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INVESTMENT STRATEGY LETTER

Investment Management Since 1959

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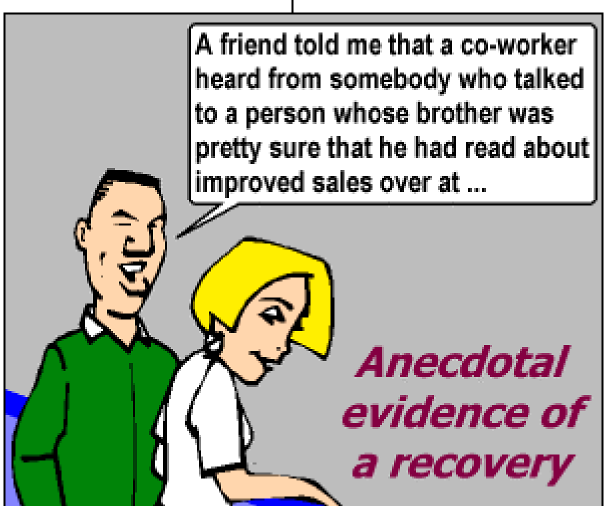
And Now For Something Exactly The Same

Since we do not write our Strategy Letter nearly as frequently as we would like, (New Year's Resolution #4), it will be necessary once again to fall prey to the temptation to address a variety of issues in one sitting. While we remain confident that all readers' eyes eagerly scan our writings until the end is reached, as a contingency plan we will start with a brief commentary, followed by some bigger picture issues that we feel are crucial as investors and important for clients and associates in understanding how we view the world in general and their money in particular.



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On no other topic is Shakespeare's line "'Tis Better to be Brief than Tedious" more applicable than in regard to an exposition of what lies ahead for the financial markets in 2002. Newsflash! The Future Remains Uncertain. Nonetheless, the investment world is full of erudite people who seemingly have lots of time on their hands and who enjoy stating much that is obvious and of little help at best in making clients money. While we can more than hold our own on a variety of grand economic and investment discussions over dinner and a decent wine, we prefer to reserve our daily routine for areas in which we feel we can add value: those being the analysis of businesses and the valuation of stocks.

On the other hand (just to show we know how to play the economics card), this is a Year-End/New Year Letter, so we will allow ourselves some additional space to address grander themes. Specifically, our view of the "Big Picture" is virtually unchanged from mid-summer with a couple of minor caveats. While we turned decidedly bullish for about three weeks post Nine-Eleven given the price declines for the stocks of numerous businesses, we have slunk back into a neutral position with the subsequent and substantial rally.

The economy remains fairly rotten with little upturn in sight and now our European friends join us in the quagmire. The Federal Reserve Board's nearly unprecedented rate cutting binge, while it beats a sharp stick in the eye, has had little to no effect on economic activity; the major reason being that this is a recession driven by oversupply rather than high interest rates choking off rabid demand for goods and services. (See our July 2001 Letter "The Epic Battle" at www.rcbinvest.com.) We maintain a healthy intellectual tension between two opposing viewpoints of the future, a tension which once again is unrelieved by 2001 proving to be yet another nail in the coffin of successful economic forecasting.

One view holds that we are in a recession, that recessions/low growth environments rarely stagnate for longer than two years, that stocks anticipate the upturn, and that therefore we are pretty close to a major economic/earnings/equity price bottom, if one wasn't already seen in September. The huge drop in energy prices plus the government-induced mortgage-refinancing boom adds to this probability. To suggest that the market is overvalued is an erroneous extrapolation of trough earnings and cash flow, just as it was flawed methodology to attach too much valuation support to peak earnings and capital returns at the top of the capital spending cycle two years ago. Stocks have also not posted losses for three consecutive years since the 1930s.

The other view, which is annoyingly well espoused by a number of overeducated bears, is that we are in a Japanese-style environment with years of stagnation to which we may look forward; Greenspan's monetary policy is pushing on a string and will continue to be ineffective; stocks overall are still woefully high in relation to nearly any historical valuation measure; and, therefore, equity investors will be hung out to dry for a multi-year period with a low probability of capital gains.

