SEMPER AUGUSTUS
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Investments Group LLC

CLIENT LETTER **January 4, 2002**

Special Points of Interest:

- Projection for the Next Ten Years
- Historical Comparisons at Market Peaks and Troughs
- Profits
- Price-to-Earnings Multiples
- The Interaction Between Profits and P/E Multiples
- Economic, Psychological, Accounting, and Investment Cost Factors Which Will Work Against Profits and P/E Multiples
- Adjustments to Profits From Accounting and Consideration of Investment Costs: 2+2=5 and There is No Free Lunch
- What Are We Doing if Our Projections Are So Dour for the Stock Market and the Economy?
- How Could Our Stock Market Forecast be Wrong Over the Next Ten years?
- How Could the Investment Actions Taken by Semper Augustus be Wrong?

Clients and Friends:

Happy New Year. Santayana said, "Those who cannot remember the past are condemned to repeat it." Those who fail to understand the application to the capital markets are experiencing a costly bit of painful history. With that bit of good cheer, it is time for a yearend newsletter.

Several people have asked whether we took them off of our client letter mailing list. Our tongue in cheek answer has been, "No, we have merely been saving up information." As promised, here it is. The January 2002 Monstrosity. Brevity not being our strong suit, we even included a table of contents.

We set out with the newsletter to discuss the downside risks to the economy and to the stock market, and to outline our expected ten-year forecast for the S&P 500. As the newsletter came together, we drew some interesting conclusions and stumbled upon a profound and perhaps original thought.

When accounted for properly, the aggregation of publicly traded U.S. companies may not be generating any profits.

Wow! We estimated three principal accounting adjustments (among the many we make when determining cash earnings for any individual company we own or analyze) for the broad universe of those companies comprising the S&P 500. We combined the true cash costs of employee stock options, write-offs, and defined benefit plans. We conclude profits may be overstated by as much as $345 billion per year. Our adjustment would reduce peak 2000 operating profits for the companies that make up the S&P 500 from $487 billion ($56.13 per share) to $142 billion ($16.37 per share). The downward adjustment for 2001 would more than eliminate the roughly $330 billion in operating profits that S&P 500 companies reported to their shareholders as earned and legitimate under GAAP accounting.

In other words, the sum total of S&P 500 companies are not generating cash, they are bleeding it. Due to aggressive use of accounting in recent years and short-term incentives for growth at any cost, cash profits are zilch, zip, nada. There are no earnings to capitalize. Having generally made a downward adjustment to our estimate of market earnings of as much as one-third in recent years, the enormity of our aggregate estimate of profit adjustments blows us away.

Further, we think the sum total of stock market investors are paying at least $200 billion per year in investment costs, excluding taxes.

Investors own a claim to the current and future profits of a company. When calculating the fair value of a business, the investment costs borne by shareholders should be reduced from the corporate profits available to the shareholder. The combination of $200 billion in investment costs and a downward accounting adjustment of $345 billion results in a downward pull of nearly $550 billion in "profits" that do not inure for the benefit of aggregate shareholders.

The average investor in today's stock market pays exorbitant prices for overstated profits. The quality of reported earnings by public companies has never been worse. Further, the most egregious transfer of wealth from shareholders to managements in history leaves investors with the short end of the stick. The facts are buried in annual reports and proxy statements, but go unconsidered by most investors.

Our paper focuses on reasons why the average investor in the stock market will likely earn only flat or negative returns for the next 10 years. Profits and p/e multiples, when combined make up stock prices, are apt to work against investors.

Our stock market forecast, EXCLUDING the accounting and investment cost adjustments listed above, is for a zero return from the S&P 500 for the next 10 years, at best, starting from the current market level. Alternatively, were the index to immediately drop to our estimate of fair value, a 45% decline to 655 would be required. From there, we estimate ten year returns could average 6.4% annually.

If enough investors realize the magnitude of profit overstatement and the erosive effect of investment costs on their bottom line, broad stock market returns for the next 10 years would likely wind up deeply in the red.

Semper Augustus completed its third calendar year in business and its third year of posting average equity returns north of 20 percent. Our equity portfolios roughly doubled in size while major stock market indices declined (S&P 500, Dow Jones Industrial Average and NASDAQ 100). While impressive in the short-run, in no way can a three-year result illustrate a superior long-term track record. We will at some point surely post poor relative results. Even negative results for short stretches can be expected. However, it has been gratifying to generate high returns for our clients in recent years when the rest of the world seems to have lost money. Thanks for your continued support.

Chad and I look forward to seeing all of you this year.

SAI results are time-weighted returns that are gross of management fees and taxes, but inclusive of trading costs and commissions paid. Client accounts are equal weighted in the composite. Returns include the reinvestment of income. SAI published fee of 1.25% would reduce the annual return by 1.25% per year . SAI has clients that pay less than the standard fee and certain performance accounts may pay more than the standard fee. Based on fee, asset allocation, commencement of a client relationship, taxability, risk factors, and other factors; returns may differ from the composite returns. January 1, 1999 is the inception for performance returns and includes terminated, taxable, tax-exempt, and leveraged portfolios above a minimum threshold. Cash and cash equivalents were a significant investment during the period presented.

Headwinds and Tailwinds

TABLE OF CONTENTS:

INTRODUCTION

2000 and 2001 saw the first two consecutive down years for the stock market in 23 years and a recession already as old as the typical post WWII slowdown. It can't get worse, right? Based on "expert" asset allocation recommendations, earnings forecasts, and forecasts for economic acceleration, one would think the bull is back in charge. Before we mount up, let's consider the outlook.

Semper Augustus projects the average investor in stocks to do no better than break even for the next ten years. Aggregate returns are more likely to be negative than positive. The tailwinds which helped push equity returns to nearly 20% per year between 1982 and the first quarter of 2000 have become gale force, icy cold headwinds. An immediate market decline to our measure of fair value would require a decline of 45% from current levels.

The notion that equity investors in the aggregate will have a tough go of it is a long-term proposition. For short periods of time, stock prices and stock markets can trade at prices far from their intrinsic worth, as demonstrated by recent pyrotechnics with internet and technology stocks. We have no idea where the stock market or individual stock prices will be two weeks, two months, or even two years from now. Over longer periods of time, however, prices do indeed become rational and predictable.

The vast majority of financial practitioners and commentators have long preached the gospel of 11% annual equity returns. An 11% annual return for the average "long-term" investor in common stocks from today's levels (already depressed for two years running) is unrealistic and unattainable. Investors have, unfortunately, let their expectations run even higher than 11%. A positive low single-digit return may be remotely conceivable. Double-digit returns, absent a repeal of capitalistic laws, are not a birthright.

To understand why the stock market will be unaccommodating to the average investor, one needs to understand the two major drivers of stock prices. The interaction between corporate profits and price-to-earnings (P/E) multiples determines stock prices. There are many influences on each of these primary variables, such as the impact of interest rates on P/E multiples.

Long-term trends in corporate profits and P/E multiples will no longer exert a favorable influence on aggregate stock prices. That does not mean that diligent, fundamental analysis cannot lead to acceptable equity returns. It simply means the sum total of all stock market investors stand to be sorely, if not devastatingly, disappointed.

