite my friends’ lamentations, no one is really good at what the consultants have derided as “market timing”. Dirty words -- market timing, only to be uttered behind closed doors and certainly not in mixed company. After all, armed with the Greek alphabet and statistical techniques of a higher order, who can dispute the consultants’ knowledge? Peter Bernstein, for one, makes a compelling case in favor of intelligent market timing in a couple forums back in 2002 and 2003 (see Kate Welling’s terrific interview with Bernstein from February 28, 2003; Welling@Weeden). If Bernstein was right, Semper Augustus would not benefit from such a shift. We thrive on market inefficiency. The market would likely be a more efficient place, as more of the really intelligent compulsory agnostics are freed of their allocation shackles. The efficient market theorists among us won’t appreciate the delicious irony, that they created a more inefficient market than would otherwise exist without “style constraints.”

The willing agnostic is another breed of cat entirely. Willing agnostics wear blinders to the outside macroeconomic world. Generally very good investors, they determined, often after relative failure, that specializing in an area of finance or investing is the road to riches. They are generally experts, disciplined to tune out the many variables not relevant to their immediate craft. These folks are very good stock-pickers, or merger arbitrageurs, or high-yield investors, or office real estate investors, or cattle traders (not HRC).

We have spent much time over the years (and recently) struggling with whether we should be more like willing agnostics. At the basic, primordial core of Semper Augustus, we are stock-pickers and capital allocators. We think our approach to investing in common stocks -- combining rigorous financial analysis with sensible appraisal -- lends itself to long-term success. At its simplest level, we benefit from short-term emotional swings in the prices of individual stocks and rely upon prices being rational and efficient in the longer term. Benjamin Graham’s introduction of Mr. Market defines our constitution. To borrow a phrase from the likes of Graham and Buffett,

we attempt to buy dollar bills for fifty cents. Easier said than done, though certainly doable over the long haul for those with the proper “wiring” and patience. At the same time, our assessment of the macro picture is an important part of our approach. The willing agnostic shudders. Our 10-year projection for the S&P 500 (later in this letter), updated annually, is an extension of the way we analyze individual companies. We incorporate a set of reasonable assumptions regarding profit margins, P/E multiples, nominal growth in corporate America, inflation, and dividend payouts to arrive at our estimate. The tool is not meant to pinpoint with precision the level of the index exactly 10 years from today but to illustrate the degree to which the aggregate stock market is currently overvalued relative to fair value. Depending on one’s projections for each of the variables we incorporate in our analysis, a higher or lower estimate of fair value can be obtained.



**Our on deck circle of good businesses
and managements has never been deeper.**

We are also students of financial history, convinced that a repeating mechanism is at work in the markets. We acknowledge the rise and fall of civilizations and the ebb and flow of the business cycle. Austrian at our core, we can’t help but be concerned about debt levels, instability in purchasing power, secular job losses, and the fallout from bubbles and economic dislocation. These are very long-tailed issues so we constantly wonder whether we shouldn’t simply ignore them in our day-to-day investing.

Our investing success is partly determined by our ability to continuously find good businesses at good prices. Despite what may arguably still be the most overvalued major stock market of all time, we continue to find ideas. In fact, our on deck circle of good businesses and managements has never been deeper. There simply aren’t enough today at the right prices to justify more purchases.

On the other hand, could we not, or should we not, simply buy more of what we already own, on the logic that what we own is generally undervalued relative to our appraisals of intrinsic value? This is a great question we ask ourselves often. We own businesses that, per our estimates, grow somewhat faster than the overall economy. We also think they are mostly undervalued, some more so than others. Even if we were too aggressive on our valuation estimates and our stocks were fairly priced, not undervalued, wouldn’t we roughly earn the underlying growth rate of our businesses combined over time? We believe so.

We think our companies will organically grow at roughly 7% to 8% per year versus 4% nominal growth for the broad economy. Only if we overpaid for our stocks, or if they are now overvalued, should we earn less than 7% to 8% per year. The notion that our stocks are undervalued, and will eventually trade closer to our estimate of fair value, draws us to our conclusion that we should earn a premium return over time. A further reward comes when we find additional good companies at a discount.

The big question: Should we knowingly pay full price for a company, even a great company, against the backdrop of uncertainty, and be content with a single digit, long-term return expectation? Our answer is no. Because we are armed with imperfect information regarding business conditions, competition, regulation, monetary instability, and are generally not able to attain a controlling position, single-digit expected returns are not enough for us. We strive to avoid situations without our cherished dual margin of safety – the quality of business and the price. We need both to counter our inevitable mistakes and unforeseen events. We set our stock market hurdles higher than most, which keeps us out of harm’s way. We also may sacrifice relative performance in certain raging market advances, like we saw during the final three quarters of 2003.

Missing the game for too long, however, can be a bad strategy. For how long can an investor, convinced the excesses seen in the last cycle will sow disaster, fully sit on the sidelines, uncommitted to stocks entirely? Some friends and good investors sit in this camp. Some missed most of the past decade. While the merits of their “bear case” are strong, without some insight as to how long the full cycle will last or its final form, the strategy may be expensively flawed. Time can be the enemy of the fatalist. Opportunity cost swells. Consider gold bullion. A gold buyer ten years ago who sensed an opportunity to buy at half off the 1980 high, is only now back to breakeven. The commodity does not earn interest, unless loaned out.

In the meantime, a program of buying good businesses at good prices yielded good results. An equity program earning 15% annually doubles in value approximately every five years. Ten years into the game, the program will grow four-fold (two doubles). Over the past 10 years, gold is flat and cash equivalents earning 6% annually only grew to 179 cents on the dollar. Even if the equity program falls by half, the cash or gold programs would still trail. A less successful equity program, earning say 7% annually, still doubles in value every 10 years or so. Tough on the fatalists, as right as they may likely be, has been the length of time to cleanse the system of the debt and capacity excesses. The bubble grew too large and is taking its sweet time to present its aftermath.

The exciting aspect of our approach has been the ongoing presentation of good businesses at good prices. When we see a good pitch we try to hit it. By reducing positions as they become fully valued and replacing those with new undervalued situations, we reap rich rewards and have built a nice cushion versus the fatalists. By buying good companies at good prices, we typically captured the growth of the underlying companies plus the accretion back to fair value (which grows over time). We have been fortunate to continuously find new ideas, or to repurchase old ideas at new discounts. We capture our gains and continue to enjoy our dual margin of safety. We think we generally have downside protection in a broad market decline. When enough compelling situations are not offered to us by Graham's Mr. Market, we are willing to wait.

We constantly remind ourselves this is a marathon, not a sprint. Forcing capital just does not suit us. Time will tell whether we would be better off as willing agnostics, and we constantly struggle with this issue. Certainly playing the role of willing agnostic would have proved beneficial over the past five years. Either way, we are happy to not be compulsory agnostics. Perpetually elated, in fact.

FIXED INCOME AND CASH EQUIVALENTS — HIDING OUT IS TOUGH

It is worth noting that both cash equivalents and fixed income outperformed the S&P 500 over the five years ending December 31, 2003. Three-month US Treasury bills returned a cumulative 17.42%, 3.26% annually. The Lehman Brothers Intermediate Government Credit Index, a good proxy for medium duration investment grade debt, returned 34.99%, 6.18% annualized. While both our equity securities alone and our composite portfolio handily exceeded both asset classes (due to our 17.7% annual result with our stocks), the S&P 500 declined over this period by 2.77%, or 0.56% per year. Our stocks beat our bonds. Our bonds beat our cash. Cash beat the S&P. The decision to not be more fully invested in stocks was thus not overly bad.

Concerning cash equivalents, sitting on the sidelines with a portion of our assets was much more bearable five years ago. As the Federal Reserve primed the monetary pump, we saw three-month US Treasury bills fall from average yields of 5.86% in 2000 to 1.02% last year. The opportunity to cash in chips and hide out is not particularly fun or rewarding today.

Other areas of fixed income are not exactly rewarding either. Coupled with low absolute or nominal yields, tight credit spreads can pose a lethal combination to holders of credit bearing fixed income securities. The acceptance of credit risk in today's environment presents enormous risk. Credit spreads versus US Treasuries compressed for all grades of corporate issuers, from AAA rated issuers down to the lowest junk rated issuers. High-yield bond (junk bond) yields shrunk from nearly 900 basis points over 10-year Treasuries in the fall of 2002 to a mere 300 basis point spread recently. Most junk bonds with 7% yields are universally unattractive.

Inflation indexed bonds don't strike us as overly appealing either. Treasury Inflation Protected Securities (TIPS) provide miniscule starting yields, bearing price risk in a rising interest rate environment. Despite the fact that the annual coupon payment is adjusted based on annual changes in the CPI, we have reservations with the calculation of the CPI. The government has an incentive to understate the index. Huge amounts of government expenditures are indexed to the CPI. For example, by understating inflation, Social Security adjustments can be kept lower than they would otherwise be.



**The government has an incentive
to understate the index (CPI).**

First, we are not convinced inflation is poised to march upward, especially with surplus capacity in too many industries and globalization of labor. Second, we think the CPI is a pitiful measure of inflation. We could write pages on the flaws with the way the CPI is calculated. The housing component, some 40% of the index weight, is based on rent equivalents instead of outright housing prices. With home ownership up, apartment occupancies are down. Thus rents have not kept pace with growth in the housing stock. The CPI incorporates “the change in the implicit rent, which is the amount a homeowner would pay to rent, or would earn from renting, his or her home in a competitive market.”

More egregious is the use of hedonic adjustments in calculating inflation. We have previously noted that we eat in nominal terms. The folks at the Bureau of Labor Statistics, the keepers of the CPI, must not. They make what they call “quality adjustments” to myriad items included in consumer prices. We are all aware that software and PC’s are adjusted. To illustrate, because processing speeds rise, a hedonic adjustment will tell us computer prices are falling more rapidly than the prices we actually pay. Further, these hedonic adjustments, especially in the area of technology, serve to overstate growth in GDP. The extra perceived “value” obtained from \$1,000 spent on a faster computer this year versus last year is added to growth in GDP, even though dollar output remains constant. Let’s see if we get this right – Prices down, GDP up, but CPI down by more than prices? Hmmm...

A change is under consideration by the BLS for the estimation of changes in healthcare costs. Longer life expectancies and less untreatable disease warrant a value adjustment in healthcare costs, they say. Despite annual increases of 10% to 15% in health care costs, including insurance premiums, drug costs, hospital costs and medical equipment costs, the BLS believes quality improvements outpace prices paid. BLS showed only a ridiculously low 3.6% inflation in the healthcare component within the CPI in 2003. We understand the BLS is contemplating further “reductions” in healthcare costs.

In addition to computers, software, and healthcare, the BLS makes value adjustments to cable TV, VCR’s, stereo equipment, education, air travel, hotel costs, DVD players, textbooks, household appliances and telephone bills. Presumably, as each of these day-to-day consumables improve in quality, the hedonic adjustments infer actual price increases are not as great as changes in sticker price. In other words, because new televisions have better pictures, despite much higher prices, the extra “value” warrants a downward adjustment to actual consumer purchase prices.

Why not make upward adjustments to prices? In reality, the value of many services declines over time, despite higher prices paid. Take education. As a greater percentage of the population obtains an undergraduate degree (thanks, Apollo Group), doesn’t the value of a degree diminish over time? A high school degree was certainly worth more 50 years ago. It won’t get you very far today. Apply the laws of supply and demand. Also, regarding computers, if built in obsolescence occurs more frequently, should a shorter replacement cycle actually be more inflationary? After all, if I have to buy a new machine every two years instead of every five, aren’t I actually spending more, not less?

We think we’ll pass on TIPS as an alternative to not being fully invested in stocks. We prefer playing when the game is not rigged against us.

Instead, we hide out in callable US agency debt. While we are concerned about a potential housing bubble and the bloated state of household debt, we accept the risk reward tradeoff. Our typical purchase over the last three years has been 10-year to 15-year paper issued by the Federal Home Loan Banks, Freddie Mac and Fannie Mae. The debt of the Federal Home Loan Banks (FHLB) is exempt from state taxes. Because these agencies attempt to balance the assets and the liabilities on their respective balance sheets, they issue lots of callable paper. For the right to take our paper away prior to final maturity, the issuers pay a substantial premium to straight or non-callable debt. Our premium averages more than 200 basis points, 2%, over US Treasuries of like maturity. We typically have one year of call protection, meaning the agency cannot call our paper away from us for one year after purchase (we generally buy new issues).

Why are these agencies willing to pay such a premium versus US Treasuries, despite their top credit rating? They need flexibility on the liability side of their balance sheets. Because they own mortgages on the asset side (some in the pipeline prior to securitizing and some permanently in their portfolio), they need protection in a falling interest rate environment. Homeowners prepay their mortgages at a faster rate when rates fall. As mortgages are refinanced, the agencies need to ratchet down their borrowing costs as well. The right to call their debt early gives them this protection.

