

August 13, 2002

Dear Friends of AAM,

This is the most important letter we have written to you in over a decade. There are several key points to highlight in this challenging period for common stocks, and we want to be focused and direct with our comments. This mid-year 2002 update highlights two key themes:

- I) We'll provide you with context for the current bear market, an understanding of where we are in the cycle, our assessment of the market valuation, and some important information on future performance based on historical studies of market panics.
- II) We'll share with you our strategy for selecting businesses and how we are preparing for an eventual market reversal.

CAN YOU BEAR THE BEAR?

The S&P 500 and NASDAQ have now fallen approximately 49% and 76% respectively since reaching their highs in the spring of 2000 – the peak of the Internet bubble. Over this period, your capital did not feel any material impact from this falloff until June of 2002. Here is why.

Bear markets go through three stages:

1. Enthusiasm/Denial – “The drop is a buying opportunity.” After a long bull market, the most popular and expensive stocks decline first. Investors are conditioned to buy during market pullbacks, and short-term advances lure people in.

This period lasted from late March of 2000 through the beginning of 2002 as the bubble in tech and telecom — which propelled the market to dizzying heights in the late 1990s — led the decline. AAM protected capital by avoiding these overvalued securities.

2. Concern - “Prices have not recovered.” People lose faith in former high-flying stocks, and they begin to selectively sell other holdings – generally those where they have made some profit. These sales are usually orderly and rational as weeds are removed from the investment garden while flowers are left to bloom.

This period began in January 2002 and ended in mid-May. Our emphasis on value continued to protect capital

CAN YOU BEAR THE BEAR? (continued)

3. Fear – “Stop the Pain!” We are currently in the final stage of a bear market where each day seems to bring bad news. Confidence in our institutions is shaken. People panic as fear reaches a fever pitch. The stock prices of a growing number of companies begin to trade at 50% to 60% discounts to their private market value and small companies can be purchased for less than the cash on the books.

During a period of fear, all stocks will go down and there is no place to hide. AAM is no exception. July’s decline in capital reflects the market’s 20% drop this month alone. So why don’t we sell? Because we believe six months down the road prices will be materially higher than they are today. The empirical evidence we will review with you in this letter demonstrates why selling into panics does not make financial sense.

Fear cannot remain unresolved in the human mind for a long period of time. For some, the resolution of fear comes from selling holdings at distressed prices without regard for the underlying value of what is being thrown away. The real risk at this stage is abandoning long-term goals to placate short-term fears. It is scary and difficult to stay the course when you are punished for it in the short-term.

Daniel Kahneman, a Princeton psychology professor with an office right down the street from AAM, was one of the first academics to explore the relationship between psychology and investing. He documented human irrationalities in decision-making and how cognitive errors are an integral part of human thinking. Kahneman found that the pain of loss is far more significant to people than the satisfaction of gain — by a factor of 2½ to 1. This observation alone goes a long way in explaining the almost uncontrollable urge to sell investments that have fallen in price. The need to end the pain by selling can be overwhelming because watching unrealized losses mount becomes too challenging to endure. Investing through a down market is scary and emotionally draining.

Unfortunately, selling a stock, picking its exact bottom, and knowing exactly when to get back in is virtually impossible other than by pure luck. Stock market returns tend to occur in sudden spurts. A recent study by Birinyi Associates analyzed the results of the S&P 500 from February 1966 through October 29, 2001. Over that time period, a dollar invested in the S&P 500 would have grown to \$11.71. Without the five best days each year, the same dollar would have shrunk to \$0.15. If you know someone who can pick the five best days each year, please have him or her give us a call.

The emotions people have experienced over the past few years provide an illustration of why the average investor buys high and sells low. Without regard for the discipline of proper business valuation and analysis, the only basis by which a person makes a decision about a company rests entirely on the movement of the stock price. Under this framework, higher — not lower — prices generate excitement among buyers of equities. People are tempted to buy when the Nasdaq is rapidly ascending and trading at a lavish price of over 5,000. These same people will quit buying when the market is significantly off its highs. This is contrary to common sense. As big fans of Coke, we are always excited when we can find it on sale at the grocery store. When prices are marked up, we stick with tap water.

WHAT PRICE TO PAY?

It is clear that stocks are cheaper than they were two years ago, but are they cheap enough?