To understand our logic, one must understand the derivation of stock prices. The most useful definition of investing in any asset is *the outlay of cash today for the present value of an expected stream of cash flows.*

With stocks, shareholders are the owners of the business. The owner of a business is entitled to the profits of the company, nothing more, nothing less. Profits can be distributed from the business to the shareholder in the form of dividends. Those profits not distributed as dividends are reinvested back into the business, with the reinvestment taking many forms. Companies may acquire other businesses or use reinvested profits to expand by hiring employees, adding to property, plant or equipment, or by building inventories. Companies can buy back stock from shareholders willing to sell. Reinvested profits can simply accumulate as cash for future use.

The most useful definition of investing in any asset is *the outlay of cash today for the present value of an expected stream of cash flows.*

Any profits not distributed as dividends should be used for the future benefit of shareholders. This benefit should ultimately be realized in the form of future dividends or in the growth of the business, which should translate to an increase in the stock price. Thus, the investment return to the shareholder can be reflected as such:

Dividends + Change in Stock Price = Investment Return

The measurement of the components of the stock price is an important part of the investment equation. The stock price can be derived by multiplying the profits of the business by the P/E multiple:

Stock Price = Profits x P/E Multiple

The purchase of a stock represents the "*outlay of cash today*" in our investment definition. The "*expected stream of cash flows*" in our definition represents the current and future profits of the business. These future profits are not known today with certainty and must be estimated. The estimates lead us to the middle part of our definition, the "*present value*".

The "*present value"* is used in determining the P/E multiple and involves some complexity. Present value represents the sum total of all estimated future profits, discounted by an appropriate rate of interest. Those profits will be earned over time. Profits earned farther into the future are worth less to us than those available sooner. Remember, future profits are not guaranteed. They may be higher or lower than we think they will be, or they may not exist at all. By assigning a probability to future profits available for our (the shareholder) benefit, we compare the attractiveness of this estimated profit stream with other opportunities available to us today. For example, we can purchase investments on a reasonably risk-free basis, such as fixed-income securities of high-grade borrowers like the U.S. Government. Depending on the risk our expected profits do not materialize, we should demand compensation for the outlay of cash in a business by demanding a higher rate of return than that available to us on a less risky basis. This compensation takes the form of a risk premium, which basically translates into the rate of interest we use to discount our expected future profits back to a present value. The total of these discounted future profits should equal the stock price. Whew.

Essentially, as investors, we try to estimate the current and future profits of a business and determine what multiple paid to those profits will yield a satisfactory investment return. The aggregation of all of the companies trading publicly in the stock market is the focus of our analysis. We incorporate the same methodology in analyzing individual businesses as we do in analyzing the entire stock market.

We believe stock prices are currently too high relative to the assumptions in our analysis of profits and P/E multiples. Stated differently, we think future profit estimates are way too high relative to the P/E multiples being applied to arrive at the current level of stock prices. We thus set out to demonstrate why earnings estimates and P/E multiples are too high. If correct, the average equity investor will not make money in the next ten years.

PROJECTION FOR THE NEXT TEN YEARS

GDP and Sales Growth

Understanding how individual components of our economic fabric interrelate is important to our investment process. We project nominal GDP and business sales will slow from annual rates of growth of 5.5% over the last 10 years and 6.5% over the last 75 years. Output in nominal terms may even decline for a couple of years, as it did in the early 1930's, which would likely cause our forecast to err on the high side. We project 4% annual growth in nominal GDP and sales for the next 10 years. Sales growth closely approximates GDP growth:

GDP today:	$10.3 trillion
2012 projection:	$15.2 trillion

Inflation

Our nominal GDP forecast means very little inflation over 10 years, perhaps deflation for a few years. We forecast no more than 1% inflation per year for the next 10 years. If inflation accelerates rapidly, the government would likely raise short-term interest rates and devalue the currency as a response. In that case, all bets are off.

S&P 500 Profits

Despite wholesale overstatement of profits today, we think a 5% after-tax margin is reasonable and attainable over time. We think our "normalized" profits should grow as fast as nominal GDP and sales for the next 10 years, or 4% per year. Profits could fall for another couple of years in the interim.

Normalized S&P 500 profits today:	$38.50 ($350 billion)
Normalized S&P 500 profits at 2012:	$57.00 ($518 billion)

Normalized S&P 500 P/E Multiple

Over a full cycle and allowing for increased liquidity over time, a 17 P/E multiple for the S&P 500 is reasonable and realistic (depending on the earnings number used, P/E's are currently 30 times to 51 times earnings). Recall the average P/E for the last 75 years has been 14.8 times. Using basic algebra, a highly probable stream of earnings growing at 6% per year discounted at 6% would be valued at 17 times current earnings. We assume normalized interest rates will not stay permanently high or low for extended periods.

Normalized 2002 P/E:	17
Normalized 2012 P/E:	17

S&P 500 Intrinsic Valuation

Fair value incorporating a 5% normalized profit margin, a 17 P/E multiple and a 4.0% growth rate (matching our projected expectation for GDP, sales and normalized profit growth) equates to:

S&P 500 recent price:	1175
S&P 500 fair value at 2002:	655
S&P 500 fair value at 2012:	970

Dividends

S&P 500 companies pay a low percentage of operating profits as dividends by historical standards. However, at our "normalized" earnings of $38.50, the current payout ratio is 40%, matching its average over time (do CFO's know more about the quality of earnings than they are letting on). We therefore assume dividends can grow at the same rate as GDP, normalized earnings, and "fair" stock market value, or 4% a year. As the slowdown unfolds, however, many companies may slash or eliminate dividends. In fact, dividends have fallen for two straight years for the first time since 1970-71, and the worst percentage drop, 3.3%, since 1951's 4.1% cuts. The last time dividends declined for three years in a row was 1931-33. Despite recent cuts, our normalized projection is:

S&P 500 dividends at 2002:	$15.75 ($135 billion)
S&P 500 dividends at 2012:	$23.31 ($200 billion)

Total Return S&P 500

Sadly for the aggregate investor, the total return forecast utilizing our variable assumptions is zero from today's levels (negative on a price basis):

Recent price at January 2002:	1175
Current dividend yield:	1.35%
2012 fair value Projection:	970

As such, a ten year price decline of -17.4% works out to an annualized decline of -1.9% per year. Adding a dividend return of 1.35% per year growing at 4% per year equates to a total return of 0% per year.

Our forecast, if accurate, would be unfortunate for the aggregate investor in the stock market. Masses of investors do not expect a 0% return, before subtracting our estimate of 1.4% per year in total investment costs. Despite market declines in the last two years, expectations remain too high.

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HISTORICAL COMPARISONS AT MARKET PEAKS AND TROUGHS

Throughout this paper, we make comparisons of current conditions with conditions as they existed at various points in the past 75 years. We generally refer to the major secular market peaks in 1929, 1966, and 2000. The year 1937 probably represented a cyclical rather than a secular peak. We use the years 1932, 1942, and 1982 as representative of major market troughs. It is debatable whether the years selected represent the true peaks and troughs. For example, many people think that the bull market, which began in 1982, actually began in 1974 with the Dow at 577. Regardless, because more than 100% of investment returns over the last decade were earned during 45 years (three secular bull markets from 1920-29, 1942-66, and 1982-2000), it is imperative that market participants recognize major inflection points in the economy and in the market.

