

capital --- QUARTERLY markets review

Wealth Management: Coping with Congress and the New Tax Legislation

Make no mistake, the new tax law is a bewildering document. The \$1.35 trillion tax cut is built on a slew of provisions that kick in over the next decade and die abruptly after 2010, unless Congress renews them. The new tax-cut bill isn't everything it should be, but if it's allowed to stand for a while, it will go a long way toward fixing some of the biggest federal miscues of the past 14 years ... eventually. The most remarkable thing about this bill is not how much it does, but how long it takes to do it.

Taken as a whole, the bill appears to be a self-negating statement, one of those conundrums from philosophy class, such as "This sentence is a lie." If the proposition is a lie, the sentence is true, and if the sentence is true, the proposition is false. If your head spins at that, wait until you do your taxes next year. Bad bills get written in the middle of the night in conference committee meetings where the representatives of contending interests and philosophies trade a little of this for a little of that until they reach equilibrium — or exhaustion.

For example, if it's a good idea to reduce most tax rates by 3 percentage points, why wait five years to get the job done? The tax bill shaves off 1 point this year, 1 point in 2004, and 1 point in 2006.

If the estate tax deserves repeal and replacement with an extension of the capital-gains tax, why leave every estate planner uncertain of the law

for 10 years? Amid all the talk about phasing out the estate tax over the next decade, Congress neglected to deal with another "death tax" that will hit many clients in the years ahead.

What is that? When we die, our assets now may avoid estate taxes, but our heirs still will have to pay all the income taxes owed on our retirement accounts. The new law suggests that they may not need to be so quick about depleting the balance in our IRAs before tapping other sources, particularly if we are in the maximum tax rate. To be sure, if our heirs end up with our IRAs, they will have to pay the income taxes owed. However, they can string out the tax bill by drawing down the account over their life expectancy. Uncle Sam eventually may get his share. Meanwhile, our heirs will benefit from years of tax-deferred growth, which will more than compensate for the eventual income-tax hit.

It's hard not to be cynical. As one pundit observed, "With so much of the tax bill's freight loaded at the back of the train, the new bill does guarantee continuous national debate about taxes." Each year a new provision will arrive in play or become a bigger share of the revenues that spenders of both parties would have wished to spend, and each year the spenders will be forced to contemplate raising some tax to pay for their favorite program. Such annual re-evaluations of policy could be

healthy for the whole country. Or, more likely, it could prompt another tax bill every year as far as the eye can see, just as the Reagan tax-cut law of 1981 triggered dozens of tune-up measures in the ensuing years.

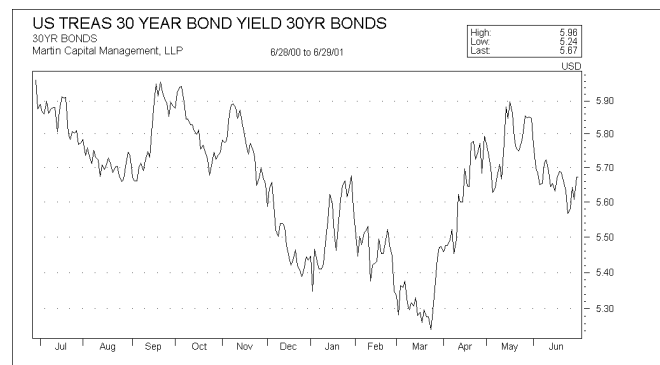
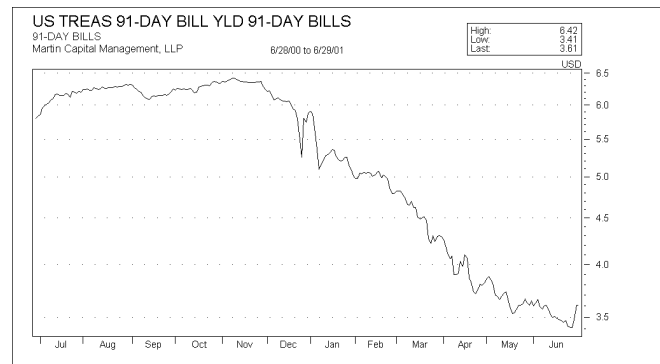
The Capital Markets

Few people are celebrating the performance of the capital markets through the midway point of 2001. Stocks have generally produced negative returns, and the yield curve on fixed-income securities has undergone a major shift from an inverted posture (in lay terms, market yields on short-term securities exceeded those available from longer-term ones) to a more normal, positively sloped orientation. In other words, even as the Fed has reduced short-term interest rates, longer-term rates have increased. Correspondingly, longer-term maturities have experienced modestly eroding prices.