If we had to be pinned down once a year, we would state that we have moved toward the former argument since Nine-Eleven, as the international geopolitical catharsis has also had a similar effect on corporate behavior. The recession denial of the past 18 months was blown away and aggressive actions have been taken both on a company as well as a macroeconomic level, all of which make an economic/earnings upturn more attainable within a much tighter time horizon. So we believe we are much closer to "back to normal" as far as the financial markets are concerned than many might consider, but we caution readers to understand that "normal" for equity return expectations is much closer to a historical high single digit number than anything we've seen in the past ten years. In fact, it is not terribly far-fetched to suggest that the 20% annualized rates of return in the 1990s should be considered to be as much as an outlier as 20% interest rates were in the early 1980s. Therefore, investor behavior that anticipates or positions for a return to that era has a high probability of producing an unsatisfying experience. This also applies to corporate management who continue to maintain a "12 to 15% earnings" goal that is equally unattainable and unsupportable by the last 100 years of economic history.

In reflecting upon the year past, one of the biggest "takeaways" in regard to financial markets is that investing is not a game nor should it be viewed as entertainment, unless you have decided to allocate a sizable portion of your discretionary dollar to treat it as such. To compare it with another major disappointment of the past year, there is a whole world of difference between firing at a tight flag bordered by water from 210 yards and saying, "oh, what the heck, I just plunked two golf balls in the water", and putting 70% of your net worth in the trend du jour to see how things turn out.

Much of what constitutes good investing involves a fairly mundane process of reading and evaluating things like process improvement in the faucets and bathroom fixtures business and its effect on increasing cash flow, debating the finer points of 7% versus 9% growth rates on discounted cash flow values, or determining what a proper "days outstanding" number should be for receivables. In fact, given the plethora of potentially rewarding activities available to people with money to invest, much of what constitutes good investing should be considered "boring" in social gatherings and delegated to the proper corner of the world where people consider investing money a living rather than entertainment.

Over the past few years, it has never ceased to amaze us just how much conversation at the gym, in restaurants, family gatherings or elevators has centered on stocks or has begun with the phrase, "Did you see on CNBC this morning…." An excellent right brain case can be made that it is highly unlikely that stocks will achieve anything remotely close to stellar returns again until their mention is verboten in polite conversation and they are relegated to a social dustbin that will inevitably be coincident with an extraordinarily low valuation and buying opportunity. In other words, we envision something akin to a national gestalt whereby it is true that the stock does not know we own it, but yet it doesn't seem possible for it to go up until we are done selling it.

The great fallacy of the Internet and its supposed ability to take investing out of the hands of the alleged elite and bring it to the masses is that it doesn't eradicate these issues, and in fact it further blurs the line between entertainment and the dull purpose of investing which is to compound dollars over long periods of time to fund dedicated needs. The marginal utility of additional information has clearly reached zero, as access to corporate information and real time pricing has obviously not made many people better investors, leading to mappable behavioral flaws like overconfidence and too much trading as it becomes difficult to see the signal amongst the noise.

To make matters worse, as was recently noted in the November 2001 issue of the unusually interesting Journal of Psychology and Investing, it is not easy nor is it innately natural for human beings to possess the inclination much less the intellectual discipline to execute the reasonably disciplined decision-making process to be a successful long-term investor. In fact, our genetic imperative, according to studies cited in the Journal, sets us up for exactly the opposite. The basal ganglia in our brain control primitive emotions and impulses such as fighting, fleeing, hoarding, breeding and *herding*, while the neocortex portion of our brain processes ideas through reason. Unfortunately for the investor, our limbic system produces emotions that enhance the base actions of the basal ganglia and it has been determined to respond more quickly than our neocortex responds. Therefore, we instinctively seek and desire to herd together and be accepted in the warm community of those who are buying Cisco at $140, and the rational thought of "maybe I should take the weekend and review the assumptions behind what it means to sell at 100 times earnings" is overwhelmed. We instinctively shun the unpopular and experience palpable symptoms of emotional and sometimes physical discomfort when it appears that you are the "only dope" to possess a contrary thought. In other words, buying stocks when they are low and selling them when they are high is not part of our genetic imperative.