We tolerate the paper given the big premium to straight agency or Treasury debt. Relative to money market rates at 1% or less, earning coupons of 6% or higher seems reasonable to us. Our bet is clearly not on drastically falling interest rates. Because callable debt can be taken away from us early, it does not appreciate much above par (face value) as rates move down. As rates fall, the probability of early call rises. On the downside, we bear price risk in a rising interest rate environment. The probability of early call recedes, and the duration of our paper expands as rates rise. We do believe, however, that the premium coupons we earn somewhat protect us on the downside. If rates rise substantially, the likelihood of 10-year paper reaching full maturity increases. The prices of the callable debt should trade closer to non-callable debt on a yield to maturity basis. However, our 6% coupons will ultimately trade in line with straight debt of equal maturity with similar coupons. In other words, when we purchase 6% callable paper, our alternatives are 4.5% straight agency debt or 4% treasury debt. In a rising rate environment, the prices of our callable debt will not fall as much as the prices of the alternate agency or treasury straight paper.

Concerning the credit quality of the mortgage agencies and the Home Loan Bank System, we share many of the concerns raised by critics. We do not own the equities of Fannie or Freddie. At some level we think these issuers are indeed too big to fail. We don't envision housing prices falling as much as stock prices. We believe our loans to the agencies are "money good". In a worst case scenario, a restructuring, despite the high leverage employed by the agencies, we think our paper would be satisfied at par or close to par. We can't fathom settling for less than 90 cents on the dollar. From that perspective, our compensation for lending to AAA credits is adequate.

Our 6+ % coupons are enough of a premium to money market instruments to bear the interest rate risk and the modest credit risk we assume. The paper is longer than we prefer, but the high relative yields offer enough compensation. Most of our agencies, which had coupons and yields higher than 6%, were called over the past three years. We opportunistically replace these called securities. Remember, in most cases, we own the paper as an alternative to being more fully invested in stocks. As we find more companies at the right prices, we will reduce our holdings of our reasonably liquid agencies. If we wind up holding the paper to maturity, 6% to 6.5% annual yields would not be too terrible. Our agency returns over the last three or so years have certainly been superior to cash yields. We bet these bonds will outperform the aggregate stock market over the next 10 years.

We still harbor sufficient macro concerns to warrant caution. The remainder of this letter will address some of these concerns.

THE BOTTOM, DEFINITELY THE BOTTOM

There was much debate about whether the market made its final lows this past March (S&P 800.73) and in October, 2000 (776.76). The notion that it reached its trough now seems a foregone conclusion, with the S&P 500 having already risen nearly 50%. Just in case the CNBC crowd jumped the gun, though, let's compare the recent lows with other market "lows" of the past 100 years:

	March 2003	Trough A	Trough B	Trough C	Avg. ABC
Price to Earnings	20	26	18	23	22
Price to Sales	1.0	2.3	1.2	0.9	1.5
Price to Book Value	2.5	3.0	2.4	2.3	2.6
Dividend Yield	2.0%	3.0	2.4	2.3	2.6
Market Cap to GDP	90%	90%	79%	70%	80%
After Tax Profit Margins	5.0%	8.9%	6.7%	3.7%	6.4%
US Gov't Bond Yield	4.5%	3.4%	4.6%	9.0%	5.7%

Clearly the nadir reached in March was one of the great buying opportunities, especially when valuations were so similar to those reached at the three prior low points depicted in our table. Right? After all, the market had fallen nearly 50% from its highs reached three years prior. Enough blood spilt, right?

From the table, valuations were squarely in line with those reached at points A, B, and C. Using three of the measures -- price to book, dividend yield and market cap to GDP -- the market was slightly higher than at each prior low. However, using price to earnings and price to sales measures, the market was basically midrange (Actually, using trailing earnings, which were used at points A, B, and C, the market P/E was 28 at March 2003.) With history as our guide, we obviously weren't working hard enough last spring. You would think getting more fully invested would have been a lay-up, with valuations so compellingly low.

You have probably guessed by now that we've been having some fun. Students of market history should be able to identify from the data in the table when each "trough" actually occurred. Instead of labeling points A, B, and C as troughs, they should have been identified as PEAKS. Point A was September, 1929; Point B was February, 1966; Point C was September, 1987. The fact is, with the exception of the last few years of the 1990's leading up to the final climax in March, 2000, the market has never been more overvalued. In other words, the market was more overvalued at its recent lows than at any prior peak, excepting 2000.

The magnitude of the bubble was enormous. At the March, 2000 peak, the S&P 500 traded at a 33 multiple to earnings. Those earnings were capitalized on peak after-tax profit margins of 7.4%. Stock prices were thus valued at over two times sales. At 7.7 times book value, with a dividend yield of only 1.0%, insanity reigned. The capitalization of the entire stock market, historically 60% of GDP on average, was over twice as great as the entire output of the U.S. economy (\$20.7 trillion versus \$9.9 trillion).

It is inconceivable to us that fundamental valuations seen last March will represent permanent lows going forward, never to be seen again. Bubbles simply don't end with stocks more fully valued than at prior market peaks. This was no garden variety bubble, either. It takes years to work off surplus capacity. Poor companies hatched with easy credit need to fail. Many have, many more need to. Yet instead of working off our excesses in orderly Austrian fashion, we decided to postpone the day of reckoning.

In hindsight, the huge run-up in the markets during the final three quarters of 2003 was virtually inevitable. Nearly unprecedented fiscal and monetary stimulus invariably made its way back into stock prices, some would say redeflating the bubble.

On the monetary front, just as the Fed had done following past crises on Chairman Greenspan's watch, the spigots were opened at the first whiff of real trouble in the markets. If there were such a thing as a lifetime achievement award for creating the most moral hazard, Greenspan would certainly be the first honoree. Think back to monetary stimulus following Long Term Capital, Orange County, Y2K, the implosion of the Asian Tigers, the banking crisis in the early 90's (Bank of New England), the Savings and Loan debacle, and various stock market declines, some associated with these and other events.

On the grandest scale, the stimulus initiated in the fall of 2002 topped the charts. When new Fed Governor Bernanke issued his "printing presses" directive on November 22, credit spreads immediately began to compress. Fast forward one year and credit spreads are near record lows. Coupled with record low money rates and negative real rates, the Fed threw everything they had in front of the deflationary train.

Sir Alan uttered these words this January 3, "There appears to be enough evidence, at least tentatively, to conclude that our strategy of addressing the bubble's consequences rather than the bubble itself has been successful." Having failed to even acknowledge the bubble during the bubble (despite his "irrational exuberance" ditty in late 1996), he wants to now take credit for presciently cleaning up the fallout? If this turns out to be an extension of the original bubble he was so instrumental in creating in the first place, we'll see if he can dance his way out of the corner again. Vindication or vacillation?

Add fiscal stimulus to the mix and the only real direction the stock market could go was up. The surprise may be the economy has not performed better. Despite third quarter GDP up over 8% (half from high tech hedonics), growth for the year remained fairly muted. The enormous overbuilt capital stock and the secular loss of jobs undoubtedly kept things from really overheating.

Yet 2004 being an election year, the White House and Congress took priming the fiscal pump in the third presidential year to the nth degree. They did more to ensure reelection this fall than any prior presidential and congressional tandem. We felt “W” would likely be the Herbert Hoover of the modern era at the outset of his first term. Given the economic headwinds he inherited, we assigned a very low probability to reelection. The cuts in dividend and capital gains rates, child tax credits and inducements geared toward increasing capital spending (accelerated depreciation) all combined to throw more than \$150 billion back to the spending households of America. Washington went all out, pedal to the metal.

That the combined fiscal and monetary stimulus reflat the bubble, and coincided with parabolic growth in debt relative to GDP (which had already been on a 20-year tear), is a worry for later, perhaps on someone else’s watch. Now more than \$33 trillion, total credit market debt exceeds GDP by over 300%, up from 158% in 1982.

Due to the advance in share prices, the S&P 500 now trades at 27 times “normalized” earnings, 1.4 times sales, 3.5 times book value, with a dividend yield of 1.6%. Throughout the past century, stocks traded at 14.8 times normalized earnings, 90% of sales, 3.5 times book, and yielded 3.5%. The NASDAQ is even more inflated. However, the folks in charge at the electronic exchange stopped providing valuation data for the Composite and for the NASDAQ 100 once the P/E multiple became an impossible number (when the companies generated aggregate losses, the numerator was a negative number). We pegged the P/E at 242 on March 10, 2000, with a market cap nearly as great as the NYSE’s (despite sales and profits only 10% as great).

We take solace in the fact that many great investors concur as to the unattractiveness of stock prices. No less than Buffett, John Templeton, Marty Whitman, Jeremy Grantham, Bill Gross and Jim Gipson, among many others, each recently confirmed the current overvaluation in most common stocks. At least if we’re going to miss the benefit of being fully invested should the market continue to rally, we have good company.

LAFFING GAS

We poked some fun at Dr. James Glassman and Dr. Kevin Hassett in our January 2002 client letter. Recall they were the academic wizards who penned the untimely Dow 36,000 treatise, just prior to the peak in the Dow Jones Industrial Average at no less than 11,722. Even though the docs subsequently insisted they didn’t mean tomorrow, but five years later, picking on yesterday’s newsmakers would be like kicking a downed Dow dog.

Fortunately, the academic mill churns out more grist. Along comes a blast from the past. Dr. Art Laffer, of supply side Reaganomics fame, couldn’t stand the prosperity of being one of the few academic economists (are there any other kind?) to have gotten it right and rested on his laurels. After all, lower marginal tax rates did increase growth and ultimately more tax revenues for Uncle Sam during the 1980’s. The doctor needed to climb down the ivory walls of his San Diego tower to introduce a new market valuation theory. Can you tell we love it when academicians try to go mainstream with their gobbledygook? Perhaps we’ll make this an annual feature.

Dr. Laffer postulated his theory last March in a report under his Laffer Associates banner [“Five Factors Distorting P/E Comparisons Over Time”; www.cumber.com/special/03-19-03.pdf]. This is arguably the most ridiculous paper we’ve ever read. We read the paper last year and laughed and laughed.

If you don’t care to read Laffer’s paper or long to struggle through our critique, then by all means skip this section. It runs on longer than it probably should, but we can’t help ourselves. Laughter is the best medicine. Thanks Doc.

The good doctor postulates the market is woefully undervalued. He concludes, “Never before have P/E’s been anywhere near as low as they are now. The price/earnings ratio today is the lowest it has ever been.” Laffer’s adjusted P/E multiple works out to a towering 3.3 times earnings. You read that right.

Laffer’s paper is a must read as a classic example of how sound theories, based largely on common sense, can spin wildly out of control with the introduction of statistics and mathematical modeling. We examine here some of the more blatant flaws with Laffer’s work, breaking down each of the five areas presented in his report.

First, Laffer prefers using “accurately forecasted future earnings” instead of trailing earnings when determining the correct numerator in the P/E equation. We agree. However, Laffer lacks a tool for measuring, predicting or deriving “accurately forecasted future earnings”. He thus suggests using concurrent earnings instead of trailing four-quarter earnings as a better proxy for the correct earnings number. The numbers are essentially the same, only more volatile because they use the most recent single quarter, not four. Concurrent earnings have no more to do with “accurately forecasted future earnings” than trailing earnings do.

Laffer neglects the potential use of “normalized” earnings; an unacademic standard based more on an understanding of reasonable levels of corporate profitability. Because the measure cannot be statistically derived with precision, it is of little use in academic circles. At Semper Augustus, we attempt to measure “normalized” or reasonable levels of corporate profitability as our earnings number for both individual companies and the market. Laffer can’t do this. He would rather use B, claiming B is slightly better than A, ignoring the possibility that C is immensely more useful, or that C even exists.

He then offers his second flawed assumption, substituting “concurrent values of the superior NIPA (National Income Product Account) earnings figures” for GAAP earnings. We agree that NIPA profits are less volatile than those reported only by public companies and are more indicative of economic reality (see our Jan. 1 2002 client letter, p. 15 and last year’s letter related to the differences between operating, reported and core earnings). We find NIPA profits are very much worth tracking and comparing to the profitability of only public company profits. Instead of trying to come up with a “scrubbed” earnings measure as we do or as Standard and Poor’s does with their “core earnings” measure, Laffer substitutes NIPA profits as the appropriate earnings number for the S&P 500 multiple to earnings.

NIPA profits measure profits for the *entire economy*, not just for the profits of the companies comprising the S&P 500. Laffer was trying to rightly demonstrate that the quality of earnings for public companies has been poor. Rest assured, profits have not been *understated*. Rather the opposite has been the case. Due to the overstatement of corporate profits, we have contended P/E’s to be understated in recent years.