Fixed-Income Markets

We are giving more attention to the fixed-income markets in this review because of the significant changes taking place in the fixed-income market, in which many of our clients have a large stake. The massive decline in short rates is not good news for putting cash to work (money market equivalents), as the returns (yields) have fallen by almost half since the first of the year. In order to reduce the “income risk,” our bond strategy at the beginning of 2001 — in the context of an inverted yield curve environment — was to employ a laddered maturity structure with the average duration (maturity) approximating 3-5 years. This approach effectively “locked in” rates for a large portion of the portfolio, reducing the impact of rapidly declining short-term rates. Depending on your circumstances, we may have realized the gains from this strategy.

No doubt it’s an immensely interesting time to be on the Federal Reserve Board. While the “irrational exuberance” that Alan Greenspan feared is clearly fading, stock prices remain richly valued by historical standards, and the sector of the economy that was principally responsible for driving enhanced productivity and growth (technology and communications equipment)



is on the ropes. At this point in the economic cycle, most of the slowdown can be attributed to inventory and capital spending reductions. Consumer spending, surprisingly, remains relatively robust. We have no idea if and when we will witness a decline in consumer spending, a development that would undoubtedly exacerbate the current economic slowdown. We will continue to manage this *macro* risk by avoiding credit risk in fixed-income securities and by buying and owning well-capitalized businesses on the equity side.

The Equity Market

The returns from our equity securities continue to be positive in both an absolute and relative sense. After being down modestly in the first quarter, the equity portion of our portfolios increased in value in the neighborhood of 9-13% for the first six months of 2001. By way of comparison, the Dow, S&P 500, and Nasdaq are *down* 2%, 7%, and 14%, respectively, over that same time span. The trend in relative performance is a phenomenon we described six months ago as “unsustainable.” So much for forecasts! Nonetheless, we repeat, “Should the equity markets continue their downward trajectory, we won’t emerge unscathed from the general malaise that has swept through the market.”

We have been relatively active in the equity market this year (as evidenced by a rather large spike in trading costs, an expense our firm bears!). Positions have been reduced in Heartland Express and Wabash National — and to a much lesser extent in Clayton Homes. More significantly, we have sold (or nearly so) our entire investments in Progressive, Belden, and Torchmark. While we have redeployed some of the proceeds into McDonald’s, Dollar General, and Gillette, our overall cash positions have increased substantially. Did we say “low turnover” was part of our investment approach?!

First, the bad news: We will all pay some hefty capital-gains taxes. But there’s also good news: We will generally not experience a lot of portfolio turnover unless the stock prices of companies in our portfolio do much better than we anticipated at the time of purchase. With the exception of Wabash National (and to a lesser extent Belden), the stock prices of the companies we recently sold rose quickly and dramatically soon after we purchased them. Thus, much of the long-term return we expected came sooner rather than later. Rising prices — and therefore falling expected returns — forced our hand. To put the equity returns into perspective: Since March 31, 2000, the equity portions of our accounts have outperformed the S&P 500 by more than 50%. More importantly, we made a little money while many others experienced high anxiety. Above all, we hope no client ever loses sleep for fear of *permanent capital losses* in his/her portfolio. If we figure out how to avoid *short-term volatility*, we’ll let you know. Just don’t hold your breath.

Irrespective of what government statistics tell us about the economy, anecdotal evidence that we encounter on a daily basis makes it clear to us that U.S. business has entered into a recession. So-called “profit warnings,” indicating that earnings will be lower than earlier “guidance” would have suggested, became the norm at the end of the second quarter. The companies in our portfolio, as detailed below, will be similarly affected by the slowdown in economic activity.