	9/29 peak	7/32 low	3/37 peak	4/42 low	2/66 peak	8/82 low	3/00 peak	now	normalized
Dow Jones Industrials	381	41	194	93	995	777	11722	10300	5800
S&P 500	34	4	20	7	102	102	1527	1175	655
After Tax Profit Margins	8.9%	-3.2%	6.4%	6.6%	6.7%	4.0%	7.4%	5.0%	5.0%
Price/Earnings S&P 500	26	nmf	8	7	18	8	33	31	17
Price/Sales S&P 500	2.31	0.48	0.51	0.46	1.20	0.32	2.13	1.58	0.90
Price/Book S&P500	3.0	0.3	2.2	0.8	2.4	0.9	7.7	5.2	3.5
U.S. Gov't Bond Yield	3.4%	3.5%	2.6%	1.9%	4.6%	14.6%	5.9%	5.3%	5.3%
High Grade Corp Yield	4.8%	5.3%	3.3%	2.7%	4.5%	15.1%	7.4%	6.8%	6.5%
U.S. Discount Rate	6.0%	2.5%	1.5%	1.0%	4.5%	10.8%	5.5%	1.25%	3.5%
Inflation (CPI)	0.6%	-9.9%	3.6%	10.9%	3.7%	11.0%	3.4%	2.1%	3.0%
Dividend Yield	3.0	17.5	3.7	8.7	2.9	6.1	1.0	1.35	3.5
Mkt Cap All Stocks	93.3 bil	15.3 bil	66.2 bil	32.4 bil	623.5 bil	1.1 tril	20.7 tril	14.4 tril	6.0 tril
Total Credit Mkt Debt/GDP	n/a	n/a	n/a	n/a	142%	158%	265%	285%	175%
Mkt Cap / GDP	0.90	0.26	0.72	0.20	0.79	0.33	2.10	1.40	0.63
GDP	103.7 bil	58.8 bil	91.9 bil	161.8 bil	789.3 bil	3.26 tril	9.87 tril	10.30 tril	9.50 tril
Unemployment Rate	2.3%	24.9%	11.7%	4.9%	4.2%	10.8%	3.9%	5.8%	5.5%
Trading Vol / GDP	135%	25%	30%	5%	20%	20%	325%	210%	30%

Sources: National Bureau of Economic Research; Bureau of Economic Analysis; Federal Reserve; Bureau of Labor Statistics; HD Brous; Semper Augustus

The chart illustrates the striking contrast between the undervalued market and poor economic climate in trough years compared with fundamental overvaluation and a strong economy around peaks.
For example, the market 20 years ago reflected 16 years of stock market under-performance, high interest rates, high unemployment, depressed profit margins, a low P/E multiple, a high dividend yield and low expectations for the market and the economy. Psychologically, few people wanted to own stocks. Who would want to own stocks when money market instruments paid close to 20% and history demonstrated that stocks did nothing but lose value?

At the market trough in 1982, stocks were valued at an extremely low P/E on depressed profits. Measures such as market cap as a percent of GDP were at levels far below average. As stocks were trading at 90% of book value and 32% of sales, with a 4% profit margin they were earning 11.2% on equity (an investor's adjusted return on equity of 12.5%). The dividend yield was high at 6.1%. Interest rates, inflation and unemployment had already started falling from record highs in September 1981. As with past market lows, investor enthusiasm toward owning stocks was nonexistent. Despite market declines over the last two years, we are at the other extreme today.

The three major secular U.S. equity bull markets of the 20th century all began from extremely depressed levels and were generally accompanied by rising profit margins, P/E multiple expansion and favorable trends in interest rates and monetary conditions.

Let's now examine the two key drivers of stock prices -- profits and P/E multiples. Profit margins peaked in 2000 and have only dropped to normal levels by historic standards. They will likely grow only as fast as GDP going forward. The P/E multiple, helped by falling interest rates and investor enthusiasm, is at an all-time high and certain to move lower.

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PROFITS

Profits, when properly accounted for, measure the amount of cash generated by a business over time. The expectation of profits is one of the two primary keys to equity investing (the other being the P/E multiple applied to those profits). Over the course of a full economic cycle, profit margins at a company ebb and flow, much like the tides. They slowly rise for a number of years, and then fall abruptly as business conditions deteriorate, which is capitalism at work. High margins are followed by low margins, low margins by high.

Over the last 75 years, after-tax net income at America's businesses have generally ranged from 3% to about 7%. This range holds true, with only a few outlying years, both on the high and low end (including loss years). The average margin over time has been 5%. In other words, the *average* business *typically* earns five cents in profit for each dollar in sales.

In addition to the absolute level of profits as a percentage of sales, profits grow over time. The rate of growth in corporate profits over the past 75 years has closely tracked the rate of growth in nominal GDP. The laws of capitalism bound the range of corporate profits. Profits therefore grow as fast over time as businesses grow. The combined output of the economy roughly equals aggregate corporate sales, with some technical differences. As nominal GDP grew at approximately 6.5% over the last century, it follows that sales and profits grew at roughly the same rate as GDP.

Over shorter periods, profits can grow much faster or slower than sales. For instance, from the recession low of 4% in 1990 to a peak of 7.4% in 2000, profit margins advanced at over 9% per year. Sales only grew annually at 5.5% over this stretch. In other words, profits grew faster than sales for 10 years. Wall Street runs into problems because it tends to extrapolate the recent past well into the future. The trouble with extrapolation of profit growth (or with any variable in a multivariate equation) relative to sales growth is it fails to recognize capitalistic laws. Profits are range bound. There exists a tradeoff between labor and capital; labor and corporate profitability. If sales grew at 5.5% per year for a very long time, profits could not grow at 9% forever, because by extrapolation, at some point in the future, profits would equal sales, and thereafter exceed sales. Nonsense.

Profit margins in 2001 dropped more year over year than in any year since 1930. In fact, the dollar decline in profits in 2001 was greater than in any year in the history of the world, anywhere, at anytime. Profit margins for the companies comprising the S&P 500 peaked in 2000 at 7.3%. When the final tally comes in for 2001, S&P 500 operating earnings are expected to fall to 5% and to 3% including write-offs. Only at the outset of the Great Depression did profit margins collapse as rapidly, from 9.0% in 1929 to 3.9% in 1930. Also, for the first time in many years, our calculation of "normalized" profits is now higher than the earnings to be reported for components of the S&P 500.

S&P 500 profits peaked in 2000 at $56 operating and $50 reported. Profits should wind up 2001 around $38 operating and $23 reported when the final tally is in. Wall Street prognosticators, wearing rose colored glasses, are looking for a 2002 rebound to $52 in operating earnings.

A material divergence took place in recent years between per share and dollar profits for public companies. Additionally, overall aggregate business profits diverged from those reported only by public companies. From 1996 to 2000, per share operating profits of S&P 500 firms grew by 38%, while aggregate national income profits only grew by 14%.

A goodly chunk of the differential between public company profits and national income comes from publicly traded companies borrowing a page from Lou Gerstner's playbook at IBM.

Here's the IBM Playbook according to Lou:

- **Kickoff:** Take on debt to finance share repurchases and operations, and to offset dilution from your stock option program. A decline in shares out will boost EPS faster than dollar profits. Wall Street won't notice this difference.
- **Extra Point:** You get a further kick from the decline in your firm's equity -- your return on equity will appear higher. Also, your effective tax rate declines as the government finances tax credits for your stock options.
- **Quarterback Sneak:** Finance customer purchases of hardware with low interest rate loans while booking 100% of revenues and profits up front.
- **Reverse:** Disguise debt by moving as much of it as you can off the balance sheet.
- **Blitz:** Aggressively manipulate accounting and actuarial conventions to inflate reported profits.
- **Timeout:** Cut research and development expenditures to push up profits in the short-term.
- **Hail Mary:** Retire early as a hero before investors realize the last drop of blood had been extracted from the pigskin long ago.
- **Overtime:** Let your successors pay the price for your transgressions. Allow the board to beg for your return from retirement to "fix" the problems at the company you "ran" so well.

