

2003 STOCK SELECTION REPORT CARD
THE GOOD, THE BAD AND THE UGLY

Stock	2003 Return	2003 Grade	Date Of Initial Buy	Comments
Analog Devices	91%	A+	12/00	<p>Our semiconductor stocks experienced a dramatic reversal of fortune from 2002. (If you are one of those clients who were kind enough to forget, <u>all</u> four semiconductor stocks received a grade of F last year.) In last year's report card, given the poor stock performance of these stocks in 2002, we needed to go into detail on the business models and fundamentals of each company. This year, given current valuations, an industry review seems more in order. Since investing in this group over the past ten years, we have come to the following conclusion: if an investor can make money investing in semiconductor stocks, they can make money investing in almost any other industry. Why do we make such a claim? The <u>future</u> performance of semiconductor stocks quite often diverges from <u>current</u> semiconductor company and industry fundamental news. The current pricing of stocks is always a constant discounting of future expected news. Changes in expectations drive changes in prices. Reported news is most often just a confirmation of expectations. Most investors (so-called professional investors too) never master this key relationship. Successful investors must be proactive, not reactive. Recall the dismal state of affairs in the semiconductor business in the fall of 2002. Business was awful. The industry was in the midst of its worst cyclical decline in its 30-year history. Rare was the company executive who even hazarded a guess on when the industry would turn around. Few Wall Street analysts had "Buy" ratings on any semiconductor stock. Very few investment management firms listed a single semiconductor stock as a top holding. <u>This is what cyclical bottoms in these stocks are made of.</u> Today the situation is the polar opposite in both expectations and opinions. Semiconductor company executives wax enthusiastically about how good current business is. And they should – current business is great. But (you knew this was coming!), semiconductor stock valuations are at multidecade highs. <u>This is what cyclical tops in these stocks are made of.</u> We entered 2003 with overweighted positions in these stocks. We enter 2004 at an underweight. Great companies all (in fact, some of the best business models we have ever followed), but very pricey stocks one and all. We expect these stocks to <u>underperform</u> their respective businesses in 2004.</p>
Applied Materials	72%	A	1/96	
Intel	107%	A+	12/93	
Linear Technology	64%	A	5/96	

Amgen	28%	C	3/93	<p>2003 was a very good year for Amgen. It was a year of solid corporate development and the stock responded in kind. The stock rose very sharply through mid-July (up 50%) on the heels of good news and high expectations. The stock drifted lower on valuation concerns and worries over Medicare reimbursement. The Company's key products delivered impressive results during 2003. Aranesp is the Company's second-generation red blood cell treatment for chemotherapy-induced anemia. Aranesp has a longer half-life than the Company's first generation anemia treatment (Epogen), which allows anemia patients to be treated with significantly fewer doses. Aranesp is taking share from Johnson & Johnson's anemia treatment (Procrit). The Company expects their anemia franchise (Epogen and Aranesp) to generate global sales of almost \$5 billion in 2004. They also expect their white blood cell booster franchise (Neupogen and Neulasta) to generate sales of \$3 billion in 2004. Enbrel sales continue to grow very well. Enbrel is a novel therapeutic that targets one of the major factors in the immune system which controls the fatigue, pain and swelling of rheumatoid arthritis. Enbrel is also an effective treatment for psoriasis. The Company expects sales of Enbrel to reach \$1.8 billion in 2004. The Company also expects to introduce a pre-filled syringe of a new formulation of Enbrel for once-a-week dosing to offset a competitive threat from Abbott Labs' Humira. Amgen continues to be a cash-generating machine. Gross margins should exceed 85%. Net margins should be their customary 30%. Free cash flow should reach nearly 30% of sales in 2004. The Company's cash hoard funds a burgeoning R&D effort and a \$5 billion stock buyback program. The Company expects to earn \$2.40 in 2004, +25% over 2002. We think the stock is cheap under \$65. We also expect Amgen to be one of our best performers in 2004.</p>
Berkshire Hathaway	+16%	C	12/98	<p>So, the master Buffett only gets a middling grade of "C" in a booming stock market. Has the master lost his touch? Far from it. From the same day the technology-telecom bubble burst (March 2000) – and Berkshire stock bottomed – these shares have gained over 110%. Despite their sharp rise in 2003, the S&P 500 and NASDAQ are still off their 2000 highs by –20% and –60%, respectively. 2003 will set the pattern of corporate activity for Berkshire over the next few years (absent a sharp bear market drop in stock prices). Buffett will continue to buy seemingly mundane mundane companies – Burlington Industries, Clayton Homes and McLane Company were acquired in 2003 - and Berkshire's growing list of corporate subsidiary children (39 and counting) will continue to send trunkfuls of cash to Omaha and Berkshire's Fort Knox-like insurance businesses will continue to generate huge amounts of low-cost float. Berkshire has changed dramatically over the</p>