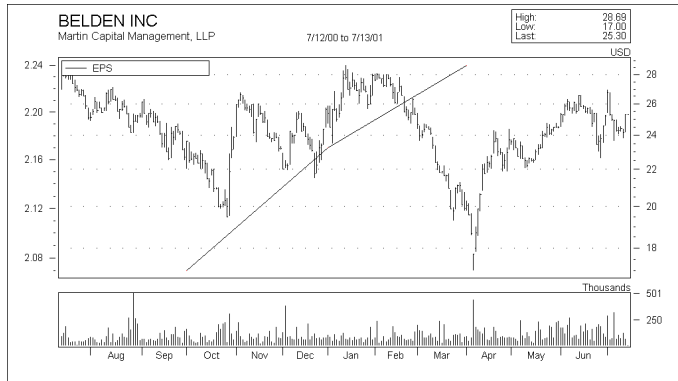
Nowhere are the recessionary conditions more prevalent than in the technology arena. Investors were not the only folks to overestimate growth prospects for technology. In fact, the entire industry now finds itself with way too much inventory and production capacity. Nortel (one of the oft-heralded darlings of the stock market mania just months ago) incredibly will report the largest loss ever recorded by a publicly traded company — a whopping \$19 *billion* (no, that isn’t a typo!). That’s what can happen when you purchase risky businesses with “funny money” (using stock as currency).

Having missed out on both the exuberance and the despair that followed, some clients have asked if it may be time to dip our toe into the “technology” water. Our response remains the same: “Perhaps.” Admitted ignorance kept us away from one of the most exciting but ultimately wealth-depleting speculative manias in recent history, and little else has changed. We still have trouble forecasting future earnings of businesses subject to unpredictable competitive conditions and other forms of rapid change. We may, however, purchase companies appurtenant to the growth in electronic automation — companies that supply component parts to a broad cross-section of end-product manufacturers. We’ll keep you posted.

Belden (BWC)

Our last report noted that we were disappointed with the way the company has diluted the claims of shareholders by aggressive stock-option issuance. The Belden businesses have performed satisfactorily, but the significant increase in stock options granted overstates reported income. While we can and do adjust earnings to reflect stock-option issuance, the change in the board’s attitude of apparent indifference toward its outside

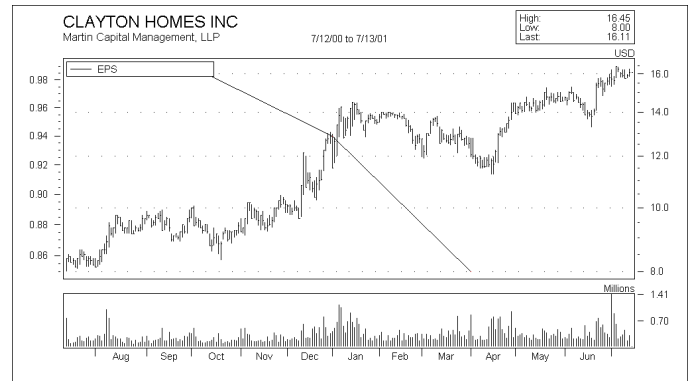
shareholders alarmed us. As the stock rallied in the second quarter, we sold our entire position. Despite the fact that BWC is a good business with attractive long-term potential, we have little tolerance for corporate governance abuses.



Clayton Homes (CMH)

CMH has weathered the storm in the manufactured housing industry in remarkable fashion. Indeed, the company elected to forgo its second quarter securitization of loans, because Clayton had a few hundred million dollars of excess cash that had been accumulating over the last few quarters. The impact of excess inventory and repossessions coming back into the manufactured housing market should be much reduced in the upcoming quarters. Nonetheless, the stock price is up substantially and, in many instances, it had become too large a position in a portfolio. Therefore, we have trimmed some of our holdings.