Since the end of 1995, IBM's stated balance sheet debt grew by $10 billion to a weighty $29 billion. Annual uncapitalized lease obligations grew by $1 billion to $1.4 billion. Over the same period, sales grew by only $10 billion to $86 billion while equity in the business fell by $2 billion to $20 billion. Meanwhile, dollar profits grew 20% to $7.6 billion (unadjusted for aggressive accounting) while earnings per share grew 58% from $2.76 to $4.35, due to a reduction in the share count by 500 million shares to 1.7 billion undiluted shares outstanding. The company spent nearly every dollar in debt proceeds and profits to retire shares while leaving the company much more leveraged today. By the way, dividends per share are only half what they were in 1985. Sales fell since the fourth quarter of 1998 yet the stock more than doubled in price. Game Over.

Rising profit margins characterized the latest secular bull market in stocks, which began in 1982 (as with the other two secular bull markets of the 20th century). The average American business earned 3.5 cents per dollar of sales in 1982. By 2000, net margins more than doubled to 7.4%. Stock prices rose over this stretch at rate of 16% per year. Over the same 18-year stretch, nominal GDP and sales both grew at 6% per year (5.5% from 1990-2000) while profits rocketed ahead at over 9% per year. Profit growth in excess of GDP and sales growth accounted for nearly a third of the advance in stock prices during the bull market (P/E expansion accounted for 60% of the gains). The following factors caused the rise in profit margins, many of which may no longer propel margins higher:

- Interest rates declined from 15% to 5%. It is certain that rates cannot fall another 10%. Falling interest rates allow companies to service their debt more easily and are generally good for stock prices.
- The national tax burden shifted from companies to households. Marginal corporate tax rates fell as personal income taxes, estate taxes, social security and national health taxes rose. Phase-outs of deductions, exemptions, and tax credits were introduced. It seems unlikely in the face of rising government budget deficits that corporate tax rates will fall further. If any tax burden will be relieved, it will be on households. The government understands the consumer drives two-thirds of the economy.
- Labor costs did not rise as quickly as profits or sales, not even close. Over long periods, there exists a tradeoff between capital and labor. Labor received the short end of the stick for many years and will, out of necessity, likely reap more from employers going forward.
- As with labor costs, companies shifted much of the onus of retirement and health benefits to employees. Employee funded 401(k) and health insurance premium shifts allowed the advance of margins. These costs have been increasingly borne by employees, not by employers. That trend may reverse.

- Commodity prices fell, lowering input prices for numerous industries. With many industrial commodities now trading at or below their costs of production, it seems likely that prices may firm or stop falling, thus raising costs to manufacturers in coming years.
- Depreciation expense declined. In the early years of the capital spending boom, suppliers of capital goods immediately booked sales and profits, but buyers depreciated the goods over several years, thus front loading earnings during the capital spending boom. In addition, as if by accounting magic, companies extended depreciation schedules on capital assets, thus reducing depreciation charges on the income statement despite economic reality. Depreciation charges fell as a percentage of sales for many years as we trended toward a service based economy . The high-tech capital spending led productivity miracle so cherished by Alan Greenspan has begun to reverse. One of the bullish arguments (which has some merit) for a shorter recession or depression is that tech equipment, software, computers, and communications gear are short-lived and need to be replaced often. The problem with this logic is that a large and increasing percentage of capital expenditures are needed to **replace** the **existing** capital stock (insight thanks to Jim Grant and Kurt Richebacher). The growth in the net new capital stock thus slows. More and more dollars of gross investment are needed to generate a net addition to the new capital stock. In the early part of the economic expansion following the 1990-91 recession, a slow initial rise of depreciation expense, reflecting low capital spending at the end of the 1980's helped profits expand. The worm has now turned. Rising depreciation charges now hurt margin growth. Further, depreciation charges, which are included in GDP, but subtracted when calculating national income profits, would, if adjusted, shave Greenspan's cherished productivity growth. Depreciation expense runs roughly $100 billion today, 1% of GDP.
- Capital gains on corporate investments (securities and unconsolidated subsidiaries) were realized and in many cases booked as operating gains. Declining stock prices have now eliminated many unrealized gains embedded within corporate portfolios.
- Insurance costs will rise as insurers kept premium increases in check in recent years. Also, in the wake of the terrorist attacks, property casualty premiums (primarily terrorist insurance) and reinsurance premiums should rise. [As an aside, even though absolute output, imports and exports are falling, imports falling faster than exports can make GDP growth appear positive. The fourth quarter will see a precipitous one-time drop in imports due to reinsurance payments from European reinsurers for the attacks.]
- HMO costs, having been kept in check in recent years, appear to be accelerating.
- Companies took on debt in record quantities as interest rates declined. Companies spent much of the proceeds of the leverage repurchasing shares, often at full or expensive prices. The net effect of the repurchases reduces share count, thus increasing earnings per share and return on equity, even if dollar profits failed to advance.
- Accounting conventions were aggressively abused to inflate reported earnings since the early 1990's. Declining operating profits and an increase in bankruptcies and debt downgrades are focusing investors on accounting integrity.
- In the short-term, the latest marketing strategy by the automobile industry, to give cars away, may put a crimp on profits. Not only is it tough to make money when offering 0% interest rates while debt costs exceed 5%, but the acceleration in vehicle sales in late 2001 likely robbed sales from 2002. October vehicle sales ran at an annual rate of 21.4 million units, as opposed to a more normal, population adjusted 15-16 million per year. The industry sold a U.S. record 17.4 million units in 2000, with 2001 sales close behind at an estimated 17.0 million units. Without 0% financing and other costly incentives in 2001, the Big 3 would have sold roughly 15 million vehicles. Household debt surged as consumers lined up to finance new cars, despite the stock market decline and rising unemployment.

Our case against expanding profit margins driving another bull market has more to do with long-term obstacles unfolding rather than with the current state of profitability. Most investors don't understand the present profit picture, which requires examination when coupled with another of the major drivers of stock prices, the P/E multiple. With the exception of the profit loss years in 1931 and 1932, the P/E multiple for reported earnings now levitates at an all time high 51 times earnings.

PRICE-TO-EARNINGS MULTIPLES

In addition to the forecast of expected profits, the selection of the appropriate P/E multiple to be applied when capitalizing profits is the other main driver of stock prices. The two most important variables impacting P/E multiples are interest rates and expected growth in profits. Recall that one finds the stock price by multiplying the profits of a business by the P/E multiple.

The higher the P/E, the greater the need for predictability and growth in earnings. Price-to-earnings multiples are also a function of interest rates. The stock price should reflect the present value of the future cash profits earned by a company, discounted at an appropriate rate of interest. This discount rate is effectively the inverse of the P/E multiple. By inverting the P/E multiple, we arrive at the e/p multiple. The e/p multiple is the earnings yield, representing the profits of a company as a percentage of the stock price.

For example, a company with $1 billion in sales and a 5% profit margin would earn $50 million in profits. If the market value of the company is $2 billion,
the P/E would be 40 times and the earnings yield would be 2 1/2%.
($50 million x 40 = $2 billion; $50 million / $2 billion = 2 1/2%)

It's simple. A company with a 40 P/E has a 2.5% earnings yield.
A 30 P/E equates to a 3.33% earnings yield.
A 20 P/E equals a 5% earnings yield and a 10 P/E equals a 10% earnings yield.