By grasping at the broadest measure of aggregate U.S. corporate profits, obviously Laffer’s P/E’s will appear lower than currently reported. After all, the companies making up the S&P 500 do not generate all of the corporate profits earned in the U.S. each year. There are nearly 6 million corporations filing income tax returns. You just can’t capitalize the stock market based on all profits earned in the country unless public companies actually earn all of the profits. Laffer concludes, “Suddenly correctly measured P/E’s no longer look so threatening.” No kidding. Why stop short at all of the profits earned by all companies in the United States? Why not use earnings from all companies worldwide?

P/E’s should be higher when profits are depressed and should be lower when profits are at peak levels. Analysts should make accounting adjustments to operating earnings calculations. The substitution of NIPA profits for S&P 500 profits, due to less volatility and higher quality, causes Laffer to totally miss the mark.

Laffer’s third assumption is that current P/E’s fail to account for interest rates. He basically takes the “Fed Earnings Model”, itself riddled with flaws, and compounds its failures with those of his own (see our Jan. 1, 2002 client letter, p. 13-14). To the extent P/E’s are affected by interest rates, the profit stream should be discounted by average future levels of rates, not simply by today’s current yields. The underlying future growth in earnings and the predictability of earnings are much more important when determining the correct multiple. Higher growth warrants a higher multiple. More predictability and sustainability warrants a higher multiple.

Laffer states, “Comparing raw P/E’s in high and low interest rate periods is inappropriate – period.” He is right for the wrong reason. Laffer desires to make P/E’s comparable over various periods by adjusting or normalizing interest rates. He introduces a mathematical formula (watch your wallets when anyone introduces a formula in investing) to “normalize” interest rates by dividing the P/E by the inverse of the interest rate ($1/i$). Got that? Laffer’s results are presented for the period 1970 to the present (the only sustained time period throughout the history of the U.S. capital markets where the Fed Model would have worked, with P/E’s moving opposite to interest rates). His results indicate the market was the most *overvalued* in 1982, when interest rates approached 20% and P/E’s were as low as 7. Conversely, he shows the market to be most *undervalued* today, with interest rates at 40-year lows and P/E’s north of 20, by any measure. Per his formula, P/E’s were really 20, not 7 in the early 80’s, while today’s P/E’s are closer to 7, not north of 20. We’re not making this up.

A good investor in the early 1980's would have been a buyer of stocks, sensing P/E's depressed, profit margins depressed and interest rates too high. Said investor would have grown a portfolio more than ten-fold, with nearly two-thirds of the gains coming as a result of P/E expansion. However, per Laffer, the market was as expensive in 1982 as it was at the peak in March 2000, using his interest rate adjusted P/E's. Laffer should have normalized interest rates, not P/E's. By ignoring the potential for higher or lower interest rates, Laffer states, "Today's interest rate adjusted P/E doesn't look significantly different from the lows of decades ago. In fact the current P/E is about the lowest it has been over the entire time period."

Laffer continues by throwing personal tax rates into the mix. As with most of his points, while correct on the surface, the point is flawed upon application. He correctly assumes a taxable investor should be willing to pay a higher price for a stock if marginal tax rates on dividends and capital gains are lower. He then introduces a formula (watch your wallets again) comparing after-tax returns for investors at older marginal rates (91% on dividends and 25% on capital gains) versus the lower rates in place before last year's tax code changes (38.6% on dividends and 20% on capital gains).

P/E's should be higher when profits are depressed and should be lower when profits are at peak levels.

Laffer fails to understand myriad aspects of the tax code and human behavior. Various loopholes, deductions and exemptions existed during periods of higher marginal rates. He completely ignores the aggregate amount of equities already held by non-taxable investors such as pension and profit sharing plans, IRA's, endowments and foundations. Such investors do not require higher prices because they are either not taxed or are lightly taxed. He also fails to recognize taxable investors are not purely driven by marginal tax rates. A lower marginal rate on capital gains will not necessarily motivate a holder of highly appreciated, low tax basis securities to sell. He fails to recognize that not all taxable owners of securities pay tax at the highest marginal rate. Also neglected is the fact that tax rates on dividends have generally matched tax rates on taxable fixed-income securities, such as U.S. Treasuries. By Laffer's logic, shouldn't bonds be immediately more valuable as tax rates move lower? His formula assumes, based on average corporate dividend payout rates of 33%, that one-third of returns are taxed as dividends and the remaining two-thirds are taxed as capital gains. With today's dividend yield of less than 1.5%, how much of the expected return is dividend driven?

Dr. Laffer then compounds his illogical tax theory with a comparison of investor behavior regarding S corporations and C corporations. He insists,

"...the capital of those with the highest personal tax rates will have the greatest incentive to gravitate towards S corporations instead of buying stock in traditional C corporations. As a result, more of traditional stock will end up in the hands of non-taxed institutional investors, tax-deferred IRA's or tax free Roth IRA's. Therefore, holders of traditional C corporation stock will in general have lower marginal tax rates and that difference will have increased over time. As such, there should be an upward adjustment to the P/E ratio of the S&P 500 stocks similar to the personal tax rate adjustment."

Wait – Didn't Laffer already make the point that taxable investors, now enjoying lower marginal tax rates, should push up the prices of stocks relative to earnings? He now insists that because fewer taxable investors own stocks, prices should also be even higher still.

Laffer states, "Since C corporations are not captured in the S&P 500 or even the Russell 3000, these indices have become increasingly less an indicator of economic activity." Wait again – Didn't Laffer already suggest capitalizing the S&P 500 based on *all* U.S. corporate profits?

Laffer's argument here is laughable. He contends wealthy individuals will switch from owning publicly traded stocks to illiquid private subchapter S corporations because of their tax pass-through treatment of profits. We frankly have not been witness to a mad dash of wealthy folks throwing most of their nest eggs at private companies to avoid the dual taxation of publicly traded C corporations.

We apologize for the length of this critique. It is too difficult, however, to pass on such a softball. The notion that the P/E of the S&P 500 is currently 3.3 is clearly absurd. By Laffer's math, the S&P was 62.4% undervalued when he issued this beauty. So the S&P was worth over 2324 last March when it was trading at 874?

Laffer is said to have introduced his Laffer Curve on a cocktail napkin in the late 1970's. It appears his new theory was hatched after too many cocktails!

FAIR VALUE/10-YEAR PROJECTION

The S&P 500 had a blistering year in 2003, closing the year at 1111.92, marking a total return of 28.69%. Despite the good year, the index remains over 27% below its 2000 high. Even worse, with the run-up exceeding the underlying growth in the fundamentals of the component members of the index or in the broad economy, the index is certainly more overvalued now than it was last year.

Our appraisal of fair value now rests at 707, up 4% from last year's target of 680. The index now needs to fall 36.4% to reach our estimate of intrinsic value. Alternatively, at a rate of growth of 4%, it will take nearly 12 years for stock prices to catch up with the underlying fundamentals. In other words, the market is 12 years ahead of itself. Below are our prior estimates of fair value since 1998:

	<u>Yearly close</u>	<u>SAI fair value</u>	<u>Required decline</u>
2003	1111.92	707	(36.4%)
2002	879.82	680	(22.7%)
2001	1148.08	655	(42.9)
2000	1320.28	630	(52.3)
1999	1469.25	606	(58.8)

To arrive at our estimate of intrinsic worth, we continue to employ a 17 P/E multiple to a "normalized" after tax profit margin of 5%. A 1% inflation rate and nominal growth of 4% in GDP, sales, normalized profits and dividends results in the following over a 10-year stretch:

	<u>Today</u>	<u>2014</u>
GDP	\$11.25 trillion	\$16.65 trillion
S&P 500 sales	\$7.70 trillion (832.00)	\$11.39 trillion (1231.56)
S&P 500 profits (normalized)	\$384.82 billion (41.60)	\$569.63 billion (61.58)
S&P 500 dividends	\$187.23 billion (20.24)*	\$277.15 billion (29.96)
S&P 500 fair value	\$6.54 trillion (707.20)	\$9.28 trillion (1046.83)
S&P 500 12/31/03 price	\$10.285 trillion (1111.92)	
*4Q03 annualized		



**Our estimate allows for a total return
of positive 1.2% per year for the next ten years.**

On a price basis, we now project the index needs to fall 0.6% annually to reach fair value ten years out. With a dividend yield of 1.8%, our estimate allows for a total return of positive 1.2% per year over the next ten years. Last year, prior to the big advance, we had projected annual returns of 3.16% annually. At the March low, our calculation allowed for a 4.8% annual return. The market was closer to fair value than it had been in the prior eight years. At our appraisal of fair value, we would project annual index returns of 6.9% per year (4% price and 2.9% dividend yield).

Our simple logic was described in more elaborate detail in our January 1, 2002 client letter. Anybody can alter our set of assumptions to arrive at a different fair value projection. For example, we project top line sales and “normalized” profits will track nominal GDP growth going forward. Our 4% annual projection is based on somewhat slower growth than in past years. For the past 10 years, nominal growth averaged closer to 5% annually and has averaged nearly 6.5% annually for the past 20 years.

Our 4% output projection rests upon the notion of an overbuilt capital stock. Surplus capacity takes time to work off, as the Japanese have demonstrated for the past 15 years. We believe excess capacity should be accompanied by muted or modest rates of inflation, or even deflation. Our forecast is based in nominal terms, not real or inflation adjusted. Remember, we eat in nominal dollars. We project 1% annual inflation, which may turn out to be too low (or too high if deflation prevails). Regardless, our output projections are thus for 3% real growth. If you believe that higher rates of inflation do not impact the value of business, or that higher costs can be passed on, then a higher inflation rate may warrant higher growth in nominal GDP, sales and profits. Stock prices should track nominal growth over sufficiently long periods of time.

More importantly, if growth does exceed 4% annually in GDP, sales, profits and dividends, our fair value calculation should be revised upward.

Our calculation is also based on a 5% “normalized” after-tax profit margin for the companies comprising the S&P 500. After-tax margins typically ranged between 3% and 7% during the past eight decades. Occasionally margins exceeded the range in either direction. In 2000 for example, just prior to the greatest collapse in profits since the 1930’s, margins reached 7.4%. In 1929, margins actually peaked at 9%. On the low side, profits troughed in the early 1980’s, and again in the early 1990’s. Both cases followed recessions and saw margins at the 3% level. For three years in the early 1930’s, corporate America actually lost money. On balance, though, after-tax profits have averaged 5% or so over time. Our process incorporates this time-tested level as a reasonable average.

If corporate profitability exceeds the 5% level *on a sustainable basis*, then our calculation of fair value may be too low. Wall Street prognosticators, in the ilk of Abby Joseph Cohen at Goldman Sachs, look for operating earnings at close to \$62 for the S&P 500 this year. Such a level implies profit margins at 7.5%, clearly on the high side historically. At least today the Street seers suggest capitalizing what are likely peak profits at a more “reasonable” 20 or so multiple to expected profits, versus nearly 33 times reported trailing earnings at the early 2000 peak. Back in 2000, the Wall Street crowd forecast 2002 operating profits at \$69 and a price target of 1655 for 2001, a 24 P/E multiple on expected margins of 9%. By yesterday’s standards, Abby Jo is now tighter than an old wound Titleist.

We are a little tongue in cheek with our “reasonable” comment. Peak profits should be capitalized at low P/E’s. Conversely, trough profits should be capitalized at high P/E’s. Only in the late 1920’s and the late 1990’s were peak profits assigned high multiples by investors. The inevitable revaluation downward, both in margins and in multiples, inflicted great pain on the investing crowd. We would assign an 11 to 12 multiple to a 7.5% profit margin, particularly in light of a still poor quality of earnings.

We also assume our “normalized” 5% profit margins should be capitalized at a multiple of 17 on projected profits. We may be too generous here. The trailing P/E multiple has actually averaged 14.8 over the past 80 years. Jumping from a 14.8 multiple to a 17 multiple assumes nearly 15% greater sustainable earnings growth. We offer up increased liquidity and higher transparency as justification for the higher P/E multiple. We may also make some concession to the low interest rate crowd as an excuse for rewarding a higher P/E. While this notion is intellectually

deficient using current interest rates, not projected rates, using the higher multiple raises the fair value calculation to our 707 estimate from 616. We make some effort to not appear fully off the deep end.

If we were more conservative in our selection of the proper P/E multiple, we could argue lower expected growth warrants a lower P/E. Further, if we believed the average level of corporate after-tax profitability will be below 5% over time, perhaps due to globalization of labor and a surfeit of capacity, then P/E's should also be lower. Few would like the impact of lower growth and margins on P/E's, so we'll leave the math alone. Rest assured, however, it's ugly.

