

July 15, 2003

Dear Friends of AAM,

Returns for all major U.S. asset classes were positive in the first half of 2003. One of us wanted to write this sentence two thousand times and call it the 2003 mid-year client letter, but a more artistic and responsible mind prevailed.

During the first six months of 2003 stocks did best, followed by bonds, and then money market instruments. Real estate rose modestly in some parts of the country but leveled off and reflected early signs of weakness in selective regions.

The AAM mid-year 2003 client letter offers perspective on the three year bear market in common stocks, highlights the dynamics of our capital allocation philosophy, and provides insight into our forward looking view of the economy and key asset classes. We also articulate our vision of the AAM culture — an approach driven by a two-pronged focus on achieving favorable risk-adjusted investment returns and serving as a personal Chief Financial Officer to our client families.

### **INDEX INVESTING AND DAN QUAYLE**

Vice President Dan Quayle, known sympathetically as a challenged orator, once observed that, “The mind is a terrible thing.” Equity investors who chose to heed Quayle’s axiom over the past three years by holding a portfolio of passive equity index investments have not fared well even with the recent strength of the major indexes. Returns with reinvested dividends for the popular equity averages over the past thirty-nine months are highlighted below.

<b>U.S. Equity Index</b>	<b>3/31/00 – 6/30/03</b>	<b>Peak to Trough Decline</b>
S&P 500	-32%	-42%
Wilshire 5000	-35%	-45%
NASDAQ Composite	-64%	-74%

In contrast, during this period, AAM achieved two critical objectives for client families:

1. Avoided large losses of capital. The laws of mathematics make it very difficult to recover after significant asset depreciation. A decline of 50%, for example, requires 100% appreciation to get back to the starting line.
2. Provided acceptable risk adjusted returns. Long-term clients are now positioned within a reasonable proximity of their best capital levels. Our emphasis on investing with a “margin of safety” proved to be a safety belt. There was some bruising but no blood.

## **INDEX INVESTING AND DAN QUAYLE - CONTINUED**

The long-term performance of client assets reflects a focused approach to security selection with a primary emphasis on overlooked and misunderstood U.S. stocks. This approach is independent (if Columbus had an advisory committee he would still be on the dock) and often contrary to the current popular opinion (dead fish only swim with the stream). We are much more Stephen Sondheim than Andrew Lloyd Webber (our apologies to those readers who prefer Cats to Company). Our approach requires patience to achieve the payoff.

## **WHY BAD THINGS HAPPEN TO GOOD COMPANIES**

We are sometimes asked what we have against growth stocks.

Do we place the mark of Cain on a company simply because its earnings are climbing faster than the market as a whole?

No. But we believe investors are often willing to pay excessive valuations for fast growing companies with unpredictable futures. This impacts long-term total appreciation in a meaningful way.

The total return on common stocks that are purchased at fair valuations and held over long periods will roughly match their growth in earnings and dividends. However, stocks purchased at a discount to intrinsic value should outperform over time while those purchased at a premium have a high probability of underperformance.