For Nasdaq buffs, a 100 P/E equals a 1% earnings yield. In this latter case, there better be a lot of earnings growth and no missteps along the way to justify a current 1% return on your money.

The earnings yield is the percentage return on an investment at today's stock price available to the owner of the company. An investor who purchases a stock with an earnings yield below that return available in long-term risk free U.S. Government securities expects enough growth in profits to make up the difference over time. For a company paying out all of its profits as dividends, the dividend yield (dividends/stock price) would equal the earnings yield.

A company deserves a higher P/E multiple when it can be reasonably expected to sustain and predictably grow its profits at a faster rate than another business. Also, the interest rate chosen to discount the expected future stream of profits impacts the P/E multiple. Generally speaking, the higher the general level of market interest rates, the lower the P/E. The lower the level of interest rates, the higher the P/E. The logic here is indisputable, lower interest costs translate into the ability to pay a higher price for any asset (think of how mortgage rates affect the ability to pay up or pay down for a house).

There is a flaw, however, with simply using current levels of interest rates to assign P/E multiples. Even very sophisticated investors make this myopic mistake. To illustrate, single digit P/E multiples in the early 1980's were justified, at the time, by the high levels of interest rates prevalent then (also, because from a psychological standpoint, stocks had declined since the late 1960's and, adjusted for inflation, were down about 75% in real terms). Given no consideration to P/E's at the time was the ultimate decline in rates from over 15% to mid-single digits today. Conversely, with rates today at very low levels, 1.75% Fed Funds, 5.3% long-term U.S. government yields, investors assume a 25 to 30 P/E is reasonable. As rates fall farther and farther, at a point, the extension of this logic does not work. For instance, would a 100 P/E or a 200 P/E be reasonable if interest rates were 1% or 0.5%? Stocks exhibit negatively convex properties (don't ask). Today's logic virtually ignores future levels of rates.

As rates fall farther and farther, at a point, the extension of this logic does not work. For instance, would a 100 P/E or 200 P/E be reasonable if interest rates were 1% or 0.5%?

We believe it more appropriate to use long-term averages for interest rates, thus "normalizing" borrowing costs for companies and individuals. We assume the cost of debt capital at high quality companies will range from 6% to 8% over very long periods of time and the cost to issue equity is somewhat higher, perhaps 9-10%. By comparison, long-term U.S. Government bond yields have averaged 4.3% since 1798. We make no projections in this regard as to expectations for short-term changes in the level of rates. Using these assumptions, a "normalized" P/E multiple for the average business (growing as fast as GDP) with average balance sheet and profitability characteristics should be valued between 15 and 17 times earnings (6.7% to 5.9% earnings yields, respectively). At 15 to 17 times earnings, investors are compensated with a premium yield versus the aforementioned average long-term U.S. government bond yield. The laws of algebra and compounding cannot be repealed.

We do allow for a higher level of "normalized" P/E multiples (lower levels of normalized earnings yields) than in the past because we think more of today's companies are publicly traded and there is more liquidity, equity ownership, and information in the system than existed 75 years ago. Allowance for a higher P/E implies the risk premium for holding stocks may be lower today than existed 75 years ago. The average P/E over the last 75 years has been 14.8 times.

Today's P/E multiples of 51 times reported profits and 30.5 times normalized and operating profits are irrationally exuberant.

Today's P/E multiples of 51 times reported profits and 30.5 times normalized and operating profits are irrationally exuberant.

THE INTERACTION BETWEEN PROFITS AND P/E MULTIPLES

Most people do not realize the famous tune popularized by Frank Sinatra, *Love and Marriage*, was originally written by an investor who understood the important relationship between profits and P/E multiples – you can't have one without the other.

The assignment of "normalized" P/E's brings us to present conditions. Ignore for now the "quality" of earnings due to aggressive accounting conventions and the aggregate overstatement of profits by public companies. Let's focus on the recent extraordinary decline in profits and how we should assign P/E multiples to the market. Glance at the following table concerning operating and reported earnings.

	S&P 500 Operating Earnings	S&P 500 Reported Earnings (excludes write-offs)	S&P 500 Reported Earnings As a % of S&P 500 Operating Earnings	S&P 500 Reported Earnings As a % of National Income After Tax Corporate Profits
1988	$24.12	$23.75	98.5%	67.2%
1989	24.32	22.87	94.0	65.2
1990	22.65	21.34	94.2	54.4
1991	19.30	15.91	82.4	37.8
1992	20.87	19.09	91.5	42.6
1993	26.90	21.89	81.4	44.4
1994	31.75	30.60	96.4	57.2
1995	37.70	33.96	90.1	54.7
1996	40.63	38.73	95.3	58.2
1997	44.01	39.72	90.3	55.2
1998	44.27	37.70	85.2	62.1
1999	51.68	48.17	93.2	75.9
2000	56.13	50.00	89.1	75.4
2001	38.00 est.	23.00 est.	60.5 est.	40.0 est.

Sources: Standard & Poor's, Bureau of Economic Analysis, Semper Augustus

Two things immediately stand out in the table. First, note the difference between operating and reported earnings. Beginning in the recession year of 1991, a wide differential exists between operating earnings and reported earnings. Operating earnings ignore write-offs. With the exception of the true diminution of earnings power of an asset requiring a write-down, write-offs tend to pervert the long-term profitability of companies over time. Write-offs are generally greatest around recessions when earnings are already bad. The logic by corporate management is to throw as much "bad stuff" into a charge-off on the notion that investors are already expecting the worst and have taken the earnings decline out of their long-term assessment of the business. For example, after-tax profits in the whole economy (national income accounts) only grew from $244.8 billion in 1988 to $282.6 billion in 1991, but actually dropped for S&P 500 companies from $164.5 billion to $107.0 billion reflecting the big write-offs during the 1991 recession.

Private businesses do not have the perceived requirement to "pretty up" reported earnings on an ongoing basis. They simply try to make money and keep taxes down. This "big bath" write-off practice by public

companies not only means that prior years' profits and returns on capital were overstated, but far too often, ongoing and future true expenses are lumped into the charge-thus inflating future profits as well. The asset impairment further serves to reduce stated asset and equity values, making ongoing returns on assets, capital, and equity appear higher. While write-offs may not directly relate to current period results, they can reflect poor capital allocation and investment decisions.

The second revelation from the table is the massive decline in *both* operating *and* reported earnings for 2001 versus 2000. When all is said and done, operating earnings should come in for 2001 at $38 and reported profits at $23. This represents a 32% decline in operating and a 54% drop in reported profits. **The declines in 2001 are more severe than in any year since 1930, when profit margins declined from 9% to 3.9%.** Operating EPS margins for the S&P 500 were 7.8% in 2000 and will be 5.2% for 2001. Reported profit margins were 7.0% in 2000 and will be 3% in 2001. The huge differential between reported and operating profits this year stems from the staggering write-downs totaling over $165 billion during the year (normal annual profits in the entire U.S. economy are roughly $500 billion and $350 billion for S&P 500 companies).

Another interesting element related to write-offs comes from the right-hand column in the table. S&P 500 companies comprised 75.4% of aggregate U.S. profits but only 63% of aggregate sales in 2000. This percentage representation by sales has been fairly steady over time. Reported profits for S&P 500 companies vary as a percentage of broad U.S. corporate profits around the 63% level. Public companies profits are much more volatile than all corporate profits. As public companies take write-offs during recessions, they effectively "lower the bar", allowing future profit growth to hurdle past broad economic, sales and profit growth.

