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2004 in Review: Surprise, Surprise

At the beginning of 2003, the Standard & Poor's 500 Index traded at 18.7 times 2003 expected earnings of $47. At the end of 2004, the S&P traded at 18.9 times likely 2004 earnings of $63.25. These valuations are in line with the historical average of 18.6 when inflation is below 2.5%.

While valuations held steady, earnings greatly exceeded estimates. According to Goldman, Sachs, earnings for 2003 came in at $53 versus a $47 estimate at the start of the year. Earnings for 2004 should finish near $63.25 versus a starting estimate of $58. These unexpectedly large earnings gains are responsible for unexpectedly strong stock price appreciation. This is consistent with our view that appreciation in the market averages is dependent upon earnings growth unaided by valuation improvement.

Earnings surprises in the aggregate are never unexpected. We believe the large forecasting errors over the past two years can be attributed to the difficulty predicting earnings coming out of recession. With economic conditions normalizing, forecasting error is diminishing. More significantly, downward revisions are running ahead of upward revisions. This marks a return to business as usual with actual results falling short of overly optimistic Wall Street projections.

2005: Show Me the Earnings

Earnings forecasts for 2005 are muddied by the inconsistent treatment of stock options expense. Under current Generally Accepted Accounting Principles or GAAP, companies can issue options to employees without counting them as an expense. Some companies voluntarily expense options in full. Some expense options in part. Most do not expense options at all. Whatever the accounting treatment, options have value to employees and represent a cost to the company and its shareholders. They are as much a form of compensation as salary. Financial statements that do not include the cost of options are, to say the least, misleading.

How big is this expensing loophole? As the table below indicates, a well-known computer company, which ignores the expense of stock options, reported cumulative GAAP earnings of $1.08 per share for fiscal years 2002-2004. According to the options-adjusted earnings buried in the footnotes, the company lost 29 cents per share.

Year	FY 2004	FY 2003	FY 2002	3-Year Total
EPS as reported	.71	.19	.18	1.08
EPS after options expense	.44	-.27	-.46	-0.29

This company is neither the only offender nor the worst. Options accounting abuse is rife - particularly among technology companies - and investors who care to look are already seeing more dirty work at the crossroads. Although options normally vest over five to ten years in order to promote employee loyalty and long-term focus, several technology companies fully vested all unexpired option grants in 2004. This accelerates their entire options expense into 2004 and eliminates any hit to earnings going forward. Meanwhile, another technology company shortened the expected life of its options. This significantly reduces the putative value of the options and minimizes their earnings impact.

These deceptive actions were taken in anticipation of a change in accounting rules. In December, the Financial Accounting Standards Board did indeed announce that the cost of options must be included in GAAP accounting for quarterly and annual reports after June 15, 2005. This will have a large negative impact on the reported earnings of many companies. While we have been incorporating options expense into our analysis for some time, it remains to be seen how analysts, investors and companies will react. Presumably, analysts will cut estimates, investors will flee in horror and companies will rein in options issuance. "'Tis a consummation devoutly to be wished" but getting from here to there is going to be a problem.

Bottom line, Goldman, Sachs is expecting options-adjusted earnings of $66.50 for the S&P 500 in 2005. It expects unadjusted earnings of $69.50. If logic and the $66.50 number prevail, the S&P has minimal upside in the year ahead. As for the average stock, Value Line's median forward p/e of 19.3 is high by historical standards and median 3-5 year appreciation potential of 35% is associated with flattish markets.

As described below, what little upside exists is predicated on actual inflation falling to "core" levels and valuations remaining at historical norms. Better-than-expected earnings or above-average valuations represent additional opportunity. Worse-than-expected earnings, higher-than-predicted inflation or below-average valuations represent additional risk.

The Comeback Kid

Most discussions about inflation begin and end with the so-called "core" Consumer Price Index. The core CPI excludes changes in food and energy costs. It increased a mild 2.2% over the past year and supports stock market valuations of 18-19 times earnings.

For those who eat and use energy, actual CPI inflation of 3.5% over the past year provides less comfort. Inflation at this rate is a significant threat to the economy and investors.

In the equity market, higher inflation is associated with lower valuations. Inflation between 2.5% and 3.5% is associated with an average S&P p/e of 17.7. Inflation from 3.5% to 4.5% is associated with an average p/e of 12.1. Reduced valuations could easily drag the market down even if earnings grow.

In the bond market, higher inflation leads to higher interest rates. Although the Federal Reserve Board raised rates five times last year, a fed funds rate of 2.25% remains well below inflation. Ten-year Treasury bonds at 4.2% and 30-year bonds at 4.9% are marginally above inflation on a pre-tax basis. Although bond prices were basically unchanged in 2004, it seems inevitable that bond prices will fall and interest rates rise from current levels.

For the economy, an increase in interest rates puts growth at risk. Much of the strength in the economy has come from rising house prices and mortgage refinancing. Homeowners by the millions have taken advantage of low interest rates to either reduce their monthly payments, take money out of their house through a cash-out refi or both. Higher interest rates put the kibosh on monthly payment reduction and may impede or roll back house price appreciation.

If and when longer-term interest rates rise, the stock market will confront both earnings risk and valuation risk. In the best case, the economy will sail through with inflation quiescent, economic growth strong and stock valuations steady. In the worst case, the economy will sink into the stagflation of the 1970's with inflation spiraling upward, growth fading and stock valuations falling.