years, but the importance and contribution of its insurance businesses (Geico, General Re and The Berkshire Reinsurance Group) has been remarkably steady over many years. In 1980 the insurance group made up 70% of assets. Last year the group made up 65%. Last year we tried to make the point that Berkshire was a surprisingly strong growth company. It still is. Here are the compounded growth rates from the Company's balance sheet and income statement over the past 8 years: cash: 32%, bonds: 46%, stocks: 5%, insurance premium earned: 51%, revenues: 38%, earnings: 38%, shares outstanding: 3.3% and earnings per share: 32%. Two items stand out – Buffett has reduced the importance of common stocks and he has grown Berkshire without a material increase in issuing new shares. In other words, shareholders have not been diluted with costly mergers and acquisitions. There is a big lesson here for all of Corporate America. We have underestimated the excellent underwriting that Berkshire's insurance subsidiaries have been posting over the past few quarters. Increasing our earnings expectations, we still find these shares (B shares) undervalued up to \$3,000 per share. We expect Berkshire to be one of our best performers in 2004.

Countrywide 50% A+ 8/03
Financial

We wish more of our stocks would react like this just after we buy them. Countrywide is our most recent addition to your portfolios. (Please see 3rd quarter client letter for more details.) The story – or shall we say our bullish story – on Countrywide is simple: we believe that the Company will thrive significantly better in a higher interest rate, post-refinance boom economy than Wall Street expects. A key driver of earnings will come from the Company's huge +\$650 billion mortgage servicing portfolio – an increase of over \$200 billion from a year ago. The Company expects 2004 earnings to be in the range of \$9 to \$12 per share. If you split the difference, the stock is valued at just 6.8x 2004 expected earnings. Even after the recent rapid 50% rise in the stock price, these shares are super-cheap. We expect the shares to be among our best performers in 2004.

First Data 8% D 4/03

In early April Concord EFS and First Data announced an all-stock merger. The surviving company would be the larger First Data. We viewed the merger very favorably and began investing directly in First Data shares by late April. So dominant would be the combined Company in certain electronic payment networks that the U.S. Justice Department wanted First Data to divest certain network assets. While First Data mulled over their options, we became increasingly worried that if First Data walked away from the merger, Concord would be in an extremely weak position as a standalone company. By the end of the year we had swapped our Concord holdings for more First Data

shares. In mid-December First Data and Concord reached an agreement with the Justice Department to divest certain assets to allow for the merger to proceed. We reviewed our thoughts on First Data in our second quarter client letter earlier this year. We have overweighted these shares in our portfolios given the Company's terrific business and its low current valuation. We believe the market is too obsessed with the combined companies' short-term earnings (no surprise here!) rather than how dominant the new Company will be in the future. Not only will the new First Data continue to dominate the processing of credit-card transactions (37% market share) and money transfers (82% market share via their Western Union division), but with Concord's Star network, the Company will process the transactions for over 70 million debit and ATM cards – or 50% of that market. Just remember this: every time you (or anybody else) swipe a debit, credit or ATM card, there is a very good chance that First Data's cash register rings again. We expect the Company to earn \$2.20 in 2004. The stock is cheap.

