

March 18, 2002

Dear Friends of AAM,

As an occasional marathoner, investing capital in 2001 was like running up a steep hill with a twenty-mile an hour head wind and ten-pound weights tied to our ankles. We got to the finish line, but it was challenging. Below, you will find a table highlighting returns for key U.S. equity investment benchmarks for calendar year 2001.

<b><u>Dow Jones Industrial Average</u></b>	<b>-7%</b>
<i>(The most quoted stock market benchmark. A narrow group of thirty of the largest public companies in the U.S.)</i>	
<b><u>S&amp;P 500</u></b>	<b>-13%</b>
<i>(A broader grouping of five hundred of the largest U.S. public companies)</i>	
<b><u>The NASDAQ Composite</u></b>	<b>-21%</b>
<i>(Fast growing public companies weighting heavily in technology and healthcare. The least relevant to the AAM style of investing.)</i>	
<b><u>The Wilshire 5000</u></b>	<b>-12%</b>
<i>(The most expansive index and most relevant to AAM's investment style. The Wilshire comprises the 5,000 largest U.S. public companies)</i>	

AAM's long-term objective is to double capital every five to eight years for growth accounts in a tax efficient and risk adverse manner. We utilize ownership in the public equity and debt of U.S. companies to achieve this objective. Although there is a correlation between the performance of your capital and the popular market indexes, we willingly trade market risk for individual business risk. This requires further explanation. Although we view a core group of individual securities as attractively priced to achieve long-term investment objectives – we don't want to rely too heavily on underlying strength in the stock market to achieve satisfactory returns.

### **THE YEAR 2000 IN SYNDICATION – GET ME A NEW SCRIPT**

This past year the U.S. equity market continued to grapple with a valuation hangover precipitated by the bursting of the technology bubble in March of 2000. At the peak of the mania – investors were willing to pay thirty-four times earnings for the S&P 500. This compares to an historical average price to earnings ratio since WWII of seventeen.

Although the NASDAQ and S&P 500 have respectively fallen by more than 65% and 30% from their 2000 highs – stocks still trade at a PE ratio of twenty-two times *expected* 2002 earnings.

## **THE YEAR 2000 IN SYNDICATION – GET ME A NEW SCRIPT (continued)**

While the U.S. equity market remains above historical valuation metrics – very low short and intermediate global interest rates have left current equity index levels in the range of fair value as the intrinsic value of a business is supported by a low opportunity cost of capital. Manias can be followed by periods of significant under valuation. A crisis of confidence triggered by recession, weakening credit, an attack on the United States, and mounting accounting scandals have shaken investors. The market was priced for everything to go right in the world for an indefinite period – it clearly has not. The decline in security prices reflects an inevitable shift in mood.

Investors by their nature are optimists. As value investors we are also realists. Bad things happen – therefore investing requires a margin of safety. Value investors don't take away the punch bowl at the party – we just give a ride home to those folks who spent the night drinking from it.

As we write to you in mid- February, the economy is showing early signs of a recovery precipitated by favorable monetary & fiscal policy and an unwinding of a glut of unsold products. Although serious flaws have been exposed in the security of the U.S. infrastructure, the nation is safer today than it was five months ago. As Warren Buffett, Chairman of Berkshire Hathaway, recently stated, “Behavior that made sense and behavior that didn't prior to 9/11 has not changed.” We believe in America and that our finest days remain ahead for our government, citizens, and economy.

## **TAKING ACCOUNT OF ACCOUNTING**

President Bush summoned Colin Powell to his office last week. Secretary of State Powell arrived quickly as one would expect under such circumstances. “Colin, I have some good news and some bad news,” the President said. “The good news is that the Iraqi's have agreed to allow us to get a count of their nuclear weapons”. Having worked on this initiative since his appointment, Powell was quite ecstatic.

After basking in such a diplomatic victory for a moment he asked, “What is the bad news?” The President paused. “They want Arthur Andersen to count the warheads”.

We've highlighted on several occasions our concern with the sloppiness of U.S. accounting and the obsession to get rich quick.

Good people do bad things when the incentives are wrong. It's like putting a bonus clause in a baseball player's contract to hit homeruns. On the surface this is not a terrible thing. But what if the greater good, winning the game, requires a bunt? The relationship between outside accountants and the firms they audit have the wrong incentives and prevent impartiality.

## **TAKING ACCOUNT OF ACCOUNTING (continued)**

The same accounting firms that are contracted by public companies to audit their books are paid large consulting fees for services in related areas. The potential for conflict of interest is immense.

## **ENRON 101 OR SHOULD THAT BE 102 ... OR 103**

Our response to the Enron scandal is surprise that something like it did not happen sooner. The accounting profession will be overhauled this year. As a result, the financial information provided by public companies will be more transparent and useful to securities analysts. This is a good thing, but the price of tuition was high.