To arrive at a higher fair value calculation today, a combination of higher nominal growth in output, sustainable after-tax profits above 5%, and a P/E north of 17 must transpire. Certainly Wall Street expects a higher result.

FLAWS AND SHORTCOMINGS OF OUR S&P 500 FAIR VALUE APPROACH—A PLEA FOR HELP

Our process is based on a set of assumptions which may be too conservative. In addition, as with many areas of investing, we have learned an old lesson -- being approximately right rather than precisely wrong is a more profitable approach. We try to incorporate a reasonable set of assumptions and an understanding of history in our projections.

Specifically, however, we may have some flaws in our assumptions. Any insight or suggestions would be greatly appreciated. Call anytime. We'll spring for a beverage or a taco for quality help! Here are some of the issues we have not completely worked out:

Our calculations regarding long-term profitability for the S&P 500 may be skewed due to the inclusion of many financial companies in the index. Lenders and insurance companies do not present income statement material in the same format as do non-financial companies. Traditional gross, operating and net margin presentations are different. Further, we have generally contended that the market has perpetually undervalued well run financial companies. (Perhaps techs have been perpetually overvalued, offsetting the difference?) If financials deserve and are now being justly rewarded higher multiples, then perhaps a higher aggregate multiple is warranted as well. Financials currently have their highest representation by market cap in both the S&P 500 and in national income profits data.

We do look at two alternatives to calculating profit margins outside of the S&P 500. Neither are perfect substitutes, however. We use aggregate national income data as well as sales figures for the S&P Industrials. Both measures confirm stock prices are overvalued. The NIPA data relative to GDP are a good proxy for aggregate profitability, especially throughout an entire business cycle. Yet, just as Laffer misapplied the NIPA data in his work, they cannot be used as a substitute for S&P 500 profitability.

Obtaining index sales data for the S&P 500 is nearly impossible. We have used the more accessible sales data for the S&P Industrials, which exclude financial companies, and the margin results are similar. Yet, given our declining manufacturing base, the similarity produced by the data for both indices may be merely coincidental. Because banks have been very profitable for so long, far beyond typical cyclical norms, perhaps current and projected levels of operating earnings for the S&P 500 are sustainable. In other words, maybe profit forecasts for 2004 are not at peak levels. Is our appraisal of "normalized" profits off the mark? Because of the inclusion of very profitable financials in the index, should our profit estimates be higher? We aren't sure, although our numbers are really close to Standard and Poor's core earnings measure. Should S&P core earnings be capitalized at a higher multiple? Was the quality of operating and GAAP earnings always as poor, even prior to the 1990's?

Concerning our estimate of 4% growth in nominal GDP and 3% growth in real GDP, will actual growth be higher? Is capacity utilization poised to briskly and sustainably recover? Was overbuilding largely constrained to the tech industry, now set to benefit from rapid depreciation and product obsolescence? We think overbuilding was broader based. However, we have observed much asset rationalization in the last couple years (look at the cinema industry). Indeed, write-offs have totaled nearly \$500 billion just for the S&P 500 component companies over the last 5 years.

Another interesting glitch in our projection results from our inability to project shareholder dilution over time. Each year we calculate the value of a single S&P 500 point (1,111.92 points at year end). The value can be derived in many ways. One method simply divides the aggregate dollar profits for the index by the price of the index. Alternatively, the market cap for the index can be derived by dividing the market cap of a component company by its weighting in the index. Market cap is then divided by index price.

Over the last few years, we noticed the value of each index point slightly rose each year. For instance, on December 31, 2002, each point was worth \$9.22 billion. On December 31, 2003, the dollar value of each index point had risen to \$9.25 billion. At the end of 1998, each point was only worth \$8.09 billion. What has been going on here? Is the annual change in the value of each point significant? We dug deeper and think the answer is yes – there is material significance to the changes.

It is clear to us that shareholders are diluted (deluded) over time. This is true even for passive investors in an index fund. In poking around the S&P website, www.standardandpoors.com, we found quarterly divisor data for the S&P 500 since March 31, 1988. The divisor at December 31, 2003 was 9250.51. This number matches the value of an index point we had already independently derived. At 1/1000th of the divisor number, each index point is worth \$9.25051 billion. At December 31, 1988, the divisor value was only 6829.56. Naturally, the value of each index point 15 years ago was only \$6.82956 billion. Perhaps a better way to look at the divisor is as an outstanding share count. In this light, holders of the S&P 500 have been diluted by 26%. The share count has risen by 35.5%. Here is the data for the market cap of the index, the index price and the divisor. Amazingly, while the market cap of the index grew 5.4-fold, the price of the index only advanced by 4-fold. Investors lost out on an astonishing 140% of the gain in market cap!

Year ended 12/31	Market Cap \$ Billions	Index price	Divisor	Percent Annual Dilution
2003	10,285.83	1111.92	9250.51	0.39
2002	8,107.41	879.82	9214.85	1.11
2001	10,463.39	1148.08	9113.82	2.72
2000	11,714.55	1320.28	8872.78	5.86
1999	12,314.99	1469.25	8381.82	3.63
1998	9,942.37	1229.23	8088.29	3.90
1997	7,554.68	970.43	7784.88	2.50
1996	5,625.76	740.74	7594.79	1.95
1995	4,588.30	615.93	7449.38	2.25
1994	3,346.16	459.27	7285.82	2.81
1993	3,305.51	466.45	7086.53	2.42
1992	3,014.67	435.71	6918.99	2.20
1991	2,823.82	417.09	6770.28	1.85
1990	2,194.98	330.22	6647.01	(0.08)
1989	2,367.01	353.40	6697.81	(1.93)
1988	1,896.71	277.72	6829.56	(2.12)*

*from 3/31/88

source: Standard and Poor's

One might ask what caused the annual dilution beginning in 1990 (share count actually shrunk from 1988 to 1990). We suppose the answer largely rests with the rise in outstanding shares attributed to stock option exercises. Offsetting the rise would be a reduction in shares from company repurchases. Mergers and acquisitions would also affect the divisor and the share count. Further, changes in index components by the very active committee at Standard and Poor's would account for some of the rise, certainly as companies with higher market caps replace those with lower valuations. A staggering 124 index components were replaced since the beginning of 2000. You read that right -- one in four components in the passive index were replaced in four short years. While many of the changes are due to mergers and acquisitions, the committee still generated more turnover than some active managers. We recall their zest to add a host of techies near the market peak, some at P/E multiples north of 100.

We have written incessantly about the evils of compensation in the form of stock options. When not expensed on the income statement and when annual grants become excessive, the underlying dilution to outside shareholders can be substantial. Many believe that most companies offset the dilution by repurchasing enough shares in the open market to offset the dilution (buy high, sell low). We generally find this not to be the case. As companies granted more and more options as a percentage of outstanding shares, the bull market in stocks absolutely served to increase share counts, diluting outside shareholders. The huge dilution seen in the table from 1997 through 2001 likely represents the surge of "in the money" option shares which were exercised. The falloff in dilution over the last two years, with virtually none in 2003, can be attributed to the bear market in stocks, which drove the prices of many option shares below exercise prices. We suppose the falloff also results from the drop in merger activity. In total, though, a holder of the index has suffered dilution at the annual rate of 2% per year for 15 years.

DIVIDENDS

During the production of this letter, we caught an interesting discrepancy in the way dividend yields are reported. Dividend yields are probably higher today than reported by the major financial reporting services. When we consider a dividend yield, we usually annualize the most recently declared dividend because current levels are generally either maintained or increased. As shareholders demand more of the profit pie, and as Washington fanned the fiscal fires with big cuts on dividend taxes, more companies increased their payouts. For the quarter ended December 31, 2003, cash dividends paid for the S&P 500 companies totaled \$5.06 per share. As recently as the March 31, 2002 quarter, the payout was only \$3.77 per share. Using the December 31, 2003 closing price of 1111.92, the dividend yield works out to 1.82%. While still extremely small by historical standards (yields have averaged 3.5% over the past 80 years), using the S&P calculation, the yield is only 1.56%. Our method annualizes the last payout ($5.06 \times 4 = 20.24$). Standard and Poor's totals the trailing four quarters' dividends ($5.06 + 4.32 + 4.09 + 3.92 = 17.39$). Even though the fourth quarter sees extra one time dividends and some companies now pay only once a year, our annualized number is more accurate in a rising dividend environment. While not overwhelming, investors are actually getting a little more than conventionally believed.

Dividends rose nearly 35% in less than two years, having been basically flat for the six years from early 1996 to March 31, 2002. Dividends were actually cut from \$4.45 in the September 30, 1999 quarter to \$3.77 by March 31, 2002. Concurrently, operating earnings also fell from June 30, 2000 through June 30, 2001 by 38% (\$14.88 to \$9.02), while reported GAPP earnings skidded a whopping 62% from September 30, 2000 to September 30, 2001 (\$13.71 to \$5.23 per share). The dividend cuts, the greatest since the 1930's, were commensurate with the drop in profits.

Dividends represent an interesting issue. Pundits opined that companies were stingy with their cash during the late stages of the bull market in stocks. At the market peak in March 2000, the dividend yield fell to an all time low 1.06%. At earlier market peaks in 1929 and 1966, yields only reached 3%. However, we do not believe puny yields were and are the product of parsimonious companies.

The payout ratio fell to 27.7% using operating earnings in 2000. We surmised in past letters that CFO's held payouts in check, not because they had attractive uses for the cash, but because they were aware of the rotten quality of earnings in their own operating presentations. Consider that operating earnings for the S&P 500 totaled \$56.13 in 2000. Core earnings, which are similar to those calculated by Semper Augustus, came in at \$38.86 (S&P's core numbers are back tested, as they didn't introduce core earnings until last year). Therefore, the payout ratio using core earnings, which are more indicative of the cash generated by a company, was 42% ($\$16.27 / \38.86), pretty typical over the past three decades.

Payout ratios have clearly declined over time, especially since the 1920's. From 1926 to 1946, companies distributed approximately 75% of their reported profits to shareholders annually. Yields averaged over 5.5% over that stretch. From 1946 to 1971, the payout ratio averaged roughly 60%. During the second half of that stretch, yields fell to the 3.3% level. From 1971 on, the payout ratio averaged roughly 45%. Yields rose during the bear market years 1973 to 1982, climbing from 2.6% in late 1972 to 6.1% by the 1982 low. During the 18-year bull market from 1982 to 2000, yields steadily declined from 6.1% to their miniscule 1.06% level at the 2000 peak. The payout ratio actually rose during the first half of the bull market, reaching nearly 80% during the 1990-91 recessionary period of depressed profits. From that point, the payout ratio steadily fell to its 27% nadir at the market peak in 2000.

We think the decline in the payout ratio during the 1990's had everything to do with the worst degradation of the quality of earnings in the history of our capital markets. The decline in yields was primarily a function of rising share prices, and secondarily due to a falling payout ratio. Rising P/E multiples accounted for nearly two-thirds of the fifteen-fold market advance, while rising profit margins accounted for roughly 30 percent of the gains.

Using our "normalized" earnings measure of \$41.60 for 2004, the current annualized dividend of \$20.24 equals a 48.7% payout ratio. The ratio is on par with the average over the past 50 years. Using Wall Street operating earning estimates, the payout ratio is only 32.6%. The still low yield of 1.82% is a function of high stock prices. The low yield cannot be attributed to a low a payout ratio or to depressed earnings and dividends. At our 707 appraisal of fair value for the S&P 500, today's current dividends would yield 2.86%, a level last seen in 1994. Interestingly, at that point, the yield would still be lower than in any year prior to 1994. Is our 707 target too high?

Investors can thank the White House and Congress for leveling the playing field. No longer are dividends and capital gains taxed at different rates. This change altered dividend policy among many firms, encouraging many to increase or initiate payouts to shareholders. A 15% tax rate on both dividends and capital gains absolutely favors most shareholders. Beyond the obvious immediate tax savings, the policy change will further help investors by shifting reinvestment responsibility.

We often favor the retention of profits by managements by the companies we like. The same is not the case for many firms. As long as management has the opportunity to deploy profits back into the firm at high rates of return, we certainly approve. Companies can redeploy profits by expanding the business internally, growing manufacturing capacity or retaining new labor input. Acquisitions for cash can also be attractive, though in many cases they are not. Management or boards can also repurchase shares from shareholders. If done on a high return basis, repurchases can be profitably accretive for owners, increasing the remaining shareholders' ownership position in the company. Many firms do not have attractive reinvestment opportunities, however.

Far too often, companies retain profits for the wrong reasons. Public company shareholders and Wall Street demand growth. All else held constant, the retention of profits will generally help grow the firm. Too often, though, reinvestment is not undertaken at satisfactory returns on capital. Companies overpay when repurchasing shares to offset dilution from option exercises. Acquisitions are done to grow the top line, regardless of profitability. Bad businesses are often acquired at unjustifiably high prices. New plants are built, often creating overcapacity in an industry. One-off restructuring charges mask the unprofitable returns on reinvested capital. Companies often not only do not generate returns in excess of their cost of capital, many actually lose money, burning cash over time.