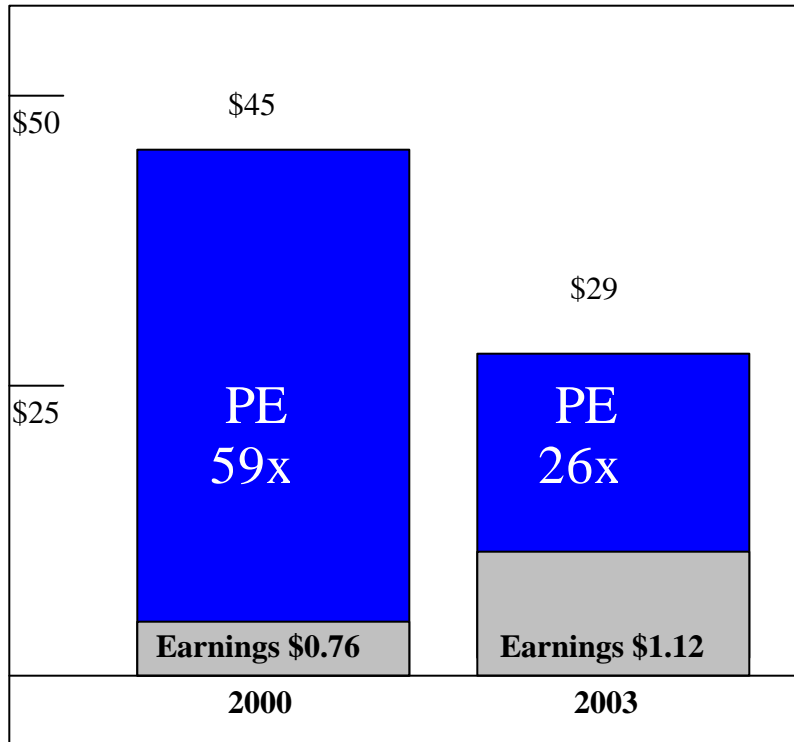
Since good outcomes always require less explanation, let's focus on an under performing scenario. The other day a friend of ours was distressed about Walgreen (WAG) — a wonderful blue-chip growth company that dominates the drugstore business. Over the last three years, Walgreen's earnings have grown but its market value has fallen 35%.

Why does a growing company have a declining stock price? The key lies in the price-to-earnings ratio or PE. The stock price for public companies is comprised of two components:

1. Earnings per share (EPS): Profit and cash flow are the oxygen that provide a company with the ability to grow and thrive.
2. Price-to-Earnings Ratio (PE): The PE is the multiple to earnings per share that an investor pays for a company's stock. Positive investor sentiment will lead to an expansion in a company's PE. The higher the PE goes the thinner the atmosphere becomes. At a certain altitude a stock becomes dizzy and falls.

## WHY BAD THINGS HAPPEN TO GOOD COMPANIES - CONTINUED

The chart (not drawn to scale) and table below highlights Walgreen's outstanding 47% earnings growth over three years. The underlying stock price though was overwhelmed by a PE contraction of 56%.



Year	12-Month Earnings	PE	Stock Price
2000	\$0.76	59	\$45
2003	\$1.12	26	\$29
<b>Change</b>	<b>+47%</b>	<b>-56%</b>	<b>-36%</b>

Source: Bloomberg, LP

[Earnings x PE Multiple = Stock Price]

In general, we have nothing against growth companies, except one often pays an excessive PE that will eventually contract at an unpredictable moment. Furthermore, dividends that have historically been a meaningful component of total return are significantly lower among growth companies. Given the change in tax law this year – this is worthy of significant consideration.

AAM's preference is to own businesses with predictable growing free-cash flows for a multiple that is reasonable, and a dividend component that contributes to total return.

## AND THAT'S NO BULL

AAM analyzes companies to assess their intrinsic value, the price a rational businessperson would pay for the entire company under normal conditions. We buy companies we are capable of understanding and whose management earns our respect. AAM sells a company when it exceeds its intrinsic value or experiences a change in its business model that impairs the valuation process. The application of this relatively straightforward discipline provides us with the ability to filter out many suspect companies.

At 96 years of age, Judge Milton Pollack is the third-oldest active federal judge in the United States. He started his legal practice just after the stock market crash of 1929 representing aggrieved investors. Over time, he has seen his share of economic cycles, and has ruled on many high profile Wall Street cases including Michael Milken and Ivan Boesky. His recent high profile decision to dismiss a class-action shareholder lawsuit against Merrill Lynch puts the analytical burden directly on the shoulders of investors. In the complaint, investors claimed that Merrill Lynch misled them because the company allegedly provided tainted stocks research. As a result, these plaintiffs argued that Merrill Lynch was responsible for their investment losses in highflying technology companies.