We believe the media gave corporate America a free pass during the bull market of the 1990's. Enron CEO, Ken Lay, was on the cover of every major U.S. business periodical portrayed as the great visionary of 20<sup>th</sup> century only eighteen months ago. Business magazines and television channels like CNBC are generally a danger to your financial health.

The United States tends to deal with its dirty laundry before the pile gets too large. When we hang it out to dry in public there is a period of let down and disillusionment that is followed by a return to a temporary emotional equilibrium.

## **THE STOCK MARKET: STARRING FEAR AND GREED**

Fear and greed are an emotional pendulum that rarely allow the human spirit to remain still. The quick dollar exists in the movies and on the lips of acquaintances at cocktail parties.

Recently, a company put up a web site promising a fast and large profit without risk. Over two hundred thousand people expressed an interest in investing in the business. They spent less time contemplating this decision than the effort that goes in to purchasing a common kitchen appliance. Fortunately, the Securities & Exchange Commission had set up the site, and the prospective investors were informed how to avoid being conned out of their capital.

Extreme fear *can be* the talisman of opportunity. When the stock market reopened in September of 2001 there was great confusion and fear. Concern was reflected in the stock prices of businesses such as Disney (No one will every feel safe again in a large public place so American) and United Technologies (No one will every fly again so Pratt jet engines will sit in cargo bays forever). Outsized returns were generated in these and other securities during a period of understandable uncertainty.

Asbestos litigation has also placed the scarlet letter on a number of superior businesses. We have been buying in to the senior notes of USG Corporation, which we believe have the potential to provide an attractive total return and offer a superior margin of safety based on our analysis of identifiable outcomes.

## **ISN'T EVERYONE LOOKING FOR VALUE?**

No one is consciously looking to overpay for an investment or see a large profit evaporate in a successful company. It is happening to investors across the country as we write to you. The body of AAM's 2001 year-end report highlights the foundational elements of our investment philosophy utilizing businesses that we have purchased in the last year to make our points concrete.

### **1. Purchase Businesses That Are Understandable to You**

BTF is a closed-ended fund in the business of owning publicly traded securities. It currently sells for a 16% discount to its net asset value. A portion of the portfolio is structured for long-term capital gains and is anchored by Berkshire Hathaway (a business we have been studying for almost two decades). The remaining assets of the fund are invested in assets with income producing characteristics. BTF does some short-term borrowing and is able to arbitrage its cost of capital favorably against the income characteristics of the securities it purchases. In addition there are 15 cents of unused tax loss carry forwards.

From its inception in 1994 through 1999 – management made sub-par investment decisions. In 1999, new management won control of BTF through a proxy fight. Over the last two years – BTF outperformed the S&P 500 by 41%.

BTF is a potential double play for investors. First management has proven they can increase net asset value under adverse market conditions, which should ultimately lead to a narrowing of the existing discount. Second, the assets in the company are undervalued and should experience meaningful growth over time.

### **2. Purchase Businesses that Possess Reasonable Future Prospects**

The long-term success of a business is predicated on one key variable – its sustainable competitive advantage – what we refer to as the size of the moat around the corporate castle.

RLI (RLI) is a specialty insurer that promises to pay policyholders that experience loss or damage related to a unique profile of risks. RLI's history with these types of risks, relationships within the insurance industry, and corporate culture provide it with a moat that other smart and very well capitalized competitors cannot penetrate. The company has been expanding on the size of this moat since the 1960's when it was selling insurance for hard contact lenses under the direction of its Chairman, Gerald Stephens.

## **ISN'T EVERYONE LOOKING FOR VALUE? (continued)**

### **3. Find Honest and Shareholder Focused Management**

The best methodology for assessing the integrity of a senior management team is to review the paper trail. One approach we apply is to examine a grouping of annual reports and SEC filings to assess consistency of vision, financial reporting metrics, and transparency.

Does management call a spade a spade? Do they gloss over mistakes and tie their message to future glories conjured up by an outside consultant? If you're a .240 hitter and have been in the league for ten years – we're not interested that your goal is to win a batting title.

*Short-term* management incentives, create *short-term* thinking, and lead to short cuts and poor corporate governance.

Reviewing the financial relationship between Berkshire Hathaway chairman Warren Buffett and his company provides an understanding of one of the elements that attracts us to the company.

- Warren Buffett is paid a salary of \$100 thousand per year to run a business with over \$150 billion in assets.
- Buffett owns over 35% of the outstanding shares of the company.
- The stock was purchased in the open market with his own cash.
- More than 99% of Buffett's net worth is in Berkshire Hathaway.
- There are no such things as stock options at Berkshire Hathaway
- Warren's never sold a share.

### **4. Pay a Reasonable Price for a Good Business**

Wal-Mart is the greatest retailer in the world. This really isn't much of a secret. Yet the current share price exceeds what we believe the business is worth.

What's the magic in assessing business value? Investing is a discipline and every investment firm will bring to the table a toolbox that matches the way they think about common stocks.