Qualitative and quantitative indicators suggest that the recent market panic has brought about a fear-induced garage sale for great businesses. Despite the recent gloom, we highlight some reasons to be optimistic about the long-term returns that will be generated from a well-selected portfolio of equities in this environment.

- **Oversold:** When investors panic, stocks are often sold with reckless abandon. This leads to a period of free fall. There have only been six occasions over the last forty years where the market has declined so fast that it fell 15% or more below the average moving prices of the prior 200 days. After this sell-off, however, the market has always bounced back.

Today, stock prices are down approximately 22% below this gauge. Below, we highlight the average gain for stocks after falling 15% below its 200 day moving average:

- 3 months +18%
- 6 months +20%
- 1 year +31%
- 2 years +60%

This indicator suggests that equities may be poised to begin a recovery in the near future.

- **Insiders with Insight:** In the first half of 2002, corporate insiders — U.S. executives and directors — purchased \$3.7 billion of shares in their companies. This figure was almost **triple** what it was a year earlier. In addition, insider selling reached a four year low in June.

Corporate insiders are the people closest to the company's pulse. Accordingly, transactions of company stock by executives and directors must be filed with the U.S. Securities and Exchange Commission within 10 days from the end of the month in which the buy or sell occurs. Insider purchases are regarded as a stronger signal than sales because insiders may have various reasons for selling — to make a charitable gift, to diversify investments, or to pay for a child's college education. Insiders have few incentives to buy their company's stock with their own funds unless they have significant confidence in their business.

- **Be Fearful When Others are Greedy — Opportunistic When Others are Fearful:** The Chicago Board Options Exchange Volatility Index, or VIX, is a leading measure of investor sentiment. Its recent reading of above 50 is relatively high and is considered a bullish signal for investors. Since it was introduced in 1993, a reading between 20 and 30 has been regarded as normal. Extremely low VIX readings indicate a high degree of complacency and are generally regarded as bearish. Conversely, high VIX readings indicate a high degree of anxiety or even panic among options traders and are regarded as bullish.

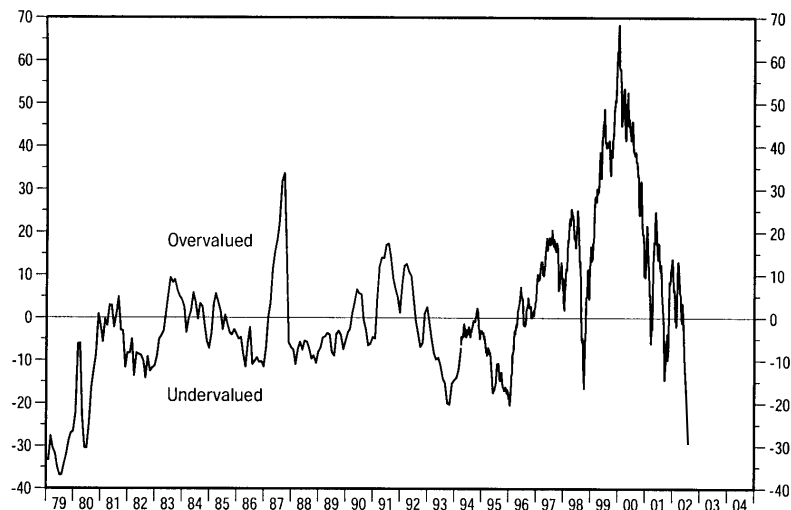
WHAT PRICE TO PAY? (continued)

- **The Fed Model:** A rational decision concerning capital allocation should reflect available investment opportunities. For most investors, the most basic investment consideration is typically between equities and fixed income instruments like money market funds, notes, and bonds.

A valuation model dubbed the “Fed Model,” because of its association with the Federal Reserve Bank, offers a method to determine the relative attractiveness of stocks vs. fixed income securities. In 1997, the Federal Reserve observed in its *Monetary Policy Report* — which accompanied Alan Greenspan’s testimony before the Congress — that the S&P 500 earnings yield has been highly correlated to the yield on the 10-year U.S. Treasury note over time. This implies that stocks are at fair value when the earnings yield of the S&P 500 is equal to the current yield on a 10-year U.S. Treasury note.

The Treasury note’s yield is straightforward — it is the annual return investors get if they hold a note until maturity. The earnings yield is the inverse of the price/earnings ratio (PE), and it is a measure of how much in corporate earnings you can expect to get for each dollar you pay for a company.