Based on the current level of the S&P 500 (1175 in early January) the current P/E is 30 times 2001 operating and 51 times 2001 reported earnings, both records. In theory, the current P/E reflects expectations that profits are currently depressed and should soon rebound. Nearly all Wall Street strategists and forecasters look for a rapid snap back in profits for 2002. They think the economy will presently bottom and that by mid-year we should be rolling again. We think the market wrongly discounts this notion and then some.

A low P/E multiple should occur when earnings are at peak levels and move higher when earnings sink. An exception to these rules occurred in the latter part of the recent bull market, which saw high P/E's on peak earnings, ditto 1929. Typically, over the last 75 years, with high earnings, the P/E has logically dropped much lower than average, at 12.5 times earnings. Wall Street is in the business of selling products to the public, and therefore is in the business of optimism, not reality. Rarely would a strategist note when the market is at a level of peak profits that high P/E's are not warranted. Bearish pronouncements hurt business. Instead, they ratchet up their earnings growth forecasts beyond reality to justify high P/E's applied to high profit margins.

So where are we now? Assuming normal future growth in the economy, reported earnings of $23 are now below long-term "normalized" levels. A normal P/E of 17 times on a normal 5% profit margin equates to a price for the S&P 500 of 655, 45% below today's level ($38.50 x 17 = 655). If we buy the argument that a low interest rate environment should produce a high P/E of say, 25 times, this values the S&P 500 at 962, 18% below today's level. The only way to allow for the market to be fairly valued or slightly undervalued today is to assume the market should trade at a peak (high) P/E based on peak profits; 25 times a 7% profit margin. The result is an S&P 500 of 1348 ($53.90 x 25 = 1348) 15% above today's level of 1175 (but still 11.5% below the March 2000 peak at 1527).

The problem with paying a high price for high earnings is that both variables are unsustainable. To justify a P/E of 25 times on the market requires companies to *average* a 7% profit margin on a sustainable basis. Based on our understanding of capitalism and the laws of compounding, that requirement is a pipe dream.

We introduce two tables to illustrate the tradeoff between profit margins and P/E's. The first, table A, introduces the derivation of how profit margins multiplied by the P/E multiple produces the price-to-sales ratio. Companies have historically been valued at roughly 90% of sales. History is correct because the average business, predictably growing at 6% and earning a 5% profit margin, should be capitalized between 15 and 17 times earnings, with greater discounts for less predictability or less growth.

PRICE-TO-SALES

Table A

		P/E									
		8	12	15	16	17	20	24	28	32	36
AFTER TAX PROFIT MARGIN	3%	24	36	45	48	51	60	72	84	96	108
	4%	32	48	60	64	68	80	96	112	128	144
	5%	40	60	75	80	85	100	120	140	160	180
	6%	48	72	90	96	102	120	144	168	192	216
	7%	52	84	105	112	119	140	168	196	224	252
	8%	64	96	120	128	136	160	192	224	256	288

Recall that profits multiplied by the P/E multiple equals the stock price. In percentage terms, percent profit margin times P/E equals the price-to-sales ratio. The logic of high profit margins capitalized at low P/E's and low profit margins capitalized at high P/E's can be found trending from the lower left corner of the table up to the upper right. We dream about stocks priced in the upper left, the "sexy" area in the table. Depressed profit margins capitalized at low P/E's equate to low multiples to sales. Conversely, high profit margins at high P/E's equate to high multiples to sales. The market has been in the lower right portion of Table A during the last few years, a most "unsexy" place to be.

In 1982, the market traded at 8 times a 3% profit margin, or 24% of sales. In other words, the market could quadruple in price just to be fairly valued, assuming fair value at 90% of sales. The 1982 valuation represented the irrational case of the market trading at a low P/E on depressed profits. Stocks should trade at a high P/E on depressed profits. Earnings for the S&P 500 were about $16.00 and the market traded at a P/E of 8 times earnings (102.42 at the 1982 low).

From 1982 to 2000, the stock market grew 15 fold (1553.11 intra-day high and 1527.46 closing high on March 24, 2000), while earnings grew only 3.5 fold ($16.50 to $56.79 peak trailing 4 quarter earnings in the third quarter of 2000). At the same time, GDP grew 3 fold, $3.26 trillion to $9.87 trillion. For nearly two decades, stock prices grew faster than earnings which grew faster than sales and GDP. On a price-to-sales basis, the S&P 500 advanced from 24% of sales to over 200% at the peak. The index is currently over 150% of our estimate for 2002 sales.

Table B extends table A. It calculates values for the S&P 500 by converting profit margins to earnings-per-share for the S&P 500 based on various levels of profits for 2002. P/E multiples from 8 to 36 are applied.

S&P 500 VALUATION BASED ON VARIOUS EARNINGS AND P/E'S

Table B

		EPS	P/E 8	12	15	16	17	20	24	28	32	36
PROFIT MARGIN	3%	23.10	185	277	347	369	393	462	554	646	739	831
	4%	30.80	246	369	462	492	524	616	739	862	986	1108
	5%	38.50	308	462	578	616	655	770	924	1078	1232	1386
	6%	46.20	369	554	693	739	785	924	1108	1293	1478	1663
	7%	53.90	431	647	809	862	916	1078	1293	1509	1724	1940
	8%	61.60	4937	739	924	986	1047	1232	1478	1725	1971	2218

Current price for S&P 500: 1175
Our estimate of fair value: 655
September 2001 low: 966
March 2000 high: 1527

If the S&P 500 generated a 3% profit margin and earnings of $23.10 in 2002 (same level of reported earnings as in 2001) and capitalized those earnings at various P/E multiples, the resultant index level can be found on the first row of the table. *Using 1982's valuation, a 3% profit margin at 8 times earnings would value the S&P 500 today at 185*. Because the index currently resides at 1175, the current P/E of 51 is off the chart. Only at extremely depressed levels of profits would P/E's approaching 50 be reasonable. The 36 P/E multiple on a 3% profit margin, found in the far right column, produces an S&P 500 of 831.

At a "normalized" profit margin of 5%, the S&P 500 would produce profits of $38.50 this year. At 17 times earnings, the index would trade at 655. As it is, at the current level of 1175, the index trades at 30.5 times our "normalized" 5% profit margin. At "peak" profits of 7%, ($53.90 EPS), we think a fair P/E would be around 12 times, which equates to the S&P 500 at 647. You should now see the logic of normalizing profits and making P/E adjustments based on whether profits are aberrantly high or low in the short-term.

If decreasingly low levels of interest rates should push up the P/E multiple, then follow our 5% margin in the table, $38.50 in earnings, out to the right columns in the table. We arrive at S&P valuation of 770 at 20 times; 924 at 24 times; 1078 at 28 times; and 1232 at 32 times. Now, we may be crazy, but the last thing we would do is try and convince you that a normal level of profits and growth should be capitalized at over 30 times earnings. History, coupled with mathematical laws of compounding, disallow exorbitant P/E multiples on anything but depressed profits.

Now let *us* extrapolate. Recall our contention that investor expectations are way too high. Wall Street estimates for 2002 assume a terrific recovery in corporate profits. Estimates average $52.53 in earnings for 2002, down from a preliminary 2002 estimate of over $69 during the first quarter of 2000 (sources: Thomson Financial/First Call, Deutsche Bank). The following "gurus" project these targets for 2002 for the S&P price level:

What in the World Were They Thinking? What in the World Are They Thinking?