In Judge Pollack's decision, he concluded that the conflicts raised by investors were issues that they would have been aware of had they done their homework. He wrote,

*The alleged conflict of interest between brokerage firms, investment bankers and research analysts that underlies the entire complaint was a matter of public knowledge for years before the amazing boom of the market initially rewarded those who disregarded such caveats.*

Scandal-plagued companies like Enron had conflicts of interest that were documented in public filings with the Securities and Exchange Commission (SEC), but were largely ignored by the investment public. Buried in the footnotes of Enron's 2000 annual report there is a section entitled "Related Party Transactions." One sentence in particular raised a red flag with attentive investors since it detailed a conflict of interest with one of Enron's senior officers, "In 2000 and 1999, Enron entered into transactions with limited partnerships whose general partner's managing member is a senior officer of Enron." The section went on to describe various off-balance sheet-financing arrangements. After Enron's debacle, the public soon learned that the senior officer in question was former CFO Andrew Fastow and that the limited partnerships he managed ultimately helped Enron conceal billions in losses while they generated handsome returns for a small group of company executives.

Most investors have neither the time nor training to carefully analyze companies. Investment decisions are based on stock tips from friends (they never tell you when it is time to sell), information from magazines, and conflicted Wall Street analysts.

## **AND THAT'S NO BULL - CONTINUED**

Other investors are aware of red flags, but they simply do not have the temperament to invest successfully over long periods of time. During market booms it is natural for investors to let down their guard. As economist John Galbraith has observed:

*In good times people are relaxed, trusting, and money is plentiful. But even though money is plentiful, there are always people who need more. Under these circumstances the rate of embezzlement grows, the rate of discovery falls off, and the bezzle increases rapidly. In depression all this is reversed. Money is watched with a narrow, suspicious eye.*

Over the past three years we have been fortunate to avoid permanent losses of capital. This does not mean that we will never be blindsided by a corporate scandal. Over time, our training and discipline provide us with a margin of safety and the ability to assess the probability trade-off for success.

## **THE FUTURE IS HALF FULL**

*The man who insists upon seeing with perfect clearness before he decides, never decides.*

-Henri Frederic Amiel, Swiss Writer

In our 2002 mid-year letter we noted that pervasive fear in the stock market had given us the opportunity to purchase many new businesses well below their intrinsic values. We did not know when values would be realized, but we were confident that investors would be rewarded for their patience. In the first half of 2003, our growing investor base was compensated for their fortitude.

After three years of declining prices for the popular averages – the valuation of common stocks now appears to be at the upper end of reasonable. When the overall equity market falls by over one-third and finally reaches the upper end of reasonable, the words we would choose to describe the overvaluation that persisted is not appropriate for a family audience.

Are the markets behaving rationally today? Why not? We believe that the economy is improving, will continue to improve, but overall will demonstrate one of the more modest post recession recoveries since the industrial age. As a result, the greatest probability is for Treasury Bonds and most categories of Real Estate to experience negative returns over the next several years as interest rates across the curve rise moderately. Furthermore, we expect money market rates to return to a slightly more tolerable level (2%ish). As previously highlighted, growth stocks will likely experience more volatility and generate lower long-term returns from the current starting line than their value brethren.

## THE FUTURE IS HALF FULL - CONTINUED

While AAM is reasonably optimistic regarding the outlook for the overall equity market, we are particularly confident that a well-constructed portfolio of value stocks will earn superior real returns over time. Insight into our sentiment is offered below.

- **Choose Wisely:** Rational investors must make decisions between available opportunities. One of the ingredients in our predictive recipe is a valuation tool called the “Fed Model”. It earned its moniker in 1997 when the Federal Reserve was reported to be using this framework to monitor the relationship between interest rates and stock prices.