The model has worked well in predicting when stock prices have been either excessively overvalued or undervalued. For example, the Fed Model showed the stock market to be extremely undervalued from 1979 to 1982. This set the stage for a strong rally that lasted into the summer of 1987. The model reflected an equity overvaluation of 34% three months before the Crash of 1987. In the mid-1990s, the model reverted to an undervalued status, which led to the unprecedented bull market in the latter part of the decade. In March of 2000, the equity market began its current decline. The Fed Model signaled this downturn one year earlier with stocks posting an extreme reading of 70% overvaluation.



The chart above highlights the Fed Model since 1979. At zero, equities and fixed income instruments have the same yield and are considered fairly valued. Stocks are relatively overvalued above zero, and undervalued below zero. The current reading indicates that equities are 25-30% undervalued relative to fixed income securities having been overvalued by almost 70% at the market peak.

WHAT PRICE TO PAY? (continued)

- **It's the Real Thing:** In light of corporate accounting scandals, serious reforms are apparent as companies feel the pressure to release more detailed information about their financial situation. *Coca-Cola* and *The Washington Post*, for instance, recently announced that they will record as an expense the cost of its stock-option grants to executives. In addition powerful organizations such as TIAA-CREF and the International Accounting Board are pushing for general acceptance of this change in Corporate America. Several companies a day are now following the lead of Coke and the Washington Post.

Due to hard work by corporate lobbyists, companies are not currently required to record stock options as an expense even though they are a real cost. This has had the effect of making reported earnings for companies — especially technology companies — look better than they really are. At Microsoft, accounting for the cost of options would have resulted in earnings of \$0.91 cents a share for the year ended June 2001 instead of the reported \$1.32.

At the heart of change is investor confidence. Damage to investor confidence also damages the market, which damages the ability of companies to raise the capital they need to grow. Eventually, businesses will see that it is in their best interest to regain investor confidence so that changes will ensue. Public officials will also heed investor outcry and bring reforms to fruition. Congress is currently working on various initiatives to stiffen penalties in instances of corporate malfeasance. There's nothing like a little time behind bars to make sure numbers add up.

To further ensure that financial statements are accurate, the SEC has ordered the CEOs and CFOs of over 900 of the biggest companies to sign affidavits verifying the accuracy of their 2001 annual reports and all other filings since that time by August 14, 2002.

AAM's INVESTMENT CRITERIA REVISITED

In the face of declining prices in the equity market, we are finding better entry points to commit capital to companies with favorable long-term characteristics. We do not invest under the premise that we can time the bottom — but with the belief that once the panic exhausts itself, today's prices will look extremely low in the future. We are confident in our portfolio of businesses, and we remain focused on purchasing companies with a margin of safety.

In our mid-year 1998 client letter, we observed that despite the growing popularity of momentum investing, we were remained focused on allocating capital based on traditional security analysis.

*AAM believes that the tenets of fundamental security valuation are as valid in 1998 as they were in 1968. Accordingly, we continue to allocate client capital employing margin of safety principles. AAM views holdings as genuine ownership positions in underlying businesses and maintains an ongoing review of the **management, business strategies, products, and long-term competitive position** of each enterprise. We analyze companies to assess their intrinsic value, the price*

AAM's INVESTMENT CRITERIA REVISITED (continued)

a rational businessperson would pay for the entire company under normal conditions — discounting all anticipated future cash flows to the present. AAM only buys businesses that we are capable of understanding, with distinct qualitative and quantitative characteristics, available at a minimum of a 35% discount to intrinsic value.

Similarly, we sell a company when it exceeds its intrinsic value or experiences a change in its business model that impairs the valuation process. AAM has purchased many outstanding businesses over time and we expect that most will continue to appreciate after they are sold. They do so with our blessing. If we ever sell for the highest price we have either gotten lucky or cut it too close.

One of our core holdings, Berkshire Hathaway, illustrates the fundamental characteristics we look for in businesses.

Management: The managers of Berkshire Hathaway have their interests directly aligned with shareholders. Chairman Warren Buffett has over 99% of his personal net worth (and 100% of his reputation) invested in shares of Berkshire and Vice Chairman Charles Munger has over 90%.