	2001 Forecast in early 2001	Recent 2002 Forecast
Abby Joseph Cohen; Goldman Sachs	1650	1425
Thomas Galvin; CSFB	1600	1375
Edward Kerschner; UBS Warbug	1715	1570
Average	1655	1475
2001 S&P 500 Closing Price:	1148	

Our esteemed Wall Street experts slightly overestimated with their average forecast of 1655 for the S&P 500 in 2001. Just a bit ebullient, n'est ce pas? Jeffrey Applegate at Lehman Brothers had a price target over 1800 (we left him out of the table as a common decency). The index, having closed 31% below the average forecast, represented a "mere" difference of $3.2 trillion in market cap, one-third of GDP.

During the first quarter of 2000, when the S&P 500 peaked over 1500 and earnings peaked over $50, the guru's optimistically forecast as much as $69 in earnings for 2002. To put a $69 earnings target in perspective, the profit margin would be 9% in 2002. A 1655 price target for 2001 equaled 24 times their 9% 2002 earnings forecast. People bought this logic. The only year profit margins reached 9% was 1929. Remember the market dropped 89% from the 1929 peak as profits collapsed. The integrity and quality of 1929 profits was nearly as poor as we have today.

The experts now forecast a more subdued 2002. Earnings estimates of $52.53 represent a 6.8% profit margin, "peak" by historical standards. A 1457 price target represents nearly 28 times estimated earnings. When compared to trailing 2001 earnings ($23 reported, $38 operating), the 1457 average price target works out to 73 times 2001 reported earnings and 43 times operating earnings. Anyway you slice it, their forecasts represent "peak" earnings and Mt. Everest-like P/E's, never a good combination.

If the expert's forecasts for 2002 prove correct, with the S&P 500 at 1456 and earnings at $52.53, the index would return 23.9% plus 1.35% in dividends for the year. Not bad, although the index would still be 6% below the 2000 peak. What kind of returns would be forecast for 2003 and beyond if the index actually hits their price target? We guess the experts would predict that 15% growth in earnings is realistic from a 6.8% profit margin. We would strongly disagree.

Unless you believe that P/E's could expand from 28 times peak margins, or that profit margins could expand to well over 7%, then the absolute best you would do would be to earn the rate of sales growth plus your dividend yield. We think sales growth will be punk for the next ten years. However, let's give the experts the benefit of the doubt and assume sales can grow at 6% (0.5% faster than they have for the past 10 years and 2% faster than we project for the next 10 years). Assume sales grow at 6% and you begin with a 1.35% dividend yield. If profit margins average 7% and the market continues to be valued as 27 times earnings, then the best you will do is 7.35% per year, before expenses and taxes. Your 7.35% return roughly equals the yield on high quality corporate bonds. That's best case. That's not what you're told. Most investors have been told and believe that stocks will return 11% per year. Any less is inconceivable to the average investor.

If a 6.8% profit margin, $52.53 in 2002 earnings, is considered normal and sustainable by Wall Street and you will earn 11% per year for the next 10 years, then the following must transpire, beginning at 1175 on the S&P 500 today.

If margins remain at 6.8% and sales and earnings grow at 6%, then to earn 11% per year the P/E must expand from 28 times to 31.4 times. In other words, you earn 1.35% from dividends plus growth in the index at 9.65% per year to 2952 in 2112. Dividends would have to grow as fast as share prices to maintain an 11% total return. Earnings growth of 6% (same as sales growth) would produce earnings of $94.07 in 2112. The P/E would thus equal 31.4 times earnings. Incidentally, at 9.65% growth, dividends would total $39.57 in 2112, raising the payout rate from 30% to 42%. Lower levels of reinvested profits ultimately translate into lower growth, further throwing water on an 11% return scenario.

Alternatively, if P/E's are held constant at 28 times, if we earn the same 1.35% dividend yield and the price of the S&P 500 grew 9.65% per year to 2952, earnings would equal $105.42. At 6% sales growth, margins would have to average 7.65% for the 10-year stretch. Margins have reached or exceeded 7.65% in only 5 years during the past 100 years: 1929, 1941 and the post-war years of 1947, 1948, and 1950. The episodes in the post-war years were fueled through repeal of the wartime excise tax on profits.

How We Derive Our S&P 500 Forecast For the Next 10 Years

Stepping back to reality, we think the present level of stock prices not only reflects a massive rebound in profits for 2002, which we do not believe will transpire, but requires Herculean changes to capitalistic laws which are less pliable than Wall Street needs them to be. Sales growth going forward is constrained by headwinds. Profit margins are bound by the laws of capitalism. The P/E expansion from 8 times to over 32 times, a quadruple, accounted for over 60% of the gains from 1982 to 2000. With interest rates having completed a secular decline, further declines would imply serious systemic deflation. Deflation hurts stock prices. Check with the Japanese or with those who survived the U.S. Depression in the 1930's. So if P/E's have peaked and profit margins advance no faster than sales advance, then low single digit returns are the most one can expect from average aggregate returns for the stock market for the next 10 years.

Semper Augustus calculates the fair intrinsic value of the aggregate stock market by "normalizing" after tax corporate profit margins at a best case 5%. We assign a "normalized" best case P/E multiple of 17. We assume growth in sales and profits of 4% in nominal terms. At profit margins of 5%, earnings for the S&P 500 in 2002 would be $38.50. Sales and earnings growth of 4% and a P/E of 17 times equate to a **655 intrinsic value for the S&P 500 today, 43% below the current market level. At a 4% rate of growth in sales, earnings and stock prices, the index would only grow to 970 in 2112. This is our forecast. At a 1.35% dividend yield, growing at 4% per year, the total return for the S&P 500 works out to 0% per year.**

Consider a ten-year extension of our logic at a higher rate of growth. If sales, normalized earnings and stock prices grow at 6% per year for the next ten years instead of at 4%, then a 5% profit margin 10 years out would equate to earnings of $68.90. Capitalized at 17 times earnings, the S&P 500 would be valued at 1171.30. This is our best case estimate which requires higher growth than we think likely. With the S&P 500 at 1175, the index is exactly 3.70 points and 10 years ahead of itself.

If our best case projection proves correct and the S&P 500 winds up at 1171.30 in 10 years, then the annual total return would work out to a 1.35% return per year, all from dividends. We will shortly demonstrate how investment costs eat up more than dividends earned each year for the average investor.

For our forecast to err on the side of conservatism, we put together a table which assumes the S&P 500 is fairly valued at 1175 today. The table illustrates P/E multiples or profit margins at various price levels for the index in 10 years. The example in the table assumes GDP and sales can grow at an annual rate of 6%. The first two columns calculate the price level of the index 10 years from now at rates of growth from 0% to 20%. The third column calculates the P/E multiple required to justify the index level in the second column if profit margins average 5%. As we previously calculated, $38.50 in earnings growing at 6% per year will grow to $68.90. Alternatively, if P/E multiples are held constant at 20 times, the fourth column illustrates the profit margin in 10 years, again assuming sales growth of 6%. Put differently, the third column assumes P/E multiples can expand, holding profit margins constant. Likewise, the fourth column assumes profit margins can expand, holding P/E's constant. Note: columns three and four are mutually exclusive. They represent an either/or scenario.