More specifically, it measures the correlation between the yield on the 10-year U.S. Treasury note and the earnings yield on the S&P 500. The Treasury note’s yield is easy to obtain. It is the annual return investors get if they hold a note until maturity and is available in the business section of the newspaper. The earnings yield divides current earnings by the price of the underlying asset. It is the inverse of the PE ratio.

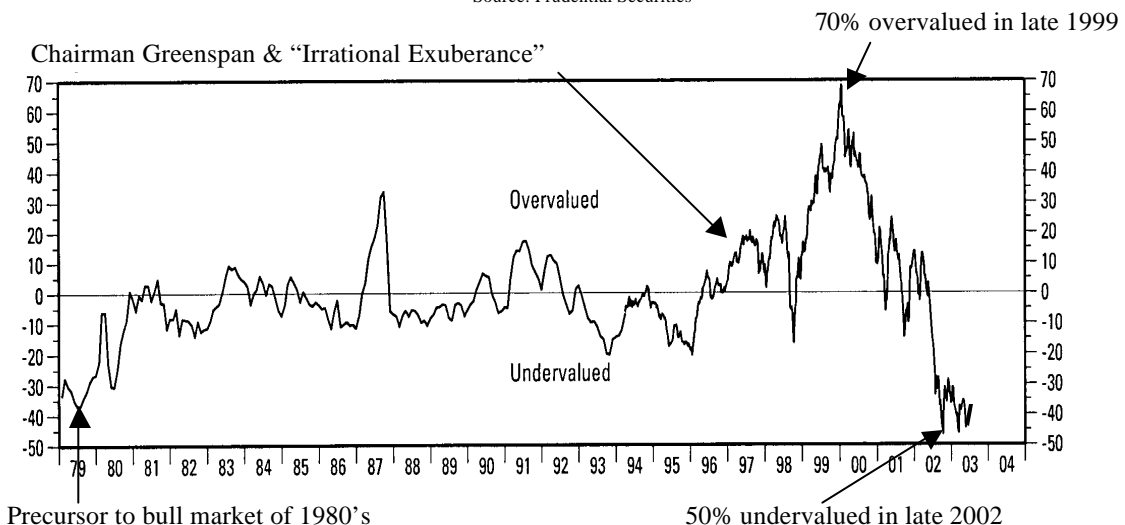
The Fed Model signaled the bull market of the early 1980’s and the grueling bear market that began in early 2000. As we write to you, the Fed Model is illustrating a highly compelling case for stocks relative to bonds.

We’ve heard people comment; “It’s different this time so the model can’t be relied upon.” It wasn’t so long ago when speculators in Internet stocks actively preached, “It’s different this time.” For those with short memories, those four words can be mighty expensive.

Highlighted below is the perspective of the Fed Model from 1979 to the present.

### **THE FED MODEL**

Source: Prudential Securities



## THE FUTURE IS HALF FULL - CONTINUED

- **A Less Taxing Scenario:** Recently enacted fiscal policy reduces the top tax rate on most stock dividends to 15%. This compares favorably to previous guidelines, which taxed dividends as ordinary income with rates up to 39.6% at the Federal level. A lower rate clearly enhances the attractiveness of dividend paying stocks for tax sensitive individuals (we are still looking for a tax insensitive individual). The use of free cash under current policy is more likely to be directly returned to investors through increased dividends.

Over the past decade, share repurchases gained in popularity along with generous stock option programs. We are all in favor of the use of excess cash flow to buyback shares, but only when the business is undervalued. Unfortunately, senior management of major corporations failed to restrict their use to such circumstances. In these cases share repurchases do not create shareholder value.

Earlier this month, Citigroup, the most profitable financial services company in the world, increased its dividend by 75%. Sanford Weill, CEO of Citigroup, noted, "The recent change in the tax law levels the playing field between dividends and share repurchases as a means to return capital to shareholders." We expect many other companies to dramatically increase dividend payouts as they analyze the Tax Act of 2003 and view it as a highly efficient method for returning excess capital to business owners.