Most managers of large businesses are primarily concerned with their personal salary and stock options (read: lottery tickets). Accordingly, they are motivated by short-term performance. Since Buffett's family owns nearly 40% of Berkshire Hathaway, he shares shareholder concerns about maintaining long-term growth and managing expenses. Buffett has been a vocal critic of stock option accounting for years. As a board member of Coca-Cola and The Washington Post, he is the primary reason these companies are now choosing to expense option grants.

Even though Berkshire ranks among the largest businesses in the world with a market capitalization of over \$100 billion, Buffett's annual salary remains at \$100,000 with no stock options. This makes him the lowest paid executive among the largest 200 companies in the United States. In short, if it's good for Berkshire, it's good for The Buffett family, and it's good for shareholders as well.

Business Strategy: Through insurance float and free cash from wholly owned businesses, Berkshire Hathaway has a war chest of nearly \$40 billion to invest. The decline in asset prices over the past two years is a tremendous boon to Berkshire because it allows the company to make opportunistic acquisitions at highly favorable prices.

Products: Berkshire owns a collection of businesses that have very little risk of being rendered obsolete by changing technologies over time. Products include ice cream to vacuum cleaners, insurance to flight services. The common thread is that most businesses have a sustainable competitive business advantage in their respective fields, and are cash rich. Each business is independently operated and managed under the auspices of Berkshire Hathaway. Companies in Berkshire's portfolio include recognizable names like Dairy Queen, See's Candy, Benjamin Moore Paints, Fruit of the Loom, Dexter Shoe Company, Executive Jet, GEICO, and Kirby.

AAM's INVESTMENT CRITERIA REVISITED (continued)

Long-Term Competitive Position: Berkshire Hathaway is regarded as the Fort Knox of companies because of its rock solid balance sheet and portfolio of strong businesses. Berkshire is now one of only **eight** U.S. companies with a AAA rating as determined by Moody's Investor Service — this is the highest debt rating a company can receive. In 1992, there were twenty-one companies in this group. Put bluntly, if there's a bill, Berkshire can pay it. Having liquidity in today's weak economic environment means that Berkshire will be able to sow capital today at favorable prices and reap the rewards down the line.

Long-term, Berkshire has attracted a solid team of hardworking and talented managers that will be able to lead the company post-Buffett. It is interesting to observe that seventy-five percent of Berkshire's operating managers are worth over \$100 million in company stock. With the financial independence offered by such net worths, many of these managers have the option of retiring whenever they want. Nonetheless, they continue to work hard at Berkshire. Why? Because of Berkshire's unique culture, and because they truly believe that they have a stake in preserving the company's vision and growth.

WHERE ARE WE NOW? WHAT ARE WE DOING?

Just like it is easy to mistake brains with a bull market, a weak market can make even the best investments look dumb in the short-term. Noted hedge fund manager Michael Steinhardt once shared the key lesson he learned early in his investment career:

I had to have the discipline to endure losses because to ultimately achieve great returns, one had to be able to stay the course and have the conviction required to take advantage of excess in financial markets. And since it's impossible to predict the end of the excess in markets, one needs that sort of endurance.

So how are we behaving at this late stage of the decline?

- We are focusing on your long-term financial goals, and looking past the valley of the current bear market.
- We are balancing realized capital gains taken over the first five months of the year and offsetting them with realized capital losses incurred in recent weeks to minimize your tax payments for the year.
- We are taking advantage of the disparity in the prices of businesses by opportunistically trading up in value and quality. We encourage you to increase your stock weighting at this time if you have been waiting for better prices. A money market account earns 1%, real estate is fully valued, and bond prices are likely to decline over time as interest rates rise from their historic lows. At current levels, common stocks are the best asset class to own over the next five years to compound your capital relative to other opportunities.

CONCLUSION

More than ever, we are here to work with you to guide your financial future. The day-to-day changes may be dramatic – but the long-term is many months and years. If your financial situation has changed, please feel free to contact us. We are your individual CFOSM and can work on a strategy for all of your assets — including those not held at AAM.

We believe the worst move today is to sell stocks just because they are going down – especially if the underlying business values are increasing.

A copy of our current form ADV II is available upon request and our annual privacy policy notice is enclosed.

We look forward to speaking with you soon and sharing our thoughts with additional commentary in the months ahead.

Best Regards,



Howard



Stephen