Gentex 40% A 12/97

Gentex has been a staple in our portfolios for six years. As one of our larger weighted positions in our portfolios over the years, the stock has been one of our best performers too. 2003's gain comes on top of the gain in these shares of +67% over 2001 and 2002 – when the market fell –33%! The stock's stellar advance over the years is no surprise to us. The Company continues to execute flawlessly. We are ever confident that the Company can grow in excess of 15% per annum for many years to come. The global penetration rate for auto-dimming mirrors is still only 13%. Despite annual price concessions, overall margins are held in check as more vehicles are incorporating more features per mirror. The Company's revolutionary auto-headlight dimming mirror technology (SmartBeam) is set to roll out in 2005. The Company continues to be an amazing cash-generating machine. Remarkably, +66% of net income has been converted to cold hard cash since 1995. By the end of calendar 2004 we expect the Company to have accumulated cash and investments to equal \$8.50 per share. We also expect the Company to earn \$1.60 in 2004. The stock becomes attractive for purchase in the mid-30's.

Home Depot 50% A 5/95

Wall Street's on-again, off-again love affair with Home Depot is on again. 2002 was a difficult year for the stock as many investors came to believe that new CEO Nardelli and his team were not up to the task of improving the Company. The bear-case held sway throughout 2002 as the Company's corporate performance fell short of rival Lowe's. Nardelli and team overreached with their merchandising strategies. Employee initiatives were too

draconian. We did not disagree with the points of the bear-case on the Company. Where our opinion did diverge from the then prevailing pessimistic consensus was that a “sub-par” Home Depot was still a cash generating machine. As the economy improved over the course of 2003, and as the Company improved as well, the financial results posted by the Company were stellar. The Company ended 2003 with the best average ticket per transaction (\$52.10) in their history, generated a return on invested capital of 25%, over \$6 billion in cash on the balance sheet and bought back \$1 billion in stock. Over the course of 2002 and 2003, the Company bought back \$3 billion worth of stock. They are currently authorized to buy back \$4 billion more. We believe that the Company can generate even more cash flow per share. They have invested nearly \$4 billion alone in 2003 for new stores and improvements in existing stores. The Company’s service goal is for 70% of employees to be on the floor serving customers (the other 30% restocking), versus just 30% just a few years ago. The current mix is 50/50. We expect the Company to earn \$2.10 in 2004. We like the stock under \$30.

Juniper Networks 175% A+ 5/01

After a dreadful 2002 (2001 was dreadful too!) for the stock, the sharp rise in these shares was a sight for sore stock ticker eyes. Telecom spending has slowly picked up. Spending in more strategic, next generation networks – where Juniper specializes – is picking up at a rapid clip. The Company’s decision not to downsize in the telecom nuclear winter of 2001-2002 continues to pay dividends. It is very critical to note that due to the very high gross margins (60%) that Juniper enjoys with their duopoly status with Cisco Systems in the all-important router market, and due to their cash-rich balance sheet, Juniper was one of the very few telecom equipment companies who even had the rare option not to downsize. As we noted in our 2002 year-end report card, Juniper was ideally situated to disproportionally reap the benefits in an increase in global telecom spending, given their deep product profile and their global presence. This is why we held on to the stock. So, business for the Company is great and 2004 looks like it could be a banner year for the Company. Now, what about the stock? Our blunt answer: In short, the stock’s valuation is lousy. As we mentioned, the Company is ideally positioned for operating leverage as telecom spending improves. To illustrate Juniper’s potential operating leverage over the next two years, assume that annual revenues grow a robust 50% from 2003 (\$681 million to \$1.1 billion) and operating margins double (13% to 26%) – annual operating earnings will then more than triple (\$.13 to \$.50). Great potential news, indeed, but at the current stock price (\$30) Juniper is valued at 80x 2004 earnings and 60x 2005 earnings!!. Great company – lousy stock. Could the stock go to \$40

or even \$50 a share in 2004? Sure. If Wall Street can collectively value this stock at 60X 2005 earnings, why not say 80X or even 100X earnings (a mere!) two years into the future!? We saw this fever-pitched movie in the Spring of 2000 – we did not like the ending. We are sellers at these heady valuations.