We view shares of stock as ownership claims on the future profit of the business. Since we can't change the management, we need to be comfortable with their integrity and approach (see #3). Instead of receiving our full share of the profit each year, (a small percentage is returned in the form of a dividend) we trust the management to use retained earnings to expand the moat around the business in ways that provide reasonable returns on capital.

#### **4. Paying a Reasonable Price for a Good Business (continued)**

Our most commonly used method of assessing business value is to take all the free cash flow that we believe a company will generate over its life and discount it back to the present.

The Limited (LTD) is a retailer that looked very attractive to us last fall. Our cash-flow assessment was a significant factor that led to our purchase decision. But we like multiple margins of safety. The Limited's publicly traded Intimate Brands subsidiary was being valued by the stock market at a level greater than LTD, its parent, which has other profitable operating divisions!

#### **5. Maintain A Sell Discipline**

The most logical time to sell a security is when it exceeds fair value. In taxable accounts we will let stocks flirt with fair value for longer periods to reduce tax liabilities. Timing the stock market to determine when to sell has historically had a very weak correlation with wealth creation.

Other reasons we sell securities:

- a. Better use of capital. If we find something we believe possesses a much clearer margin of safety after factoring in tax consequences – we sell.
- b. If a business is acquired by a public company we don't admire or a private company where the decision is taken out of our hands –we sell.
- c. If our assessment of the margin of safety of a business is faulty – we sell. In 2001 telecommunications and technology experienced rapid and seeming permanent changes in fundamentals. We were catching a falling knife with our small purchases. We sold.

Capital allocation is like chess. Unless you have the next series of moves thought out while your make the current play – the chances of a successful outcome are limited. Without a sell discipline an investor is a slave to price. Rising prices increase greed and declining prices enhance fear. The end result is buying high and selling low. This may work in Argentina and at Enron, but only for a while and with severe ultimate consequences.

## **AAM AND THE STOCK MARKET**

To succeed using the AAM discipline of capital allocation requires patience and an ability to travel outside of the herd for some period of time.

We study stock prices to look for irrational behavior. On any given day someone may be willing to sell us an ownership stake in a business at a material discount to our assessment of fair value. They may also be willing to buy one of our current companies at a premium.

We don't rely on a tail wind from the stock market to improve your capital position over time – but it sure does help. The average annual return as measured by the S&P 500 was 10% during the 20th century. We wouldn't be surprised to see the major equity indexes under perform historical returns by 3% to 4% per year through the next decade.

The current level of earnings power in relation to stock prices and Gross Domestic Product would appear to be a limiting factor. Significant productivity gains and/or another market bubble would be required to prove our conclusions conservative. Both are possible but don't bet the farm on it.

The outlook for value investing should be far better than the average return on stocks and other major asset classes as:

1. A bottom up approach to investing always uncovers individual nuggets.
2. The market is moving to a more rational plain fueled by a focus on earnings quality, transparency, and business simplicity. This focus plays in to the strengths of a value-oriented manager.
3. We are not closet market indexers. AAM structures concentrated portfolios of investments that have a reasonable probability of supporting a doubling of capital every five to eight years.
4. We accept short-term losses of capital but seek to avoid permanent losses in capital with great vigor. Therefore we require a margin of safety.
5. Real estate looks expensive, high quality ten year bonds will get an investor 4% after-tax, and other hard assets are likely to only keep pace or marginally exceed a nominal inflation rate of 2.5%.

For building real purchasing power over the decade a concentrated value oriented portfolio of equities is where our efforts are concentrated.

## IN CONCLUSION

Alter Asset Management, Inc. is ten years old next month. The journey has been fantastic and I'm motivated for continued success over the next decade. I have to be!

We continue to eat our home cooking as my family assets are invested in the same equity securities as our clients. My personal net worth is tied to the success of these businesses through direct ownership. As we highlighted earlier, aligning objectives and creating the right motivation is extremely important.

There are numerous changes in the tax code this year. The most beneficial of which is the improvement in the 529 plans for college savings. If your children or grandchildren might be headed to a University – these state sponsored plans provide the grantor with amazing tax benefits and control over the disbursement of funds.

Alterasset.com just completed an interim makeover prior to the introduction of our new site later this year. Keep your valuable comments coming and take a moment to visit the site.

Knox the Seeing Eye Dog, sponsored by AAM's clients, is doing well and will be up for placement next year. Nancy and I have caught the canine ownership bug as a result of our involvement with the Seeing Eye Foundation. Although the deposit is non-refundable, I welcome your attempts to talk us out of it.

In addition to the client letter, the year-end report contains important tax information for non-sheltered accounts, a portfolio profit & loss statement and performance history.

My gratitude and appreciation to our growing family of AAM clients and to the best group of professionals I could have ever hoped to work with. What a great ten years!

As always, a copy of Alter Asset Management, Inc's ADV II, is available online or by request.

We'll write to you again in July and speak and/or visit before then.

Best Regards,



Howard