There are many companies who are quite profitable on a stand alone basis. With little opportunity for profitable growth, dividend policy should be geared toward more full distribution of profits. A company earning, for example, 15% on capital, but only 3% on reinvested capital, should distribute most of its net income to shareholders. Often the shareholders have better reinvestment prospects than the company. An extremely profitable smaller company is more attractive to us than a less profitable larger company. Instead of rewarding unprofitable growth, shareholders will generally benefit from receipt of a larger slice of the profit pie.

ACCOUNTING ADJUSTMENTS — GLACIAL IMPROVEMENT, YET IMPROVING

We write about accounting issues and the adjustments we make every year. For the first time under our direct observation, the quality of earnings reported by American companies is actually improving. Slowly. While the adjustments we make to profits are still staggering relative to operating results, progress was made to close the gap.

We make three sets of primary adjustments to corporate profits. There are myriad ways to manipulate accounting and profitability. However, adjusting for stock options as compensation expense, adjusting expense, benefit and return assumptions for defined benefit plans, and adding back portions of write-offs and write-downs serve to capture the majority of profit overstatement. Write-offs and write-downs in particular are a timing adjustment. Profits can be overstated for a period of years, both before and after a charge. Our adjustments reduce and improve the profit calculation, treating a portion of write-offs and write-downs as ongoing expenses.

Wall Street optimistically projects a 14.0% rise in operating earnings for the S&P 500 in 2004, from \$54.39 per share to \$62.00 per share. During 2003, operating earnings grew 18.1% from \$46.04 in 2002. Our accounting adjustments for the index were projected at \$188 billion, \$20.41 per share for 2003. Our adjustment for 2004 is larger than for the past year. We make the following adjustments to operating earnings on a top-down basis. The process parallels the more specific adjustments we make on a company specific basis:

Semper Augustus Reduction in Profits (from S&P 500 Operating Earnings)

	2003		2004	
Compensation as Employee Stock Options	\$43 billion	\$4.67/share	\$39.2 billion	\$4.24/share
Option Tax Credits	20 billion	2.17/share	20.0 billion	2.16/share
Pension Adjustments	75 billion	8.14/share	75.0 billion	8.11/share
Write-Offs	50 billion	5.43/share	76.7 billion	8.29/share
Total Estimated Adjustments	\$188 billion	\$20.41/share	\$210.9 billion	\$22.80/share

Our accounting adjustments are projected to increase 12% from \$188 billion to \$211 billion. Unfortunately, the year over year “improvement” in the quality of earnings is not due to an absolute reduction in our adjustments. Rather, the year over improvement is due to the 14% forecast increase in operating profits growing faster than the increase in our earnings adjustments.

In 2003, the quality of earnings related to option compensation improved, as companies granted fewer option shares to employees. We expect improvement on the option front in 2004 as well.

A lower amount of write-offs during the year closed the gap between operating and reported earnings, as fewer goodwill charges were taken and FAS 146 kicked into gear. Surprisingly, if Wall Street forecasts for operating and reported earnings prove correct, write-offs will accelerate in 2004.

Shockingly, pension plans funded status probably eroded despite the big gains from the stock market in 2003. Both benefit payments and unfunded liabilities expanded faster than pension plans booked gains and companies contributed assets.

In all, improvement was evident, yet the pace of improvement broke no speed records. Public impression that the quality of earnings is vastly improved is misguided. Earnings quality remains poor and companies face huge challenges in bringing confidence back to the cash quality of ongoing and sustained profitability.

We wonder what happened to core earnings, Standard and Poor’s much ballyhooed scrubbing of operating results? Our adjustments closely match S&P’s. We suppose Wall Street has too much vested interest in keeping core earnings in the closet. If analysts and investors took earnings quality to heart and simply paid attention, core earnings might crawl out of the accounting backwaters and cast a light upon the continued poor quality of earnings.

We applaud S&P for their introduction of core earnings last year. We criticize managements, Wall Street and the popular financial media for their ostrich-like ignorance of a much more meaningful measure of corporate profitability. One can only keep its head buried in the sand for so long. After a while, suffocation ensues.

Though issued with great fanfare, the core earnings approach has failed to catch on. Do companies have a motivation to overstate profits, preferring measures that exclude the cost of tangible write-offs, stock options, and realistic pension expenses? Do zebras have stripes? We suppose the major players in the con game of excluding “bad stuff” from profits won’t warm up to a core earnings measure anytime soon. CNBC does not highlight core earnings for reporting companies. Instead, they dutifully report whether companies “beat” Wall Street consensus estimates by a penny or not. We have never seen Mark Haines ask a CFO what impact stock options would have had on reported results if expensing were required. When was the last time Maria Bartiromo dug into the recurring nature of “one-time” write-offs of tangible assets?

Let’s face it. There are too many players in the system with a vested interest in reporting the most rosy and exaggerated earnings possible. Managements need the fluff to maximize their compensation. Wall Street firms need underwriting business. Yes, thanks to Elliott Spitzer, we now know analysts were shills for investment banking departments. We now have a “Chinese Wall” between banking and research. Right. What incentive do analysts have to report on core earnings if nobody else uses the measure? Why agitate the underwriting clients of the firm?

Last year, we detailed Standard and Poor’s introduction of their core earnings measure. While their adjustment methodology is somewhat different than ours, the magnitude of the gap between operating profits and core earnings is quite similar to the difference as estimated by Semper Augustus.

For the S&P 500 in 2003, S&P calculates preliminary core earnings of \$42.00 per share, versus \$54.39 in operating profits. The difference of \$12.39 was much lower than the \$22.38 difference in 2002 and \$22.85 in 2001.

For 2004, S&P estimates operating earnings of \$61.70 and core profits of \$44.20, a difference of \$17.50. Our adjustment of \$22.80 is greater than S&P’s, primarily because we assume a much higher level of normal pension expense.

Interestingly, both S&P’s core earnings measure and our adjustments reduce operating earnings down to the proximity of our “normalized” earnings measure. Recall we use a 5% after-tax profit measure, equating to \$41.60 for 2004. Reducing Wall Street consensus estimates of \$62.00 for 2004 by our accounting adjustments of \$22.80 leaves \$39.20 in adjusted profits.

Believers in operating earnings can skip the next three sections of our letter. We attempt to shed some light on the three major areas of accounting where we make adjustments.

**We suppose the major players in the con game
of excluding “bad stuff” from profits
won’t warm up to a core earnings measure anytime soon.**

PENSIONS

There is a certain type of Japanese blowfish which, when not prepared properly, causes instant death to its digester. The poisonous fugu is the only delicacy not permitted to be served to the Japanese emperor. Like the emperor, we would not digest a fugu under any circumstances, regardless of the reputation and training of the chef. Likewise, from our perspective as investors, we could give a flying leap as to the quality of pension accounting. In fact, the worse it is, the better for us. Only 2000 or so of the 10,000 publicly traded domestic companies have defined benefit plans. There are therefore 80% of all public companies in the U.S. without plans. Over 50% of the defined benefit assets and liabilities of all public companies rest with component members of the S&P 500. Some 150 companies in the index itself do not have defined benefit plans. Most of the liabilities are concentrated within a handful of companies. At many of the companies with plans, the size of the plan is so small as to be immaterial relative to the operations of the firm. When we analyze companies with plans large enough to be material to the firm itself, the use of aggressive assumptions and deceit will generally cause us to simply pass on purchase. Webster's calls the poison within the fugu a "toxic principle". If the book defined bad pension math, we suppose the same definition could apply. There are too many good fish in the sea to risk financial debilitation (ours and yours) by sampling ill prepared pension fugu. Live to fight another day, we say.

The rise in stock prices last year should have materially improved the health of defined benefit plans. *Despite the stock market gains, we believe funded status actually eroded in 2003.* A continued rise in liabilities, or benefit obligations, combined with net cash outflows (benefit payments in excess of company contributions for the nth year in a row), likely more than offset the rise in plan assets attributed to the big year in stocks. That said, given increased plan liabilities and cash outflows, had the stock market declined in 2003 on par with the prior year's decline, the pension issue could have wreaked havoc on the entire financial system. Thanks again to Sir Alan and Dubya.

Recall in last year's letter we projected plan assets for the 347 companies with defined benefit plans in the S&P 500 would total roughly \$1 trillion. We were close. Plan assets ended 2002 at \$951 billion. Plan liabilities ended 2002 at \$1.163 trillion. Pension plans were thus \$212 billion under-funded. Including Other Post-Employment Benefit (OPEB) liabilities, which are mostly unfunded, the liability exceeded \$500 billion.

We also noted that because half of companies employ smoothing techniques (moving averages) of up to five years when calculating investment returns, plan assets were probably overstated by as much as \$100 billion. For instance, the S&P was down 22.1% in 2002. A 60/40 equity to fixed income mix would have produced a 9% loss. A company using a five-year moving average to calculate investment returns would have actually recorded a gain due to the inclusion of the big market gains from 1998 and 1999. The opposite happened in 2003. The 28.69% total return from the S&P 500, coupled with bonds returning only 2%, would have produced an 18% gain (again using a 60/40 asset mix). However, companies employing five-year smoothing would have booked gains of only 3.37%. They would have had to include the three prior down years as part of their calculation. We are waiting to see how many companies try to dump smoothing now that it hurts results, though we don't know how they can from an accounting perspective.

If all this is confusing, it should be. Pension math is bizarre. An analyst basically needs to keep two sets of pension books for companies who smooth investment returns. Making analysis difficult, there are no ongoing disclosure requirements regarding smoothing or the assumptions used. We guarantee, however, if you call the "smoothers" of the pension world -- companies such as FedEx and Lucent -- and ask if the true fair market value of plan assets matches the reported plan assets in the pension footnote, you will certainly not get a straight answer. Nor will the answer be, "yes."

We will illustrate dual sets of books using reported plan assets for the "smoothers" and using our adjusted real market value plan assets for the "non-smoothers". For 2003, we assume the companies using smoothing generated an investment return of 3.37%. We use a 60/40 blended return of the S&P 500 and the Lehman Aggregate (a good proxy for high quality government, agency and corporate debt with a 10-year or so average maturity). Companies not smoothing produced an 18.01% return for the year. Assuming half of companies smooth, we assume all companies with pension plans gained 10.69% for the year.

S&P 500 2003 Pension Plan Cash Flows, Investment Returns and Funded Status

	<i>With Smoothing</i>	<i>Without Smoothing</i>
<i>\$ Billions</i>	Reported (Inflated) Assets: 10.69% return	Our Calculated (Not Inflated) Assets: 18.01% Return
Beginning Plan Assets	\$951	\$851
Investment Performance	102	153
Benefit Payments: 11% y/y	(90)	(90)
Company Contributions: 31% y/y	<u>60</u>	<u>60</u>
Ending Plan Assets	1,023	974
Projected Benefit Obligation: 12% y/y vs. 2002	(1,303)	(1,303)
2003 Under-Funded Status	(280)	(329)
2002 Under-Funded Status	(212)	(312)

This is interesting stuff for the two or three of you who really like pension math. For those who don't, the difference between beginning plan assets represents what managements told you plan assets were worth and what we think they were worth. It is shocking there could be a difference. Due to the higher (real, unsmoothed) investment performance attributed to the lower beginning asset value in the right column for 2003, the difference between reported assets and our calculated assets is now only \$49 billion, versus roughly \$100 billion last year. We have FASB to thank for Statement 87 and subsequent modifications to smooth the impact of pension plans on balance sheets and income statements. So much for simplicity!

Note that we estimate benefit payments totaled nearly 10.6% of beginning plan assets for 2003 (9.5% using the phony, overstated smoothed values). The distribution rate was up from 7.6%, 6.2%, 6.0%, 6.1% and 5.9% in each of the prior five years. The percentage distributed jumped due to falling asset values in the prior couple years combined with rising benefit payments. Benefits are predetermined and irrevocable. Simply because the stock market falls does not mean retiree benefits are reduced as well. A pension plan represents an obligation to pay. Imagine the howls from GM's retirees if pension benefits were cut.

Equate current distribution rates of more than 10% to a rule of thumb concerning prudent spending rates in retirement. Prudence often dictates spending no more than 5% to 6% of your nest egg in retirement, particularly if there is a desire to leave some inheritance to heirs. A 10% annual distribution will necessarily erode principal if the investment portfolio earns less than 10%. Forget about inflation. To maintain purchasing power, you would need to earn 13% if inflation averages 3%. When asset values fall, maintenance of fixed-dollar spending can be lethal on a now diminished asset base.