In an investment management firm, we constantly struggle with these issues and we would like to believe some of our success has derived from an ability to at least recognize them and seek to minimize their effect. While it is somewhat of a running gag at RCB, we joke that if we have more than one person strenuously agreeing with a position, we should fire them because the second opinion is merely an expensive redundancy and makes the rest of us nervous.

A ***very*** tangible way to see these issues at work is in regard to the positioning of one's portfolio to the S&P 500. Despite nearly overwhelming evidence that the only way to outperform a given benchmark net of fees is specifically to be different from it, it would seem that an investment manager must posses superhuman mental strength to develop the fortitude to stray from it, judging from what we read in the financial press and experience as players in the "industry" of investment management. In the late 1990s, just as in the late 1960s, many investment managers felt intense pressure to buy the 50 largest stocks in the S&P 500 and/or any number of insanely valued tech stocks because it was considered to be professional suicide to deviate from the consensus. Despite the short-term satisfaction derived by extreme groupthink and the moral support from the herd, this behavior is invariably counterproductive to longer term results and exactly the opposite of what a serious investor must do. Yet this thinking continues to dominate the behavior of a majority of investors who continue to purchase stocks that have already gone up but now represent a higher proportion of the index and sell or ignore stocks that have already gone down because they are a small piece of the index.

This inanity has gone so far that one of the world's largest corporate pension plans, Unilever, actually sued a money manager in the UK for "underperformance" versus an index. (The case against Merrill Lynch was recently settled prior to a jury decision, with Merrill Lynch paying a significant sum without admitting guilt, etc.) This was a value manager who had superior performance for nine years and the basis of the lawsuit was that the manager then underperformed for an 18-month period that not surprisingly coincided with the Dot-Com boom. We are not talking about losing money or fraud, but underperformance. As to why an allegedly sophisticated client would pay an investment firm substantively higher active management fees and, at the same time, terrorize the manager into guaranteed mediocre performance, is an unanswered question.

While we have got savvier as a firm and examine our results ex-post facto in order to be able to explain to enquiring minds how and why we choose to be different, we ***absolutely and utterly*** do not try to look like a particular index or attempt to position a portfolio in a way that is pleasing to what passes for consensus thinking in the media or the investment industry. Most clients would agree that a portfolio that is pleasing to look at is one that has delivered solid results over an extended period of time, despite its inability to bring a cocktail party to life with its contents or enhance your ability to bond with your fellow man.

So in the new year, we again begin by seeking to avoid repetition of old mistakes (leaving plenty of room for imaginative new ones). As we have noted ad nauseam, the math of avoiding a preponderance of stupendous mistakes works very much in the investor's favor. If we can get that right, much of what follows is made much easier. Since any attempt at a written "game plan" in the investment business is nothing but an unnecessary sacrifice of a perfectly decent tree, we remain opportunistic and optimistic that the follies of our fellow man in the financial markets will continue to produce both severe under- and over-valuation of common stocks. We will strive to be vigilant, to seek out what truly represents value, be diligent enough to recognize it and then have the fortitude to step to the plate and take a substantial position solely on the basis of its merits as an investment.

On that note, we have made what we feel to be key additions to our firm over the past year in order to improve the veracity of our statement in the previous paragraph. Jim Henderson joined us this past summer as a Senior Portfolio Manager/Analyst with substantive research responsibilities and Brett Cicinelli recently joined as an equity research analyst. While the rules of small numbers may superficially alter the following statement, we think it says a lot about our firm when our ratio of investment professionals to Marketing and Client Service professionals is eight to one. Our affiliation with City National Corp. has begun to bear fruit and their focus on distribution and administrative issues further enables RCB to focus on what is truly important (but often forgotten) as an investment manager: taking care of clients and generating better than competitive returns.

Our best for the New Year.

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Note: Past performance is not indicative of future results.

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