Legg Mason **59%** **A** **9/02**

Legg Mason had an outstanding 2003. The Company is that rare financial services firm that has changed its corporate stripes over time from a commission-based, full-service brokerage firm into much more of a fee-based investment manager. The Company ended the year with all-time corporate highs in revenues, income and earnings per share. The Company's Private Client Group had its best pre-tax margin quarter ever. Investment banking reached an all-time high. Assets under management (\$250 billion) are at an all-time high. Investment management fees as a percent of overall corporate revenue (65%) are also at all-time highs. Assets under management have grown at 25% and 32% per annum, 5 years and 10 years, respectively. Asset management pre-tax margins exceed 32%. Brokerage pre-tax margins reached 20% in 2003. We expect the Company to earn at least \$4.30 in calendar 2004. We are buyers in any meaningful weakness in the stock.

MBNA **32%** **B+** **6/00**

We had high expectations for MBNA for 2003 and the Company did not disappoint us. The stock posted a terrific return for the full year of 2003, but the real story was the performance of the stock from the final bear market lows in mid-March. Since those panic lows, the stock has doubled. The Company's unique affinity program guided the Company quite well as other credit card companies stumbled (some poorly) over the past two years. MBNA continues to be the world's largest monoline credit-card issuer with \$115 billion in assets. The Company's business model is predicated on a simple, but powerful fact: affinity-based lending leads to better borrowers. The Company's typical cardholder has been employed 11 years, has a family income of \$71,000, owns a home and has an 18-year history of paying bills promptly. The Company's loan loss is typically one-third less than industry averages. The Company has over 5,400 endorsing organizations and financial institutions. The Company's international efforts will continue to be a leading source of growth. MBNA International now has over ten million cardholders – two million new accounts in 2003 alone. Over 140 new affinity endorsements bring the total international endorsement to nearly 1,500. The Company's return on managed assets has grown for five consecutive years. Return on equity should once again exceed 20% in 2004. We expect earnings to exceed \$2.15 in 2004. The stock is attractive for purchase in the low

20's.

Merck **N/A** **N/A** **6/92**

We entered 2003 with very low confidence in Merck. Our concerns were over the Company's new product pipeline, post-Medco divestiture growth rate and post-Zocor patent expiration growth rates and profitability. The Company's strategy to grow solely through internal R&D (as opposed to a merger and acquisition strategy of Pfizer) has come home to roost, as the Company's pipeline is not living up to even the most pessimistic expectations. We made good money in these shares since 1989. If our antenna had been fine-tuned even more a year ago, we would have made more still. Nevertheless, we had to sell these shares.

Microsoft **7%** **D** **6/00**

Given the terrific returns enjoyed by technology stocks last year, a 7% return in these shares is a disappointment. Perhaps we should not have been surprised. Microsoft just might be the anti-technology stock. Recall back in 2001 when many technology stocks were getting hammered, Microsoft's stock rose 53% - it was our best performing stock that year. Microsoft is unlike many traditional "tech" companies in that Microsoft holds a monopoly position (a U.S. government blessed monopoly, by the way), generates steady earnings and cash flow and has a diverse (and growing) product line that is less economically and technologically cyclical than almost any other tech company we know of. In fact, we expect Microsoft shares to trade more like classic growth companies like, say, Pfizer. We expect these shares to underperform most tech stocks in booming markets like 2003 and outperform when the economy's growth rate slows - as we expect in 2004. The Company continues to reinvest its cash and investment rich balance sheet (+\$65 billion) to diversify its product line away from the traditional desktop PC. The company will likely generate over \$1.3 billion (not a typo) in operating cash flow per month in 2004. We expect these shares to be one of our better performers in 2004.

Nextel **143%** **A** **3/96**

Nextel continues to defy the few remaining skeptics. Just as recently as the summer of 2002, Nextel was widely viewed as just another busted, debt-ridden telecom company. Their industry-leading customer profiles and industry-leading margins and growth did not matter to Wall Street. Fast forward to the end of 2003. In 18 short months Nextel has evolved from an ostensibly debt constrained story, to a G.A.A.P. earnings story, to a free cash flow story. This amazing transformation has even surprised the growing legion of Nextel bulls. The stock, as one would expect, responded in kind. To the chagrin of the long list of short sellers the stock has risen **11-fold**

from those seemingly dire days in 2002. The Company earned just \$.12 per share in 2002. We expect full year 2003 earnings to reach \$1.40. If 2004 capital expenditures remain at management's current level of expectations and customer churn trends down (a good thing), 2004 earnings could very well reach \$2.00 per share. The stock will be headline-driven over the course of 2004 from merger and acquisition rumors to multibillion spectrum purchases. These bullish expectations of ours are above current consensus. We would like to take advantage of any pullback in the stock to add to positions.