- **A Realistic Bar:** Individual stocks are impacted in the short-term by their performance vs. earnings expectations. If you've ever been to the dog track, it's like the canines chasing after the bunny. Wall Street firms employ top-down market strategists to forecast the overall market and bottom-up industry analysts to predict earnings for a select group of companies that they follow. Over the last four years there had been a great disconnect between the top-downers and bottom-uppers with the latter showing much more enthusiasm. For 2003 and 2004 the two groups are roughly in sync.

What does this mean? We believe the more recent trend largely results from more conservative expectations by bottom-up industry analysts and the companies they research. Instead of jumping over six-foot hurdles, more recent expectations only seem to require CEOs to walk over more realistic two-foot bars.

- **Bashert and Shotgun Weddings:** Corporate marriages through mergers and acquisitions have picked up dramatically over the past several months. The recent spate of deals has featured both friendly and hostile transactions across industry groups. We view such behavior as a sign of increased confidence among senior corporate executives, and a general assessment that the market valuation of many businesses is attractive.

## **IF AT FIRST YOU DON'T SUCCEED, SKYDIVING IS NOT FOR YOU**

Are there reasons to be pessimistic? Certainly, but we believe probable causes for concern are already in stock prices. We read about them every day. Historically low interest rates continue to encourage the potential irresponsible use of debt to fund consumer purchases, job creation is anemic, manufacturing capacity utilization is only about 70% globally, and the geopolitical situation could destabilize at any time.

Markets discount news headlines and generally look six months to a year ahead in time. We believe the improved tone for stocks is indicative of a strengthening economy, paced by aggressive monetary and fiscal stimulus as well as a bounce in business spending.

We are never without problems or conflicts. Birth and death are the only things that are black and white in this world. Everything else operates in shades of gray. Biologist Louis Pasteur said, "In the field of observation, chance favors the prepared mind." At AAM, we spend our days considering the probability of financial outcomes; particularly what we gain when we are correct and more importantly the potential damage when we are not.

We'd all like to own businesses with the potential for obscenely large gains. More often than not though they also carry a high probability for a significant permanent loss of capital. Successful long-term investing requires avoiding these large permanent impairments.

NASDAQ investors grazed happily through the first months of the year 2000 on the green acreage of a farm that offered significant immediate rewards. Unfortunately, underneath the vegetation was a high probability of a severe negative event – biting into the manure that made things grow in the first place. The run-up in NASDAQ prices was very seductive, but when conditions reversed, it wiped out all gains and piled on devastating losses.

Using a baseball analogy, we would rather put the ball in play then swing for the fences and run the risk of striking out. This is the optimization process when one invests with a margin of safety at AAM. It also means more modest performance when compared to the popular averages in speculative markets when everyone is swinging for the fences and temporarily connecting. Because when pushed, we'll accept lower potential price increases in exchange for a high probability of avoiding losses. We want a strong on-base percentage to score runs consistently. Over time this is what compounds capital and wins games.

## **SAY IT AIN'T SO JOE**

These words were reportedly uttered by a young baseball fan outside a courthouse in Chicago to which the star leftfielder Joe Jackson is said to have replied, "It's so kid. It's so." This exchange summed up the national disbelief that the Chicago White Sox had conspired to lose the 1919 World Series to enrich professional gamblers and themselves.

## SAY IT AIN'T SO JOE - CONTINUED

What led to this? The team owner Charles Comiskey was notoriously cheap. His Chicago White Sox team was the best in the league, but it was one of the worst paid. His penny-pinching extended to laundry services.

The team picked up the nickname 'Black Sox' because they often played in dirty uniforms. Thus, gamblers found a receptive audience when they approached individual players on the team with the idea to fix the World Series in return for more than a year's pay.