DEE-FENSE

On balance, there is more risk than reward for the stock market averages in 2005. Earnings are unlikely to exceed expectations, particularly since most estimates do not reflect stock options expense. Valuations have more downside than upside since they reflect an inflation rate below current levels.

Of course, we care about our stocks, not the market averages. Here, we can be cautiously optimistic.

In our universe, we literally classify stocks as buy, sell or hold. Stocks are buyable for fully invested accounts when they have 40% appreciation potential over the next 12-24 months based on reasonable expectations for earnings and valuations. Stocks which no longer meet this purchase threshold but have not reached their sell target are holds. Stocks which reach their target prices become salable. Reasonable expectations for valuation are conservatively based on long-term medians, not the elevated valuations currently placed on the market averages.

As more of our stocks are classified as holds and fewer as buys, overall appreciation potential shrinks. While we remain convinced that worthwhile returns lie ahead, it is nearly certain that returns will be modest by past standards. As Yogi Berra said, "The future ain't what it used to be."

Regarding new ideas, it is difficult to find buyable stocks. Although we are searching with an ever-widening net, a fully valued market combined with a lack of dispersion among individual stocks has created a dearth of opportunities. We are confident that opportunities will arrive but "who knows where or when."

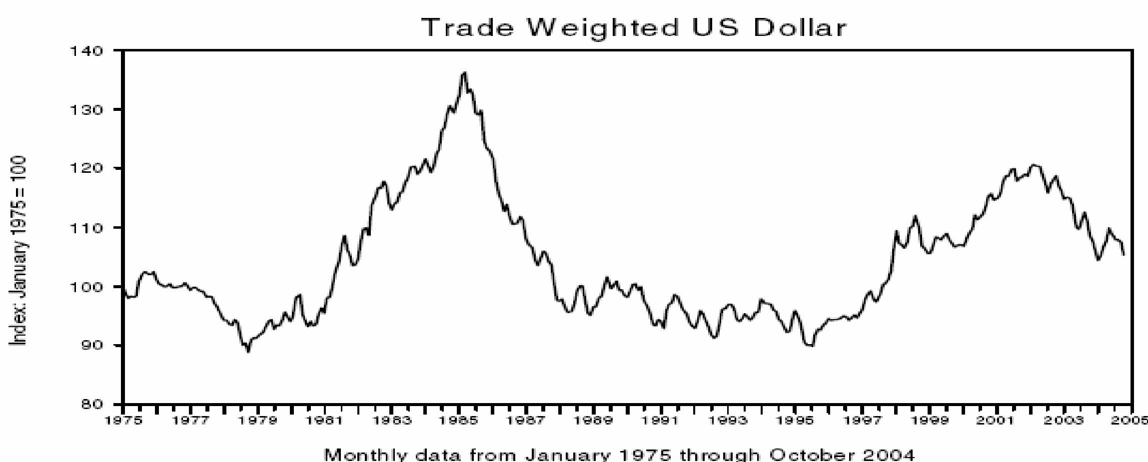
The Dollar is Falling

One can hardly pick up the newspaper without reading about the "plunge" or "collapse" of the U.S. dollar. For those who have not been watching closely, the Euro once traded at about 80 cents and now trades at about $1.35. The dollar has had less extreme declines versus the Canadian dollar and other "Western" currencies. The Chinese yuan and, by extension, most Asian currencies are pegged to the dollar so fluctuations have been muted.

As the chart below indicates, the bigger picture is not nearly as dramatic as the headlines suggest. While the dollar has fluctuated considerably, its trade-weighted value in October was slightly higher than its value thirty years ago.

Two points should be made. First, currencies frequently overshoot the mark. From September 1998 through January 2000, the Euro fell 30% against the dollar. After four years of rallying, the Euro is about 20% higher than it was six years ago. The dollar's decline from its average level is much less severe than the decline from its extreme.

Second, one would be hard pressed to connect the value of the dollar to U.S. budget deficits, trade deficits or interest rates. For example, the dollar was strong in the early 1980s when budget deficits and interest rates were high. The dollar was strong in the late 1990s when the budget was in surplus and interest rates were low. Trade deficits have been common for decades.



Source: US Federal Reserve.

For our part, our interest in international investing generally stems from its growth potential. The multi-national companies in our portfolios – whether headquartered in the U.S. or abroad – operate in areas that may be faster growing or on different economic cycles than the U.S. While a falling dollar is a "plus" factor for these investments, it represents the frosting rather than the cake.

We could fill pages speculating about the direction of the dollar and the repercussions of change. Suffice it to say that we take currency into account when making investment decisions.

Summary

Many investors are throwing caution to the wind after two years of surprising strength in corporate earnings and stock prices. At current levels, the stock market averages anticipate both continued earnings growth and lower inflation. Accounting gimmickry in options is being ignored. Meanwhile, interest rates are astonishingly low compared to inflation. It seems likely that rates will rise and bond prices fall.

Investors seem to have forgotten that defense, not offense, wins championships. Investment losses count for more than gains. The S&P 500 fell 50% from its 2000 peak to its 2002 low. After rallying 50%, the S&P remains 25% from its peak.

We intend to stay on defense by selling stocks as needed, maintaining our standards with regard to new purchases and holding cash if opportunities are absent.

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