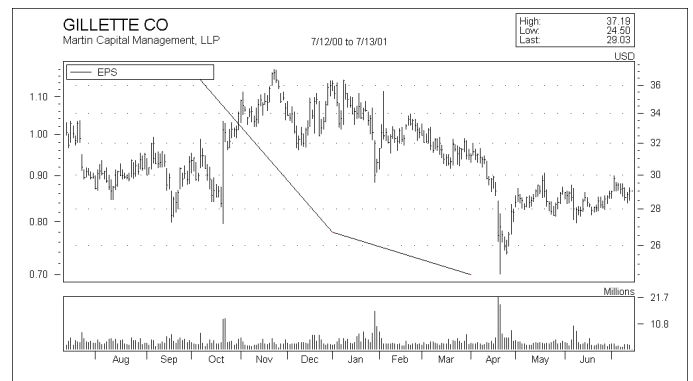
Because of its financial strength and diversity of operations within the industry, CMH holds a number of trump cards that may prove useful in a very difficult environment for virtually every segment of the manufactured housing industry, including finance. The company admittedly missed out on an opportunity to substantially reduce its share count through share repurchases well below \$10. Still, there may be other opportunities that arise as the cycle eventually turns.



Gillette (G)

This company has had its share of problems over the last several years. Some of them, like currency and economic trends in the lesser-developed countries, are simply beyond their control. Other problems have been self-inflicted. Still, there's no question that Gillette dominates the most attractive product category in consumer non-durables (72% market share in razor blades) and is the market leader in the fast-growing, but more competitive, battery business (Gillette owns Duracell).

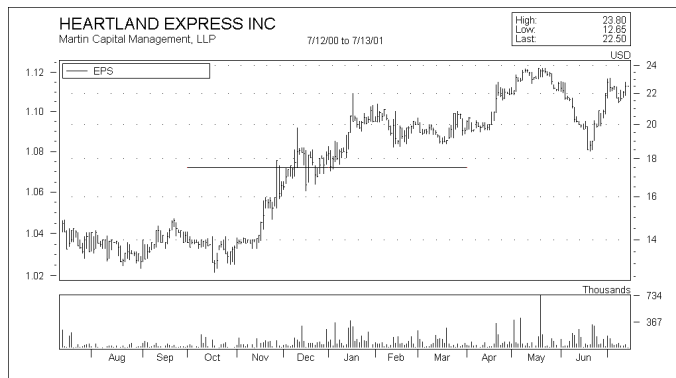
The new CEO, Jim Kilts, has outlined a number of problems currently being addressed. These include more accountability as the company moves from a matrix organizational structure to divisional management, more marketing support for its second-tier products, and an end to channel stuffing (building inventory in trade channels), among other issues. Some of the fixes will cost money in the short run, but Kilts is clearly positioning the company for renewed earnings growth.



Heartland Express (HTLD)

Heartland continues to perform extremely well in what has been described as the most difficult period in the history of the trucking industry. Economic pressures combined with skyrocketing insurance premiums, along with escalating driver pay and fuel costs, are punishing large carriers and devastating smaller ones. More than 1,100 trucking companies folded in the first quarter of 2001 alone, which is on top of a record 3,670 that went out of business in 2000.

The industry’s softness benefits HTLD in a number of ways. Obviously, the number of competitors (for both drivers and freight) is falling. In addition, Heartland has been patiently waiting (with \$140 million in cash) for acquisition opportunities. Eventually, the right opportunity will come along. We reduced our position solely because of the rapid rise in the price of the stock. As the stock price rose, the expected return from the investment declined proportionately, just as Heartland became one of our largest holdings. Success sometimes forges its own anchor. We couldn’t be more pleased with the way Russ Gerdin has been running the company and trust that Wall Street, in its manic-depressive nature, will give us a chance to beef up our position once again.

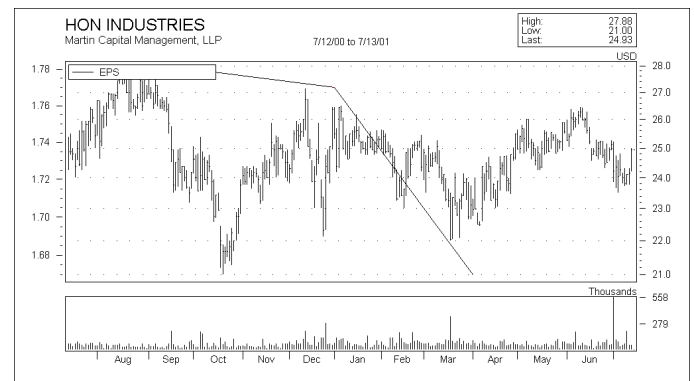


Hon Industries (HNI)