Unfortunately, stories like this abound in all facets of life. The renowned leadership expert, Dr. Steven Kerr, observed that, "Whether dealing with monkeys, rats, or human beings, it is hardly controversial to state that most organisms seek information concerning what activities are rewarded, and then seek to do those things, often to the virtual exclusion of activities not rewarded."

Business headlines over the past few years have exposed several cases where individuals have acted inappropriately due to poorly structured reward systems that have created conflicts of interest.

Arthur Andersen and other accounting firms have been under the microscope after several high profile fiascos exposed how these companies compromised their accounting oversight to win lucrative consulting contracts. At investment banks, for example, controversy has centered on analysts who issued biased research reports to develop investment-banking clients.

AAM was founded with the vision of being a different kind of firm. Our research is independent – so we have no allegiance to any particular brokerage firm. We negotiate the lowest commissions while demanding the best executions on the buy and sell orders we carry out.

The **only** fee AAM earns is a percentage of a client's assets under management. We are paid more when client capital appreciates and less when it declines. Furthermore, we eat our own home cooking. Our families hold very similar investments to our clients. So we prosper or suffer in proportion to those who trust us with their assets.

We do not sell insurance, annuities, or any other financial products that can compromise the recommendations that we make for the client families we serve. By way of example, we will meet with your insurance agent, we'll help you find better pricing or products to manage your risk, but we don't receive any separate compensation for being your personal CFO.

Every day we strive to be your trusted advisor, to better understand your current conditions, financial aspirations, and risk tolerance. It can only work well without incentive for conflict.

## IN CONCLUSION

Voltaire said “Appreciation is a wonderful thing: It makes what is excellent in others belong to us as well.” We get the chance to work with people we like and respect everyday. Most exciting for us is the opportunity to learn from each other. Our client base comes from diverse backgrounds around the world – but the basic humanness you have demonstrated to us over the years is priceless and keeps us tap dancing to work each day. We’ve come a long way together but the journey is still fresh and we look forward to the future with continued enthusiasm.

We are working on a significant upgrade to Alterasset.com that will be completed before the end of 2003. Let us know if you have any feedback. Alterasset.com will continue to be a significant method of communicating important information within the AAM community.

Personally, we are very happy for Kelli Renda. Professionally, we are sad to report that she will be leaving AAM at the beginning of August to become a full-time mother. With two cute children at home, it was impossible to compete (especially with what we look like in the office most of the time). Kelli has been instrumental in the growth of AAM, and to our sanity. We will miss her in the office every day but have made a friend for life.

You may have heard Marianne Donnelly’s voice on the phone recently. She will assume many of Kelli’s responsibilities on a full-time basis next month. She brings her own strengths to AAM and has worked in quality control for a number of years. Marianne is friendly, bright, and hardworking. We look forward to a long association.

Janet Chen recently joined AAM as an Analyst. She received her BS and MS in Geophysics from the Massachusetts Institute of Technology. At M.I.T. she also played on the women's varsity tennis team and coached there for one year. Janet has spent the last seven years working for a Fortune 500 company, and we are excited she is with us.

Welcome to our new clients who have joined AAM in the last six months. We are glad you’re here.

There are several weddings and other happy events taking place in our client family the rest of the year and we are honored that you’ve thought of us on such occasions.

We’ve seen amazing courage this year from two of our clients who won tough battles with serious illnesses. We wish you many long and happy years.

**IN CONCLUSION - CONTINUED**

As in the past we continue to manage each portfolio to its risk tolerance. We have enclosed your AAM Investment Policy Statement (IPS) if an executed copy has not already been received. Please return it to us no later than August 15<sup>th</sup>. As always, please let us know if there are any changes that need to be made to your IPS.

A copy of our current Form ADV II is available upon request and our annual privacy and proxy-voting policies are enclosed.

We'll write at length in late February when we send out the annual report and tax information. In the interim, we'll speak to you and hope many of you have a chance to meet us at World Headquarters. Have a safe and happy summer.

Warmest regards,



Howard



Stephen