As an example, Bubba Jefferson retires today with a \$1 million nest egg. He spends 10% or \$100,000 in the first year. If he also loses, say, 20% or \$200,000 on his investment portfolio during the year, he will only be left with \$700,000. If Bubba wants to again spend \$100,000 in year two, his spending rate will have jumped to 14.3%. Perhaps he can justify maintaining his lifestyle because he thinks he'll "get it back" in the market. Well, now Bubba has to earn 14.3% each year just to tread water at his diminished \$700,000. To get back to even, he needs to earn \$400,000 (\$300,000 market value plus \$100,000 spending), a whopping 57.1% return. Perhaps Bubba should have set his sights a little lower, retiring later with more, spending less, and, to state the intuitively obvious, not coupling a high spending rate with a portfolio capable of losing 20%. Does Bubba remind you of anyone you know?

Pension America has become Bubba Jefferson. Benefit distribution (spending) rates of 6% or so for many years were fairly reasonable. Had companies not manipulated pension and actuarial assumptions to lessen ongoing pension cost and to even report income on the P&L, they would have contributed more assets to their pension plans over the past many years. The plans could have better withstood a bear market. High assumed rates of return, combined with returns exceeding those outlandish projections, allowed the stock market to do the saving for the companies. To wit, from 1998 to 2001, companies in the S&P 500 made contributions to pension plans totaling on average 1.2% of beginning plan assets each year. The plans were thus nearly 5% cash flow negative each year. Outsized investment

gains more than made up the difference. According to Standard and Poor's, the companies comprising the index projected investment returns between 8.63% and 9.17% for the 10 years through 2002.

Plan assets totaled \$444 billion in 1992. Liabilities, the PBO, totaled \$392 billion. For the next 10 years, assets compounded at 7.9% annually while liabilities compounded at 11.5% a year. Actual investment earnings must therefore have compounded at nearly 13% because plan cash flows were negative 5%. Relative to 9% return expectations, managements extrapolated investment success well into the future, even raising return expectations to their highest level ever in 2000, right at the market peak.

Due to smoothing, investment results were actually reported as positive 4.9% in 2000, despite a 9.09% decline in the S&P 500. Even a 60/40 asset mix, when coupled with the 11.63% return from the Lehman Aggregate, would have produced a 0.8% loss. Managements were either fooling themselves or they didn't understand how aggressive their assumptions were regarding their plans. Did they step up in 2001 and increase plan contributions? Are you kidding? With the funny math, plans were still reported to be 123% over-funded by the end of 2000, down modestly from an all time high 128% in 1999. Contributions actually *declined*, from \$16.2 billion in 2000 to \$15.6 billion in 2001.

Executives eventually learned that to the extent their pension plans were over-funded by at least 125%, the pension plans could make the benefit payments for Other Post-Employment Benefit (OPEB) Plans, namely healthcare benefits for retirees. These plans are like Social Security. They are "pay as you go" schemes, largely unfunded by assets. We believe these plans have present value liabilities in excess of \$320 billion, and are only funded by no more than 15%, or \$48 billion of assets. If companies have to come up with \$30 to \$50 billion (we aren't sure of the amount) each year for OPEB benefit payments, why not manipulate your pension plan assumptions to keep the company off the hook? Heaven forbid we incur expenses. Our earnings per share will suffer. Oh, my stock options, my bonus . . .

Pension plan accounting is in desperate need of repair. In the early 1980's, interest rates were high and stock prices were low. Expected return assumptions for pension plan earnings were less than 7%, on average. Coupled with high interest rates, and therefore high discount rates, liabilities were adequately funded by plan assets, despite undervalued stock prices. As interest rates and discount rates fell, PBO calculations put pressure on calculated funded status. Fortunately, stock prices were rising at a double-digit annual clip.

Companies wailed at the initial introduction of FAS 87 in 1985. They wailed about the volatile stock market, clearly outside the control of management, impacting the balance sheet and the income statement. After all, pension plans are not assets of the company, only liabilities. While pension contributions should be an expense of the company, managements insisted the costs are not "operational" expenses (though they didn't complain when pension "income" flowed through the income statement – many treated the profits, never to be enjoyed by shareholders, as operational). Managements insisted plan liabilities are not "operational" liabilities and keeping most of the plan shortcomings off the balance sheet would be a good idea. ERISA, which governs funding requirements, mandates contributions and balance sheet recognition when plans are under-funded by 90% for three years or by 80% for one year. Kowtowing to management, FASB, as is their custom, lightened the reporting requirements regarding financial statements. By establishing deferred gains and losses which are amortized into the income statement slowly, FASB sought to reduce the "volatile" nature of pension reporting. What they really accomplished was allowing companies to aggressively manipulate assumptions regarding expected return on plan assets, the discount rate for calculating the present value of pension liabilities, and assumptions regarding the increase in employee compensation, which impacts the value of the liabilities (lower comp increases equals lower liability).

Somebody is going to have to explain to us how the aggregate capital markets can earn 9% a year on average when we can't identify a single asset class that we think can make that number. Government bonds yield less than 5%. Corporate fixed income spreads are as tight to U.S. Treasuries as they have been in years. Stocks provide an earnings yield of less than 5%, calculated using inflated profits, to boot. Cash equivalents yield less than 1%. Cap rates on real estate are unreasonably high. The notion of averaging 9% on invested pension assets seems absurd to us.

We suggest overhauling pension accounting. Reporting under FAS 87 distorts the cash and cash flow impact on financial statements. FASB is planning on some disclosure modifications to FAS 87 sometime this year. Most significant among FASB's suggested changes are disclosure requirements regarding asset allocation and expected returns. The best alternative would be to eliminate the use of an expected return assumption from GAPP accounting entirely. Any unfunded liability would immediately be reflected in the balance sheet. Actual investment results falling short of interest cost would immediately flow through the income statement. Short of these changes, we think the following disclosure and presentation standards would also make sense:

- Disclose the number of pension plans and unique characteristics of each plan.
- Disclose investment performance of each asset class and for the entire pension plan(s). Performance for each of the past 10 years should be reported, as well as cumulative and annualized returns from plan inception.
- Disclose the allocation among each asset class and changes among asset classes during the reporting period.
- Disclose ending allocation for each yearly reporting period.
- The expected return should be disclosed at each reporting period. The return assumption should be justified by management for the entire pension plan(s) and for each asset class.
- Disclose average credit rating, maturity and duration for fixed income securities.
- The reporting period should be quarterly.
- The discount rate assumption should be disclosed and reset quarterly, not annually.
- Disclose compensation rate assumptions and changes quarterly.
- Disclose turnover for the portfolio and for each asset class.
- Disclose and quantify all plan costs – investment management, consulting, actuarial, legal, administrative, and brokerage.
- Smoothing should be disallowed when calculating fair value of plan assets. Fair value of plan assets should equal market value at reporting date.
- All unfunded liabilities should be carried on the balance sheet (line item if material).
- All unfunded OPEB liabilities should be carried on the balance sheet (line item if material).
- Disclose the time period over which defined benefit liabilities and OPEB liabilities are amortized.
- The PBO and the ABO should use the same conservative discount rate.
- Both the PBO and the ABO should be reported. The difference between the two should be reconciled (ABO excludes wage inflation).
- Management should justify its selection of the discount rate (mortality rates, age of workforce, and number of active/retired and average vesting status).
- All plan holdings should be disclosed in a SEC filing, similar to mutual fund reporting or investor 13-F's for equities.
- The number of active and retired participants should be disclosed for each reporting period.
- A sensitivity analysis disclosure should be made for changes to the estimated investment return, discount rate and compensation rate. All changes in these estimates should be disclosed each reporting period.
- Pension and OPEB contributions should be an expense of the firm in the period in which they are made. Contributions should be quantified and disclosed in the pension footnote. They are part of compensation expense, to be treated as operating expenses. Service costs and interest costs, offset by expected returns, treated as smoothing devices, distort the nature and timing of cash flows.
- Any non-cash pension contributions should be disclosed. Currently, company stock can be contributed up to 10% of plan assets under certain circumstances.

Specifically, we think pension investment reporting should be presented in the format of an investment portfolio review. This format should be presented on an annual basis, with interim reporting periods presented on a year-to-date basis:

Beginning market value (real values, not “smoothed”)
 + Contributions (company and participant)
 - Withdrawals (benefit payments, management fees, brokerage costs, consultant fees, actuary fees, legal fees)
 + Investment income
 + Change in market value
 = Ending market value (real values, not “smoothed”)

The government provided breaks beginning in 2002 for companies with under-funded pension plans under ERISA. To prevent potential charges to shareholder's equity and mandatory contributions, the ERISA defined discount rate was changed for at least a two-year period. Corporations had lobbied for a change in the discount rate, from use of the long-term U.S. Treasury yield (no longer a 30-year yield due to suspension of 30-year auctions over 3 years ago) to a higher-yielding corporate benchmark. The Job Creation and Worker Assistance Act allowed the use of a

four-year rolling average of long-term government yields. Because long-term Treasury yields had fallen, the blended yield allowed the discount rate employed to rise. Thus, pension under-funding was less pronounced and required contributions were limited. Further government extension of the break, set to expire this year, was introduced in 2003. Companies are still lobbying for a permanent change to allow use of a higher yielding corporate benchmark as the ERISA driven discount rate.

The pension problem can be mitigated. Short-term government relief from funding and liability recognition requirements is not the solution (though a tax deduction for company contributions to funded OPEB plans would help). Our interest rests in not seeing pensions become a systemic catastrophe. Companies need to be realistic with their assumptions. Plans should be funded on an ongoing basis to ensure long-term health of the plan and of the company. By utilizing realistic assumptions regarding expected investment returns, compensation inflation, and through use of a conservative discount rate, the ever expanding crisis can be contained. Intelligent reporting requirements under FASB can help. The system needs an immediate overhaul.

If companies assumed a more reasonable estimate of investment return on plan assets, pension expense (or a reduction in pension credit) would be higher and reported profits lower. Benefit distributions are now in excess of 10% of plan assets and are thus obviously in excess of projected investment results using a 9% return projection. Annual benefits and PBO liabilities also grow, having compounded at 11.5% a year for the last 10 years. Plan assets have only compounded at 7.9% per year through the end of 2003. To both make up the shortfall and to reduce or eliminate present under-funding, two things need to happen. First, investment returns exceed return projections and exceed the amount of distributions. This result is unlikely. Alternatively, companies can massively increase contributions to plans. Further, benefit payment increases can be slowed. If benefit payments run at 10% of assets and investment earnings average 6% of assets (a more reasonable estimate than 9%), companies would need to contribute 4% of assets to simply stand still. In this scenario, not only would the PBO not shrink, but due to aging workforces and increasing numbers of retirees, the PBO would actually still expand. At a minimum, companies should be required to make up the difference between benefit payments and investment shortfalls. To the extent plan earnings exceed benefit payments, the excess plus ongoing contributions should be applied against any remaining liability or added to surplus.

Required contributions become even more material if OPEB benefit payments and liabilities are considered. OPEB benefit payments are currently larger, and are likely to grow much faster, than assumed. Most companies use a high single digit estimated growth forecast, falling to 5% after 3 years. When OPEB benefit payments of \$30 billion are added to our estimate of approximately \$100 billion in benefit payments for S&P 500 companies in 2004, benefits will total \$130 billion. OPEB assets, at a mere \$48 billion, plus pension assets of \$974 billion total \$1.022 trillion. Benefits thus total 12.7% of plan assets. If investment earnings total 6%, companies should be required to contribute 6.7% of assets, \$68.5 billion dollars to make up the shortfall. In addition, a contribution to close under-funded status should be required. Contributions since 1998 to defined benefit plans, excluding any OPEB contributions or benefit payments, were:

1998	\$10.7 billion
1999	12.1 billion
2000	16.2 billion
2001	15.6 billion
2002	45.9 billion
2003	60.0 billion*
*estimated	

Most of these contributions did not reduce reported profits. In fact, most companies were reporting net pension income instead of expense. Making annual contributions up to \$75 billion to \$150 billion after tax would be unthinkable for companies. After all, at \$62 in consensus estimated operating earnings for 2004, earnings are \$573 billion. Necessary pension contributions, accounted for properly, would drastically reduce reported results. We suggest reducing profits by 13% to 26% for pensions. A change in expected return assumptions, from 9% to 6%, would likely add \$30 billion to pretax pension expense.

Regarding our ongoing pension adjustment to S&P 500 profits, we believe company contributions should be an operational expense in the year in which they take place. The current under-funded liability needs to be eliminated over some period of years. The combined pension liability of \$326 billion plus the unfunded portion of the OPEB liability of \$272 billion totals almost \$600 billion. If elimination of the shortfall were required over six years, as an example, companies would need to contribute \$100 billion pre-tax to their plans each year for six years, on top of ongoing annual contributions to satisfy current and growing benefit payments.

