

King Alan is (Almost) Gone! Long Live the King?

The future remains its usual uncertain self; but there is one certainty with which the world's financial markets must deal in the upcoming months; the retirement of Alan Greenspan as Chairman of the Federal Reserve. While most of Wall Street seems content being glued to the Weather Channel or pondering when the cost of filling up the family Hummer could approach three digits, we suggest that these risks can be priced and managed by the market. However, entering 2006 with a new man in what some consider the world's most influential position is an underwater risk that, as Greenspan himself notes, represents new concerns.

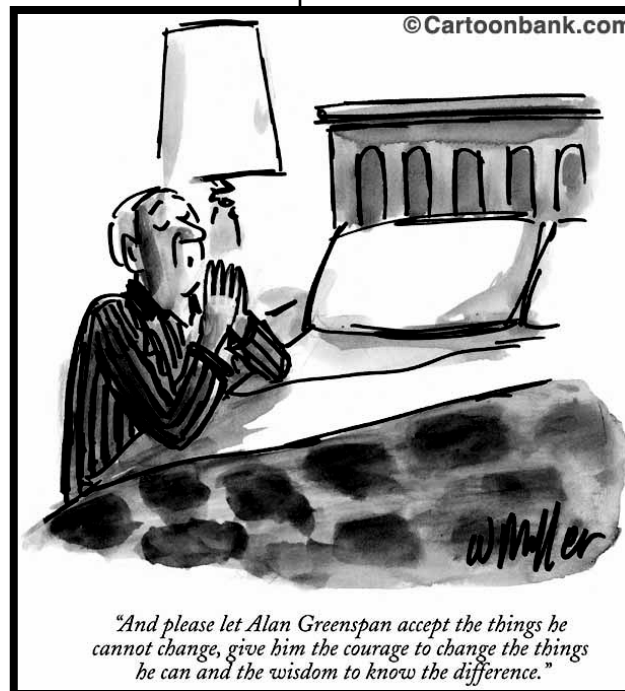
The occasion referencing these thoughts was the 2005 Annual Symposium of the Federal Reserve Bank of Kansas City held in Jackson Hole, WY. While it is unclear how much of a bash it was given that the attendee list was composed almost entirely of aging economists, this year's event was billed as "Farewell to Alan."

There continues to be much debate about Greenspan's reign: is he the Michael Jordan of central banking, or is he single-handedly responsible for creating two of the greatest bubbles in recent history, the aftermath of which remains an uncertainty? Probably a little bit of both would be our answer if pressed, but what matters going forward is that if he is The Greatest,

he has neglected to tell anyone else how to perform a repeat act when he is gone. Greenspan's most interesting feat is that he managed the Herculean task of introducing economists to the age of celebrity and humanized the role of central banker like no one before him. His peers praise his intellectual flexibility, his eclectic views on economics, and his ability to avoid being slavishly devoted to any particular model or methodology.

Those are terrific qualities for an investor and thinker, but they also destroy the illusion of a grand magician and settle us back down into the realization that Greenspan is as human as the rest of us; he assimilates information, processes it, reaches conclusions and then begins again. The next logical step is, if he is human, he is perfectly capable of being wrong and that is where his successor comes in. It is difficult to imagine a worse position than to succeed Greenspan and be at the epicenter of global second guessing. It is impossible to find someone on earth with enough gravity and credibility on day one to equal a persona eighteen years in the making and more carefully cultivated than that of Bob Dylan.

Why does this matter and why should we care? After all,



stocks have appreciated an average 10.5% for each of the last 80 odd years, while plenty of both good and bad choices have come from the office of the Federal Reserve Chairman. For some insight, let's return to Jackson Hole for words from the man himself.

After starting with some unremarkable perceptions of the obvious, like taking a few pot-shots at the housing market, he got to the heart of the matter. "Given our inevitably incomplete knowledge about the key structural aspects of an ever-changing economy...the paradigm on which we have settled has come to involve, at its core, crucial elements of risk management." This is the heart of the debate over Greenspan the Genius or Greenspan the Moral Hazard. Is anyone capable of consistently divining the future in order to correctly assess major risks and then take what will be considered the correct monetary path? Even if that is possible (it's not), is it desirable?

It has been argued Greenspan's policies to avoid the outcome of his perception of worst case scenarios or global financial disasters have significantly reduced the risk that accompanies certain behavior in global financial markets. This elimination of moral hazards of levered speculation in everything from Las Vegas condos to global fixed income arbitrage to currency machinations courtesy of foreign central banks naturally emboldens participants to speculate further, confident Uncle Alan will bail them out again with aggressive monetary easing should things get a little hairy.