Paychex **35%** **A-** **4/01**

Paychex is a terrific business and 2003 was business as usual for the Company. The Company only has one comparable competitor (ADP). The Company dominates the payroll processing for small businesses. The Company enters 2004 with almost 500,000 clients. The average client is a business with 14 employees. 1,500 sales reps sell in the country's 100 largest markets. Outsourcing payroll is a no-brainer decision for small businesses. A small employer must file and make payments for over 40 payroll tax returns per year – and deal with countless tax law changes per year. Yet only 15% to 20% of the Company's target market outsources payroll. A key source of growth and operating leverage is the cross selling of additional services. Cross selling is a gold mine for the Company. After-tax returns on incremental invested capital are currently 200%! 90% of payroll clients utilize Taxpay. 62% utilize Employee Pay Services. The average revenue from a typical client (14 employees) using payroll, tax pay and payment processing amounts to just \$2,300 per year. Multiply over 500,000 clients and you have yourself one dandy business. Revenues for 2003 increased 15%. Earnings, hurt by low float interest income, grew only 7% in 2003. Return on equity for fiscal 2003 was a sterling 29%. We expect earnings for fiscal 2004 (May) to reach \$.85 and at least \$1.00 in fiscal 2005. We are buyers on any meaningful pullback in the stock.

Pfizer **16%** **C** **2/00**

We were not surprised by the small gain in these shares last year. 2003's performance derby was dominated by cyclical stocks and low quality stocks (see Client Letter). Pfizer had a terrific 2003 on the corporate front. They completed their merger with Pharmacia and distinguished themselves as the leading pharmaceutical company relative to their less than inspiring industry competitors. The Company's product profile remains daunting. They have eight products that generate over \$1 billion in annual revenues. Lipitor is the world's best selling medicine for atherosclerosis (cholesterol). The Celebrex-Bextra franchise is the leading arthritis brand. The Company remains on pace for 20 major NDA filings over the next five years. The Company's 12,000 worldwide sales reps have

been ranked the industry's most productive for nine consecutive years. The Company's financial strength is unmatched. The Company has received Standard and Poor's highest balance sheet rating for 18 consecutive years. Over the last 5 years the Company has bought back \$25 billion in stock. They still have a heady \$5 billion remaining in buyback authorizations. The Company will generate nearly \$12 billion in cash from operations. The Company's cash hoard, as a strategic asset was never better displayed than when they bought Esperion Therapeutics for \$1.3 billion in cash in mid-December. Esperion's cardiovascular drug has been shown to reverse the effects of heart disease by mimicking the effects of good cholesterol by reducing plaque in the arteries. This acquisition will serve to boost the Company's leading anti-cholesterol (Lipitor) franchise. In financial perspective, the Company paid for this very promising opportunity with just one month's worth of cash flow generation. Classic Pfizer. The stock is cheap in the mid-\$30's.

PPDI **-13%** **D** **1/02**

We have parted company with PPDI. The Company has dramatically changed their corporate strategy. We believe this changes their business model too much for our comfort. Recall that PPDI is the leading pharmaceutical and biotechnology contract research organization (CRO). Since our initial investment in these shares two years ago, the Company has generated industry-leading growth, margins and cash flows. In addition to contract research, from time to time the Company has bought and invested in earlier stage drug discovery. At year end the Company announced a significant acceleration in such deals. We overlooked the small dilution to current earnings for such deals, but their current emphasis in this strategy has just become too much in our view. If we wanted to own a drug discovery company, we have our favorites already: Amgen and Pfizer. Also, we believe that this change in strategy could well be recognition that the long-term fundamentals of their CRO model are likely not as promising as the past. In any event we decided to move on.