We are leaving our annual S&P 500 pension accounting adjustment at \$75 billion after-tax, which equals \$8.11 per share for 2004. This amount equates to annual pension pre-tax expense of \$115 billion. In reality, by using more conservative assumptions and mandating the PBO and OPEB liabilities should be eliminated over a period of years, the annual charge could easily be twice as great for the next 5 to 10 years.

We are surprised at how complicated pension accounting is. The degree to which it allows a distortion of cash and cash flow reality is mind boggling. As is often the case, the worse the state of accounting is -- the more inefficient stock prices are in the short and intermediate terms. To the extent disclosure is efficient, we can generally identify which companies have issues and which don't.

Ultimately, we wouldn't be surprised if taxpayers wind up on the hook for the massive amount of liabilities currently in pension America. The companies with the most under-funded plans relative to the operations of the firm are most at risk. We make the argument that these companies are not being run for the shareholders but for the pensioners, current and future. Our advice? Don't eat the fugu.



*"These ye shall eat of all that are in the waters; all that have fins and scales shall ye eat:
And whatsoever hath not fins and scales ye may not eat; it is unclean unto you"* Deuteronomy 14:9-10

STOCK OPTIONS

We saw two improvements in the area of stock option compensation last year. More companies either adopted or will adopt the fair value method of treating option compensation as an expense of the company. More importantly, the number of option shares granted to employees actually shrank last year, for the first time in our memory. While our accounting adjustment, which treats option compensation as an expense, is still a huge adjustment to operating earnings, the adjustment is shrinking. For this year, our option adjustments reduce S&P 500 operating profits by \$39.2 billion, \$4.24 per share, versus \$43 billion, \$4.67 per share in 2003.

In last year's letter, we projected companies would again grant 2.5% of outstanding shares to employees as stock options, as we believed they had in 2002. We were pleasantly surprised when the number granted in 2002 only amounted to 2% of outstanding shares (we could have known this earlier had option reporting been required quarterly, instead of annually). Many experts combined the lower number of option shares granted with conventional Black-Scholes methodology to pronounce the value of options granted during the year declined. As we have noted in past letters, the Black-Scholes option pricing formula is plagued with flaws. In this case, we believe options granted at lower strike prices have more value than those granted at higher prices, all else held constant. Because stock prices had fallen for three years, we believe grants made during 2002 were much more expensive than grants made during years with higher share prices.

That said, we are thrilled to see the number of option shares granted declining as a percentage of outstanding shares. If we can get back to the "good old days", we might even become giddy. In 1996, companies "only" granted 1% of outstanding shares to employees. Even further back, in 1982, grants totaled a mere 1/10th percent of outstanding shares. Imagine how costly 2.5% grants would have been at the market lows in 1982. We try not to think about it.

On the negative side, the percentage of shares outstanding in option programs continues to grow. The total now approaches 10%, up from 7% five years ago. With falling stock prices, fewer options have been exercised. Ongoing grants have thus driven up the overhang.

What is precipitating the recent parsimony regarding option grants? Are boards and managements getting option religion? We believe the answer has to do with FASB's upcoming showdown with Congress. As they did 10 years ago, FASB will champion the notion that grants of employee stock options should be treated as an expense. FASB's international counterpart, the International Accounting Standards Board (IASB) has already embraced full expensing treatment. In 1994, corporations vehemently opposed expense treatment. The most profligate abusers, mostly tech and telecom companies, directed serious campaign dollars to Congress. Congress in turn threatened the very existence of FASB. The issue was dropped.

The tech industry has again circled its wagons, bracing for a fight in an attempt to maintain the lowest quality of reported earnings possible. However, the industry lost its standard bearer. None other than Microsoft, once an option abuser extraordinaire (see our January 1, 2000 client letter detailing our assessment of Gates & Co.), has adopted expensing treatment of stock options. The company regularly granted 2% to 5% of outstanding shares each year to employees, and spent heavily repurchasing shares to somewhat offset dilution from exercises. Perhaps with an assist from Omaha, Microsoft did get option religion. Not only has the number of option shares granted in Redmond in recent years declined, but the firm adopted expensing of options effective July 1, 2003.

In Microsoft's 2001 fiscal year, the company granted 4.2% of outstanding shares to employees. In 2002, the number dropped to a low 0.8%. Last year, there was a relapse, when the grant total jumped to 2.4% of outstanding shares. However, our downward annual option adjustment to Microsoft's annual earnings is now "only" 25% of reported profits, versus over 50% a few years ago. By the time the company fully adopts FAS 123, the downward earnings revision for employee stock options should be minimal. Microsoft will also continue to see a decline in reported profit margins.

Microsoft continues to repurchase shares to offset the annual dilution from option exercises. In each of the past three years, the company spent over \$6 billion repurchasing shares, not including their put option fiasco in 2001, when the company covered put sales on their own shares to the tune of \$1.3 billion. We believe they continue to overpay for their repurchased shares. The put obligations a few years back compelled them to *really* overpay. Even

net of the cash received from employees upon exercise, the company is still repurchasing over \$4 billion annually, roughly 40% of reported profits in each of the past 3 years.

Despite what appears to be a very expensive option program at Microsoft, the company will no longer champion Silicon Valley's fight against option compensation. We never would have believed the company would voluntarily run options through the income statement and cut down on the number of grants. Perhaps they learned option shares can be a double-edged sword, cutting both ways. Employees love the upside when stock prices rise, but are intolerant of underwater options and prefer cash when share prices fall. Or perhaps the company saw FASB ultimately winning this go around with Congress and the writing was on the wall. Or perhaps Gates has spent enough time in Omaha, dispelling the notion that you can't teach old dogs new tricks. After all, the Master in Nebraska is a patient sage.

For the S&P 500, 115 companies have now jumped on the FAS 123 option expense bandwagon, up from 65 at this time last year. More importantly, of the 23% of companies now expensing, the representation weighted by market capitalization is much higher, perhaps at 40% or more. To illustrate, Microsoft is the second largest component in the index by size. Their decision to charge the cost of employee stock option grants is more meaningful to aggregate profits than had the smallest component in the index decided to use the same accounting treatment.

To arrive at our downward adjustment for option compensation, we assume most companies choosing to expense will phase in the treatment over a period of years. We use five years, a typical vesting schedule. There are other available treatments. The 65 companies who began treatment in 2003 may have had a market cap representation of 20%. For 2004, those companies are now in their second year of FAS 123 adoption. The next 50 companies, those to begin expensing in 2004, are in their first year of treatment. We thus use a blended 30% of market cap to expense this year. If no more companies choose to adopt FAS 123, and if FASB does not make adoption compulsory, in five years we will see 40% of the option cost actually running through income statements. If FASB requires expensing, we would expect nearly 100%. For the current year, we assume 12% of the cost will be expensed, up from a mere 2.6% last year (should have been 4% -- our math last year didn't account for any market cap adjustment based on the sizes of the firms expensing -- the number was too small to be material).

To illustrate our math regarding our adjustment for the S&P 500:

- 65 companies (13% of total but 20% of market cap) now in 2nd year expensing
- 50 companies (10% of total but 20% of market cap) now in 1st year expensing
- 115 companies (23% of total but 40% of market cap) now expensing
- Blended rate of 12% of market cap expensing (20% for 2 years and 20% for 1 year)
- S&P 500 market capitalization at 12/31/03: \$10.286 trillion
- Assume option grants @ 2% of outstanding shares for 2004
- \$10.286 trillion x 2% = \$205.7 billion
- Pre-tax expense @ approximately 1/3 of face value of grant = \$68.6 billion
- After-tax expense at 35% marginal rate = \$44.6 billion; \$4.81 per share
- Actual after-tax expense on P&L @ 12% = \$5.4 billion; \$0.58 per share
- Unexpensed cost is thus \$39.2 billion; \$4.24 per share
- Full expense would shave Wall Street expected profits by 6.8% and our "normalized" 5% margin by 10.2%

We again point out that actual results will depend on the market cap of each company on grant date, actual vesting schedules employed, volatility and interest rate assumptions and dividend yields at grant dates. A more precise calculation can obviously be made on a company by company basis, as we do for the individual companies we analyze and appraise. We wish we had the time to adjust each company in the S&P 500 for our demonstration.

In past letters we also discussed the notion that grants made above fair value (our definition representing the appraised value of the company, not the Black-Scholes number in the model) are less costly than those made at or below fair value. We again illustrate a company making two separate grants in a year at two different strike prices. The grant made at the higher strike price under Black-Scholes is more costly:

1 million shares @ \$60/share; approximate expense: \$13 million
1 million shares @ \$40/share; approximate expense: \$8.7 million

In the example, the higher expense is driven by the higher share price at the time of grant. From our perspective, reality couldn't be farther from the truth. If Semper Augustus assumes the intrinsic value of the stock at \$50, then giving away shares at \$40 is clearly more expensive than at \$60.

With the S&P 500 overvalued by 36%, grants above fair value should impact the option expense somewhat less:

- At 707, S&P 500 market cap = \$6.54 trillion.
- 2% of \$6.54 trillion / 3 = \$43.6 billion
- After tax, "normalized" option grants would be \$28.4 billion; \$3.06 per share.

We purposely do not make this offsetting reduction to our option compensation expense adjustment for two reasons. First, in our experience, option grants made where the stock price subsequently falls below the strike price tend to be either repriced or repaid with entirely new grants at lower (and more expensive, in our view) price points.

Second, Black-Scholes further disregards repurchases of shares to offset the dilution that takes place upon exercise. These repurchases, like the ones Microsoft makes each year, are often made at prices in excess of the intrinsic worth of the firm and are thus extremely costly to the shareholders. In other words, the cash spent to repurchase is not inuring for shareholder benefit. The combination of these factors, both unrecognized as expenses in the income statement (actually, some of the repriced options may wind up in the income statement) are high enough to counter the fact that many options are issued at prices above our estimate of fair value and are thus less costly.

Our \$4.24 employee stock option adjustment is 8.6% lower than our projected adjustment of \$4.64 last year. The lower percentage of shares granted, 2% versus 2.5%, a 20% decline, is somewhat offset by the higher market cap of stock prices. The December 31, 2003 market cap was \$2.1 trillion higher than at year-end 2002.

We are leaving our adjustment for option tax credits unchanged at \$20 billion for 2004, \$2.16 per share. The credit was as high as \$35 billion in 2000, with the prices of tech and telecom stocks in the stratosphere. The credit was probably as low as \$12 billion in 2002, when fewer option shares were exercised due to the sheer number underwater. With stock prices now well above recent lows, the credit will likely rise this year. The actual number will bounce around as employees exercise portions of their options. The greater the difference between strike prices and market values, the greater the credit.

The tax credit represents a federal corporate giveaway. Firms with non-qualified option plans (versus incentive stock option – ISO plans) actually receive a tax credit representing the difference between the exercise (strike) price paid by the employee at exercise and the market price of the stock on that date. Even though the company never treated the option grant as an expense in the first place, the tax authorities actually deem a handout to be a good idea. The government deems option compensation to be an expense in one area. The full difference between the strike price and the market value on the date of exercise is treated as ordinary income to the employee. Isn't it funny that options can be viewed as income to individuals, but not as an expense for companies? Who makes political campaign contributions, again? We forget.

We may be in error backing the tax credit out against operating earnings because the credit does not appear in the income statement. It is evident as operating cash flow, however, because it provides a real tax break. That said, because we present our option compensation cost adjustment on an *after-tax* basis, we think the elimination of the credit from operating profits makes sense. In other words, because the expense is not taxed on the income statement in the first place, we need to adjust the calculation of net income so as to not overstate the operating cash generated by a company.

WRITE-OFFS: RESTRUCTURING CHARGES AND WRITE-DOWNS

The most accounting improvement during 2003 occurred in the area of write-offs. Over the past 21 years, the companies comprising the S&P 500 have taken write-offs totaling \$884 billion. Operating profits totaled \$5.73 trillion while reported profits, which exclude write-offs and write-downs, totaled \$4.84 trillion. On average, companies wrote off 15% of their operational profits each year over the past two decades.

We believe the write-downs of depreciable and depletable assets, plus restructuring charges from current operations, should be included in earnings. Companies reporting these charges as non-operating would have you believe they are one-off events, and should be excluded from assessing the ongoing profitability of a company. We disagree. The charges represent poor operational decision making by management at the point of cash outlay and cannot be dismissed, merely due to their asynchronous nature.