Hon’s major markets, office furniture and fireplaces, have been impacted by the economic slowdown. Even so, Hon generated a record amount of cash from operations in its latest fiscal year. Moreover, even with

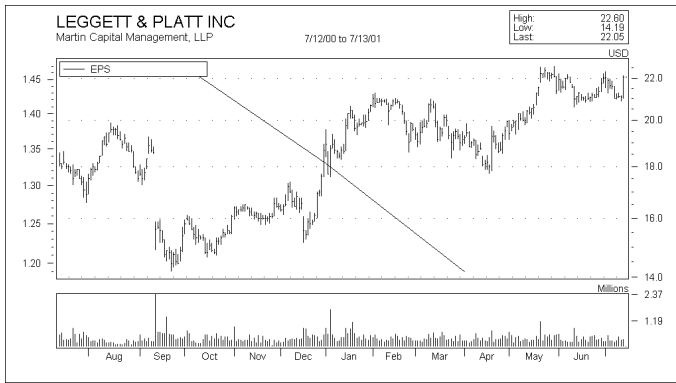
reduced earnings, the return on invested capital is superior to most businesses.

We recently hosted Hon’s CEO, CFO, and director of investor relations. During our meeting, it became obvious that there is a relentless force within the culture of Hon that forms the bedrock of the company’s obsession with taking the costs out of their products — a program known as RCI (rapid continuous improvement). Hon has regularly achieved 6-8% improvement in productivity (sales/employees) in each of the last 10 years. The ongoing drive to lower costs fits well with Hon’s product strategy, which emphasizes the value and convenience segments of its markets. It may be rough going for a few quarters, but the company has a stellar balance sheet and generates lots of cash. We look forward to the resumption of growth.



Leggett & Platt (LEG)

Much of what was said about HNI can be echoed about LEG, as weak markets take a short-term toll on LEG’s earnings. We have much confidence in LEG’s management team’s ability to make it through, and even take advantage of, the difficulties in its varied markets. LEG’s highly developed acquisition strategy (targeting firms with revenue of \$40 million to \$60 million) has proven to be a very profitable source of growth. Given the fact that LEG remains nicely profitable, even at reduced levels of business activity, the company will continue to generate enough cash to further fund acquisition or share-repurchase activity.



McDonald's (MCD)

MCD is sailing against strong headwinds. The continued recession in Japan (and other developing countries), a strong dollar, and the widely chronicled mad cow disease have made it very difficult for the company to maintain its growth machine. Even when these temporary factors fade away, it seems unlikely that MCD will be able to match its former growth rates. Nonetheless, we believe that the company will still be able to sustain a growth rate most large American businesses can only dream of — and we're confident that the price we paid for the stock is eminently reasonable.



Progressive (PGR)/Mercury General (MCY)

During the second quarter it became clear that the turn in the cycle we have been talking about has transpired. Obviously, the stock prices of auto insurance companies anticipated improved prospects, and we cut back our holdings in the auto insurance industry by half. Rather

than reduce our holdings in both Progressive and Mercury, we elected to sell our entire position in Progressive, primarily because it became quite a bit more expensive on a P/E relative to MCY. As usual, time will tell whether it was the right strategy.

If there were any fears that Progressive had become a broken company, its latest results laid them to rest. PGR is a remarkable machine as evidenced by the speed with which it addressed the changes taking place in the industry, in addition to a few company-specific issues. It seems likely we may someday own PGR again.

In the meantime, MCY is in the midst of rapidly improving fundamentals in its core California market. Competitors are swiftly increasing premium rates, and submission activity at MCY is growing accordingly. The company may be about ready to address one of its few weaknesses. The company has too much capital for the volume of business it's generating. MCY recently filed a shelf registration for a \$300 million debt offering, which we have reason to believe may be used to repurchase stock. Stay tuned.



