

## **WEDGEWOOD VIEW. 2003 ANNUAL REVIEW**

### **THE REBIRTH OF THE STOCK MARKET**

Well, that's better. After suffering through one of the worst multi-year bear markets on record, the stock market rebounded sharply in 2003. After one final gut-wrenching decline during the first quarter, the stock market advanced for ten consecutive months.

The line of demarcation between winners and losers was clear. Those investors who stayed the course through the brutal bear market lows of October 2002 and March 2003 were the big winners. The stock market advance was so broad that investors in every major category (growth, value, large cap, small cap, etc.) posted terrific returns. At the margin, the best returns were found in those sectors most leveraged to the rebounding economy, plus those sectors that declined the most at the tail end of the 2000-2002 bear market. Correspondingly, the biggest losers were those investors (read: speculators) who tried to market-time the stock market and never got back in. Worst of all were those countless investors – even the most seasoned – who, after one too many false rallies, one too many corporate chieftains in handcuffs, and one too many Wall Street firms charged with conflicts of interest – just threw in the towel on the stock market for good.

For the record, the benchmark S&P 500 Index and the Dow Jones Industrial Average both gained nearly 30% for the year. The frenetic NASDAQ gained 50%. Tony, Dana and I are very pleased to report that we easily outperformed the benchmark S&P 500 Index in 2003.

So, what do we do for an encore this year? Broadly speaking, we will (always) stick to our “investment philosophical investment.” More specifically, we will continue with the type of activity that you have seen in your portfolios recently; namely, we will continue to pare back

those companies with excessive valuations to fund purchases in cheaper current holdings and/or to invest in new companies. However, we must admit that after such a broad-based advance, we are hard-pressed to find the type of industry-leading company (at attractive purchase valuations) that we prefer to own.

In fact, dissecting the returns of the average stock, rather than the market capitalization returns of the major indices, one can easily see just how buoyant the stock market has been. The market research firm Morningstar did just such a study. Here are the eye-popping findings from their database of 5,999 stocks for 2003:

- Percent of stocks up in 2003: 87%
- Average individual stock return: 90%
- Median individual stock return: 38%
- 2,496 stocks had negative earnings in 2003 – average return: 117%
- Stocks with positive earnings – average return: 68%
- Stocks with an “F” grade balance sheet strength – average return: 111%
- Stocks with an “A” grade balance sheet strength – average return: 56%

So, what to make of this data? In short, it goes to the heart of the struggle why we are having so in finding more than a few truly outstanding bargains in the stock market. We believe that stock prices have all but digested the news and effects of record waves of refinancing (associated with generational low interest rates), investor friendly tax cuts, massive monetary stimulus, all-time highs in the level of corporate profits, and the all-too-rare event of a synchronous global economic recovery. But like the weather in our home state of Missouri, one does not have to wait very long for a new front to blow in.

Smith Barney recently published a study comparing current valuations with corresponding future performance. The S&P 500 Index is currently trading at 21x 2003 earnings. Since 1940 (a long enough period which covers more than a few low interest rate environments), subsequent 12-month returns starting with trailing P/E's over 20x averaged -1.6%. The

median 12-month return was -5.3%. How many investors are expecting these types of returns in 2004? We agree, not too many.

Investor conviction was rewarded in 2003. We expect investor patience to be rewarded in 2004.

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Chief Investment Officer

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