As an example, a plant built during 1999 in the heart of the tech boom may not now be needed. If the plant is mothballed, destroyed or sold at a loss, many companies would treat the accounting write-down associated with these actions as non-operational and exclude them from current period expenses. We agree the restructuring charge should not be a current period expense. However, management did decide to build the plant 5 years ago. Real money was laid out at the time. If the entire cost was capitalized, say at \$10 million and was being written down on a straight-line basis over, say, 40 years, then carrying value after 5 years would be \$8.75 million. If the plant is sold for \$1 million, management would ask us to ignore the \$7.75 million pre-tax loss because the plant is no longer part of the ongoing operations of the firm? We totally disagree. The loss is real. Dollars were spent and are now gone for good. The recognition of the loss is real and represents a timing difference. In reality, profits were overstated for five years. We simply can't wink and ignore the cost of having built the plant and sold for a loss. We should either spread the \$7.75 million loss over the past 5 years, or for simplicity's sake, reduce this year's operating profits by the amount of the loss. Even if the decision to build the plant was made by a prior management, it still represented an operational decision, and the loss needs to be recognized.



We believe the write-downs of depreciable and depletable assets, plus restructuring charges from current operations, should be included in earnings.

Over the past 21 years, the following represented operating and reported profits for the S&P 500:

Period Ended December	S&P 500 Operating Earnings Per Share	S&P 500 Reported (GAAP) Earnings Per Share (Excluding Write-Offs)	Reported Earnings as a % of Operating Earnings	Operating EPS Market Cap (Billions)	Reported EPS Market Cap (Billions)	Difference In Dollar Terms (Billions)
1984	\$16.92	\$16.64	98.3%	\$115.39	\$113.48	\$1.91
1985	16.64	14.61	87.8	113.48	99.64	13.84
1986	15.83	14.48	91.5	107.96	98.75	9.21
1987	19.91	17.50	87.9	135.79	119.35	16.44
1988	24.12	23.75	98.5	164.73	162.20	2.53
1989	24.32	22.87	94.0	162.89	153.18	9.71
1990	22.65	21.34	94.2	150.55	141.85	8.71
1991	19.30	15.91	82.4	130.67	107.72	22.95
1992	20.87	19.09	91.5	144.40	132.08	12.32
1993	26.90	21.89	81.4	190.63	155.12	35.50
1994	31.75	30.60	96.4	231.32	222.95	8.38
1995	37.70	33.96	90.1	280.84	252.98	27.86
1996	40.63	38.73	95.3	308.58	294.15	14.43
1997	44.01	39.72	90.3	342.61	309.22	33.40
1998	44.27	37.70	85.2	358.07	304.93	53.14
1999	51.68	48.17	93.2	433.17	403.75	29.42
2000	56.13	50.00	89.1	498.03	443.64	54.39
2001	38.85	24.69	63.6	354.07	225.02	129.05
2002	46.04	27.59	59.9	424.25	254.24	170.01
2003	54.39	45.12	83.0	503.14	417.38	85.75
2004	62.00	46.50	75.0	579.70	434.78	144.93
Total				\$5,730.28	\$4,846.40	\$883.87
Avg. '84-'04			87.1%			
Avg. '84-'00			91.0%			
Avg. '01-'04			70.4%			

If Wall Street forecasts for 2004 operating and reported profits prove correct, then for the four years from 2001 to 2004, companies will have written-off \$530 billion in assets. Considering operating earnings are projected to be \$580 billion in 2004, recent charges are no small matter. Looked at another way, 60% of all the write-offs taken over 21 years will have occurred in the four years 2000 to 2004. For perspective, the current book value of the S&P 500 is \$3.23 trillion.

Most of the improvement in earnings quality during 2003 resulted from a much lower amount of restructuring charges. While write-offs and write-downs totaled \$170 billion in 2002, the amount dropped by half to “only” \$86 billion last year. The year over year difference equaled \$84 billion, \$9.08 per share. Operating earnings grew 18.1%, while reported earnings, due to lower charges, grew a whopping 63.5%. Much of the restructuring amount for 2002 had to do with legitimate charges under FAS 142, when big chunks of goodwill were written-down. We exclude these legitimate charges from our earnings adjustment.

Also at play was the introduction of FAS 146 in 2003. The new accounting standard limits the recognition of write-downs (assets already paid for) and restructuring (to be paid for in the future) to the periods when the expenses are truly incurred.

Interestingly, using Wall Street consensus forecasts for 2004, the difference between operating and reported results is projected to widen again, to \$145 billion, \$15.50 per share.

Our accounting adjustment for S&P 500 write-offs excludes 25% of restructuring charges over a rolling 6-year period. Our write-off adjustment for 2004 is therefore \$76.7 billion, \$8.29 per share. Our adjusted figure is slightly more than half of Wall Street’s forecast difference between operating and reported results.

We attempt to exclude legitimate non-operating charges such as those incurred under FAS 142 and a decade ago under FAS 106. Our use of rolling 6-year periods is an attempt to spread out the effect of recessions. Companies are keen to take big charges when earnings are already depressed, priming the pump for higher operating earnings once the economy recovers. Wall Street rarely fails to ignore write-offs taken in the teeth of a recession. A more precise analysis would be done on a company by company basis. We think this method for the index, however, captures the essence of charges which should be included in assessing the profitability of companies.

By simply ignoring write-offs and write-downs of tangible assets, profits are overstated, as well as returns on capital and equity. Asking investors to forgive prior sins not only overstates past and even future profitability, but perverts a realistic analysis of the sustainable profitability of a firm or the ability of management.

THE RED DRAGON, SUCCESSOR TO THE TIGERS, SUCCESSORS TO THE RISING SUN. CHINA.

It seems as though every investor and financial observer has an opinion regarding China. For many years we have acknowledged Chinese potential. Fans of Coca Cola, for instance, always talked about the prospect of each Chinese citizen consuming just one Coke product daily. Obviously, with over 1.2 billion thirsty mouths, the fantasies are endless. We noted with interest that nearly all of our family’s Christmas gifts we received this year were made in China – digital camera, clothes, power tools (don’t laugh) and toys all emblazoned with a “MADE IN CHINA” sticker. Only a nice bottle of Bordeaux and the always appreciated box of See’s Nuts and Chews were produced outside of the PRC.

China has indeed grown at a rapid rate for many years, and we believe they can grow faster than the U.S. for an indefinite period (a decline in our relative standard of living does not imply a decline in our absolute standard – in fact – probably a win, win). However, rapid growth is not without bumps in the road. Any secular advance is met with cyclical downturns. We are by no means expert on the Chinese situation, and we have no idea whether the game is in the second, seventh, or ninth inning. Our guess, however, is that China is due for a respite. Given the enormity of their advance over the past few years, the pause that refreshes can create serious dislocations throughout the industrialized world.

China's GDP is just over 10% of U.S. output. With a population four times as great as ours, their GDP per capita is \$1,000 versus nearly \$40,000 in the U.S. The Chinese economy grew at nearly 10% per year for the past five years versus growth of only 4% annually here. Since 1996, nearly 20 million Chinese migrated from rural areas each year in search of manufacturing work in the urban centers. To put that mass exodus in perspective, the U.S. has roughly 14 million manufacturing jobs in our entirety, with an all time high of only 23 million following World War II. Chinese demand for energy and food has grown at incredible rates. Five years ago, China consumed 2 million barrels of oil daily. This year, they will become the number two worldwide consumer, guzzling over 5.5 million barrels daily. By contrast, Japan, until now the world's number two consumer, had flat demand at approximately 5 million barrels daily since 1989. Steel and aluminum productive capacity grew over 20% annually for the past three years. A scrap steel trader friend of ours has seen scrap triple in price in less than three years. Electricity consumption grew 15% last year. Soybean bushel imports doubled over the past two years, with unit prices having doubled in dollars as well (no pain with the Renminbi fixed to the dollar). The USDA estimates total Chinese agricultural imports will grow to \$5.4 billion from \$3.5 billion in 2003. The Baltic Freight Index, a great proxy for global shipping costs, surged five fold following China's inclusion in the WTO in late 2001. The index had been sleepy for many years prior. Chinese M2 was up 20% last year. Chinese stocks soared 80% last year, with major copper, aluminum and auto companies soaring 200% to 500%. Three major Chinese internet portals, Sina, Sohu.com and Netease.com all rose over 220% last year. Foreign currency reserves doubled over the past five years.

Despite all this growth, the banking system in China is a mess. Chinese officials estimate non-performing loans at the four biggest state owned banks are 17%, down from 21% in 2002. Private observers think the number is closer to 45%. In the last two months, China injected \$85 billion of its foreign currency reserves into three of its state owned banks. Total non-performing loans range between \$400 billion and \$800 billion, depending on estimates. By comparison, the Japanese, with an economy three times the size of China's and with bad bank debts of their own, have between \$500 billion and \$900 billion of bad debt on their books.

The notion of a potential downdraft in China's economy hinges on a chart we used prior to the collapse of the Asian Tigers in 1997 and 1998. For five years straight, capital spending by the Tigers grew over 25% annually. The chart compared an eerie prior increase in Japanese capital expenditures in the five years leading up to the peak in their economy and stock and real estate markets in 1989. Similarly, the Chinese grew capital expenditures at 25% annually for the past five years. Overlaid with bad bank debt, massive imports from the world in energy and foodstuffs, and a central bank now repatriating some foreign exchange reserves, where are we in the cycle?

A slowdown in Chinese demand can have a material impact on global growth. The slowdown and dislocations created by the Tigers in the late 1990's were painful. China has developed on a more massive scale than the Tigers had previously. With the globe awash in debt, can a nasty cyclical downturn in China's upward path be dismissed lightly, especially with their enormous impact at the margin? We have no idea when they will slow, only that they likely will. The fact that we can't seem to avoid a discussion without China mentioned today reminds us of similar excitement around the technology, telecommunications and internet bubble.

If China slows sooner rather than later, we would expect the dollar to halt its slide and prices of many commodities to roll over, including the precious metals, oils and many agricultural commodities, such as soybeans. While we believe China, and much of the rest of Asia, will continue to grow their standard of living faster than ours, we know that when growth themes become mainstream, they are often poised for a downdraft.



The slowdown and dislocations created by the Tigers in the late 1990's were painful. China has developed on a more massive scale than the Tigers had previously.

CONCLUSION

To ensure the accounting horse is dead, we have beaten it again with our annual treatise. The topic pervades our investment approach so thoroughly that it is too hard to ignore in our letter each year. Investment success is really about keeping mistakes to a minimum. Our focus on quality accounting eliminates lots and lots of companies from potential purchase. Good businesses practice good accounting, period. Bad businesses may also practice good accounting, but a good business cannot practice bad accounting. We take to heart what Benjamin Graham wrote in Security Analysis in 1934:

“When an enterprise pursues questionable accounting policies, **all** its securities should be shunned by the investor, no matter how safe or attractive some of them may appear. You cannot make a quantitative deduction to allow for an unscrupulous management; the only way to deal with such situations is to avoid them.”

We are incessant worriers. That is probably a good thing. We disdain the academic notion that high investment returns can only be accompanied by high amounts of risk. We take the opposite view, that from time to time, the market presents opportunities to earn wonderful returns by assuming very nominal amounts of risk. For us, the business has to be right, and the price has to be right. We examine our process and approach to ensure we continually identify and understand these opportunities, and are in a position to take advantage of them.

We have more fun doing what we do for each of you than should be allowed. This profession is as much about relationships as it is about investing. The investing part is educational and investigational. No two days are the same. We hope to continue to add to our cumulative investing knowledge. We learn each day how much there really is to know, and how little of it we actually know. We are humbled by the confidence and trust each of you place in us. You have our undivided focus. We look forward to seeing each of you over the course of the year. Thanks for your support.

Christopher P. Bloomstran

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Additional Performance Calculation Information:

Past performance is no guarantee of future outcome. When calculating investment returns and composites, Semper Augustus Investments Group LLC uses time-weighted gross returns, including the reinvestment of income. Performance figures are calculated before Semper Augustus Investment Group LLC's management fee, custodial fees, and other miscellaneous expenses, but after deduction for brokerage and SEC fees. January 1, 1999 is the inception for performance returns and includes all terminated, taxable, tax-exempt and leveraged portfolios. Based on asset allocation, commencement of a client relationship, taxability, risk factors, and other factors; individual client returns may differ from the equity composite. Return calculations are not audited and are subject to adjustment at any time. Cash has been a significant investment for Semper Augustus Investments Group LLC since inception.

Recent Client Letters:

Still Facing Headwinds

January 1, 2003 Letter

Headwinds & Tailwinds

January 4, 2002 Letter

Price Matters

November 20, 2000 Letter

Predictions for the Next 15 Years

January 1, 2000 Letter:

Predictions

Future Economics of
Microsoft

Property Casualty Insurance

August 6, 1999 Letter:

Mercury General

Broad Market Profile

July 12, 1999 Letter

Energy/Energy Services

March 23, 1999 Letter:

Diamond Offshore

Schlumberger

Transocean Offshore

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