Wabash National (WNC)

The board of directors of WNC recently asked the company's founder, Jerry Ehrlich, to step down as CEO. The following day the company announced that its losses for the second quarter will be more than expected, no doubt reflecting the troubled state of the trucking industry, along with more write-downs and restructuring charges, as the new interim management team attempts to get the company back on track. We applaud the board for making what had to be a very difficult decision. Jerry Ehrlich's unbridled optimism, vision, and knack for innovation led the company from the entrepreneurial stages to become an industry powerhouse. Unfortunately, some of those same traits (especially the unbridled optimism) make him ill-suited to manage a much larger and more complex company. Jerry Ehrlich will remain chairman of the board, which will allow the company to continue to leverage his product knowledge and customer relationships.

We believe the changes that can be made at Wabash will allow the company to finally leverage the advantages it enjoys in the form of proprietary products and distribution channels, assuming it exercises great wisdom in selecting a successor. These advantages should allow the company to achieve reasonable levels of profitability when the demand for truck trailers returns to a more "normal" level. If the company is able to realize its earnings potential, the shares are very reasonably priced. Thus, notwithstanding the avalanche of bad news we suspect will continue to plague the company for the next few quarters, we are once again buyers for those accounts that currently own only modest positions.

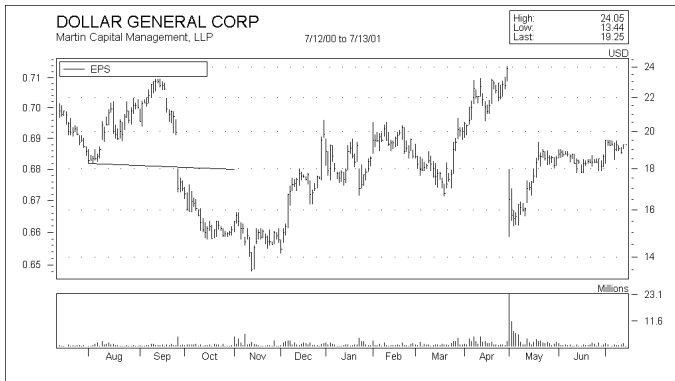


New Addition: Dollar General (DG)

We have established an initial position in Dollar General, a company with a stellar track record. DG stores attempt to offer the convenience of the ubiquitous "7-11" stores, but with greater variety of products at much lower prices. DG clearly occupies a niche designed to serve lower-income consumers. Nearly half of DG customers are over the age of 55. Two-thirds of DG customers earn less than \$30,000 per year (vs. the average U.S. household of \$38,000), and half of DG's customers earn less than \$20,000, making them eligible for food stamps.

DG operates roughly 5,000 stores that do close to \$1 million per year in sales, with a store-level contribution profit of around \$90,000. Including inventory and leasehold improvements, it costs DG approximately \$175,000 to open a new store. Most new stores are profitable in the first year. To date, the company has penetrated a relatively small segment of the United States in which it can open new stores, so there is considerable room for expansion.

Dollar General recently reported that it would be required to restate its financial results over the last three years. Cumulatively, DG made \$1.84 per share, and the restatement is estimated to be a relatively immaterial \$.07 per share. Nonetheless, investors are understandably nervous about the "cockroach in the kitchen" syndrome whereby the initial "shock" is often followed by others. Think of Oakwood Homes, Consec, and Cendant ... to name a few examples of that phenomenon. In each of those cases, however, the CEOs were, shall we say, men of weak character. That is clearly not the case with Cal Turner, CEO of Dollar General. Moreover, the company has grown very rapidly during this time, primarily with internally generated cash flow. We are inclined to view the restatement as a systems/controls issue that will be corrected by a new CFO, rather than a deceitful attempt to defraud investors. Turner, after all, owns 15% of the company.



Not Exactly Fishing in a Stocked Pond

Over the last 12 months we have seen a diminishing number of attractively priced stocks. Recently, we've seen some very good industrial companies' stocks — Kaydon and Dover, specifically — begin to slip as their business outlooks deteriorate. For the most part, however (especially for large capitalization stocks), valuations continue to be rich. Thus, most of our research remains focused on small and mid-cap companies.