Greenspan continues: "The lowered risk premiums – the apparent consequences of a long period of economic stability – coupled with greater productivity growth have propelled asset prices higher...Such an increase in market values is too often viewed by market participants as structural and permanent. To some extent, those higher values may be reflecting the increased flexibility and resilience of our economy. But what they perceive as newly abundant liquidity can readily disappear. ***Any onset of increased investor caution elevates risk premiums and, as a consequence, lowers asset values and promotes the liquidation of the debt that supported higher prices. This is the reason that history has not dealt kindly with the aftermath of protracted periods of low risk premiums.***"

Therefore, our point is that Greenspan's passing of the baton to Ben Bernanke, creates a new and exciting risk

for the financial markets; most importantly, a risk that has not been well factored into equity and fixed income pricing. What will become an interesting dynamic is that of the new Fed Chairman seeking to "prove" his monetary manhood, and the only practical way to do that outside of tabloid exploits is by raising interest rates and erring on the side of conservatism. Since stocks remain mostly fairly valued, intermediate to long-term bonds reflect few macroeconomic risks and credit spreads reflect nothing more than greedy hands reaching for tiny yields; the real bullish case to be made is the flattening/rising interest rate cycle is on the verge of turning around. We are not quite sure that scenario is quite likely in the short to intermediate term, which creates the highest probability outcome of more churning around a trading range for the equity markets.

In news from the home front, Reed Conner & Birdwell LLC (RCB) is in the midst of a distinctly mediocre year as far as both relative and absolute performance is concerned. The cornerstone of long-term success for any investment firm is obviously good performance and as RCB has grown to \$4 billion in assets, we have been able to deliver this for our clients. A fact of investing life, however, is that good long-term performance is not a linear, quarterly function. Like many roads encountered on a journey, it can sometimes be frustratingly bumpy. In fact, we suggest that our long-term success is in no small part due to our ability as a firm to withstand intermediate periods of time (the shorter the better!) during which we appear to be doing all the same things on the field, but the results take their time to appear on the scoreboard. The statistics behind great long-term investment records reveal that quarterly outperformance occurs something less than 60% of the time, the key being not to be very wrong when you are not the top dog. Flexibly sticking to our knitting has served us well over more than four decades and we remain vigilant in the search for undervalued opportunities in an environment that we still consider not to be very target rich.

In 2005, the main difference between plodding along as we have done, and actually having a pretty good year has clearly been one's exposure to the energy sector; the stocks of which are up an average 41% through the third quarter. It would be basically fair to come out and state, and not for the first time, that: "we missed it." The saying goes something like this: "when a commodity with a reputation for unpredictable price volatility meets

a manager with a reputation for being unable to forecast commodity prices, it is the reputation of both that remains unchanged.” Internally, we have discussed the economics of the oil industry for the past eighteen months in nauseating detail, and in fact we have a terrific energy analyst, Geoffrey Stewart, who does excellent company work. The simple fact is that as a “value firm,” we missed the early money and recognize the behavioral finance dilemma that comes with buying stocks that have appreciated quickly by arguing they are still inexpensive after 50% price increases where your entire variable of success is predicated on a commodity number that drags a dismal record of forecasting behind it. *Naturally*, the energy stocks appreciated another 50% from that determination.

Having made one mistake, our current position is that paying today’s prices for most energy stocks is a second one. Oil is actually reasonably plentiful in the world, aside from some short-term post-hurricane disruption, and much of the “price” movement during the past six months has been demand and speculation-driven rather than supply-driven. What that means to us is that it does not take much of a global economic slowdown to take a decent club to pricing and hence the securities behind it. While we respect the longer term secular arguments for higher energy pricing, we suggest the increasing volume of questions on this particular theme, some of them involving our sanity, has usually indicated in a variety of topics and sectors the vicinity of an inflection point in the trend du jour.

We argue that the biggest risk from our thinking regarding energy prices lies in Washington, not the Middle East, Venezuela or the Gulf of Mexico. The market forces of the world are working overtime developing both short- and long-term improvements in energy efficiency and carbon alternatives, something you would think the environmental movement would be crowing about as it finally gets what it wants due to natural causes. The potential for inanity out of Washington in order to “do something” to interrupt this extraordinarily high energy price environment is worrisome (witness the sun-drenched intellectual reasoning of our Hawaiian elected officials who neatly capped gasoline prices at an arbitrary rate).

Closing on a very positive note, while our trailing long-term performance has been a wonderful friend to our existing clients, it says little to our new or potential

clients, who are focused on the *next ten years*. We would like to reiterate we have never fielded a better team than the one currently in uniform and that extends from research and trading to administration and client service. This is a people business and on that basis alone, we are bullish on our ability to protect and grow client capital. We recently added a long-term friend of the firm and a seasoned investment professional, Joel Schiffman, to our client service and marketing team, and his ability to communicate portfolio strategy to our client base is equivalent to adding another research analyst in terms of enabling the investment team to maintain focus on creating performance.

Lastly, we would be remiss if we did not further publicize the news that investment manager J & W Seligman announced they are suing Eliot Spitzer, alleging that he has exceeded his authority by launching an investigation as to whether their mutual fund fees are too high. Their claim correctly notes that only the Feds/SEC have this authority and the complaint goes into some fun detail about how the prospective Governor of New York tried to politically arm-twist Seligman officials. Let us recognize bravery when we see it!

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October 2005

The opinions expressed herein are those of Reed, Conner & Birdwell and are subject to change without notice.

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