Hypothetical P/E's or Profit Margins at Various Levels for the S&P 500

10 Year Annual Gain in S&P 500	S&P 500 Index in 2012	P/E at 5% Profit Margin i.e. $68.90 eps*		Profit Margin At a 20 P/E Multiple*
0%	1175	17.0		4.3%
1%	1297	18.8		4.7%
2%	1432	20.8		5.2%
3%	1579	22.9		5.7%
4%	1739	25.3		6.3%
5%	1914	27.8		6.9%
6%	2104	30.5		7.6%
7%	2311	33.5		8.4%
8%	2537	36.8	**OR**	9.2%
9%	2787	40.4		10.1%
10%	3048	44.3		11.1%
11%	3336	48.4		12.1%
12%	3649	53.0		13.2%
13%	3989	57.9		14.5%
14%	4356	63.2		15.8%
15%	4754	69.0		17.2%
16%	5183	75.3		18.8%
17%	5648	82.0		20.5%
18%	6150	89.3		22.3%
19%	6691	97.1		24.3%
20%	7275	105.6		26.4%

*Assumes 6% growth in nominal GDP and Sales

A recent study by the Vanguard Group concludes the majority of 401(k) investors are counting on long-term annual returns of at least 15%. In the table, a 14% price gain (total return of 15.35% if dividends keep up with earnings) in the S&P 500 would result in an index level of 4356 in 10 years. At 6% percent sales growth, the P/E would be 63.2 times with profit margins at 5%. Likewise, a 20 P/E would require earnings of $217.80 (4356/20). At 6% growth in sales and a 20 times P/E, profit margins would have to expand to 15.8%, over twice the level considered "peak" for the last 75 years. The average U.S. business currently earns less than 15% before counting interest, taxes and deprecation charges.

Bull markets are generally accompanied by both expanding profit margins and P/E multiples. In the table, a price gain of 14% per year would produce 4356 for the S&P 500 10 years out. Instead of looking at the extremes of a 63 P/E or 15.8% profit margins, a result combining the two extremes could be considered. A 35 P/E multiple would require earnings of $124.46, a 9% profit margin.

Remember the recent notorious book, Dow 36,000? The front cover claimed, "Rock solid investment advice…long-term investors can place it on an altar next to the works of Benjamin Graham, as well as Warren Buffett's annual homilies to his Berkshire Hathaway investors." We can extend our table from the S&P 500 to the Dow Jones Industrial Average. If profit margins were to average 5% and sales growth 6%, then a 7275 S&P 500, at 105.6 times earnings, would equate to the Dow in ten years at 36,000. Alternatively, if the P/E for the Dow were 20 times, then the profit margin would have to be 26.4%. From our estimate of intrinsic value today, the S&P 500 and the Dow require 41 years of growth at 6% to reach these levels. At 6% growth in price per year from today's levels (assuming the indices are fairly valued), the S&P 500 and the Dow would be worth 7275 and 36,000, respectively, in only 31 years. In January 1999, the authors of the book, James Glassman and Kevin Hassett, thought the Dow would be worth 36,000 within 5 years. Unlike the complete writings of Graham and Buffett, Dow 36,000 is not on our altar. Crazy.

In January 1999, the authors thought the Dow would be worth 36,000 within 5 years. Unlike the complete writings of Graham and Buffett, Dow 36,000 is not on our altar.

ECONOMIC, PSYCHOLOGICAL, ACCOUNTING, AND INVESTMENT COST FACTORS WHICH WILL WORK AGAINST PROFITS AND P/E MULTIPLES

For those of you still with us, let us now present our case why growth expectations for sales and economic growth are too high, why a 5% profit margin, *realized* by the investor, is unrealistic, and why P/E's will probably collapse at some point in the next ten years. The economic climate should at best yield flat returns for the S&P 500 for the next ten years. Investors should at least contemplate the possibility of negative returns from stocks over the next ten years

The expectation of poor economic growth, poor profit growth and a collapse in margins (read: confidence) has to do with the tremendous overbuilding of the capital stock in at least the last half decade. During the last 5 years of the bull phase ended in 2000, growth in capital spending averaged over 20% per year, reaching over 10% of GDP in 2000 alone. The last economic expansion was accompanied by slower growth in GDP

Annualized Changes in GDP

Year	Growth per Year
1929-2000	6.5%
1933-1951	10.5%
1966-1982	9.2%
1982-2000	6.5%
1990-2000	5.5%

Source: Bureau of Economic Analysis, Semper Augustus

Behind expectations for slower growth in the economy and sales, and for contractions in P/E multiples and profit margins, a combination of the following is likely: Monetary stimulus will have little effect on the economy; a bursting of the debt bubble we believe has unfolded in the last 20 years, thus an extended period of corporate and household bankruptcies and continued rising unemployment; an increase in protectionist trade measures; reductions in the growth of ownership of U.S. financial assets by foreigners; a precipitous decline in the trade weighted value of the U.S. dollar; a rise in labor's claim on the economic pie; continued weak capital spending; an increase in household savings and a correspondent decline in consumption; and a decline in stock market participation by institutional and individual investors. In the following section on accounting and investment costs, we discuss the need for a reversion to more conservative accounting conventions employed by public companies. We further quantify aggregate investment costs, which also detract from profits realized by investors.

Interest Rates -- Panacea or Placebo

The majority of investors and prognosticators believe that the recent declines in interest rates will have an immediate and lasting positive impact on the economy and the stock market. In fact, they project higher short-term rates by mid-year. We doubt it. During 2001, the Federal Reserve slashed its Fed Funds target 11 times, reducing the target rate from 6.5% to 1.75%. The discount rate now stands at 1.25% and major bank prime rates reside at 4.75%. The U.S. has not experienced such low levels of rates in over 40 years.

Alan Greenspan has become a cheerleader for the economy. During Greenspan's entire tenure as Fed chief, he has fought inflation, lowering interest rates as a stimulative measure. He is slowly awakening to the notion that companies, swimming in easy credit during the majority of his reign, have over-invested in capital assets for too long. An overbuilt capital stock needs to be utilized or reduced. No level of interest rates will encourage a company to add to an already over-leveraged balance sheet to add to capacity while current capacity goes unused. Years of disinflation, or declining inflation rates, may be turning to deflation.

Economists for years blamed the Fed for the 1930's depression. They claimed the Fed too slowly reacted to the slowdown in capital spending and rising unemployment. As it does today, the economy had too much capacity, both fixed and labor. Generally forgotten, the Fed began to slash rates immediately after the September to October stock market crash in 1929.

From its September 4, 1929 peak of 381, the Dow Jones Industrial Average dropped to 200 by mid-November. Before the November low, the Fed cut its discount rate from 6% to 5% on November 1, 1929. On November 15, it cut again from 5% to 4.5%. It cut to 4% on January 30, 1930, to 2.5% by June of 1930, and to 1.5% by mid-1931. The Fed was not sitting on its hands, acting as aggressively as the current Fed during the current economic and market slowdown. The series of Fed interest rate cuts and increases during the 1920's and early 1930's resembles those administered over the last 10 years (we will provide the data to anyone who cares to evaluate the exciting similarities).

Throughout the devastating decline
in the 1930's, low rates did not help.
Credit became sparse.
Huge levels of idle capacity
left companies unwilling to build.

The impact on the economy of aggressive Fed stimulus from 1929 to 1931 was benign. Working off an overbuilt capital stock is a timely and painful process. From a level of $103.7 billion in 1929, nominal GDP declined to $56.4 billion by 1933. The stock market lost 89% of its value from the September 1929 peak to the 1932 low. The loss represented $87 billion in market value, 84% of 1929 GDP. By comparison, from the March 2000 market peak to the September 21, 2001 low, the market lost $9 trillion in value, 91% of 2000 GDP, but only 45% of its peak value -- so far.

The situation parallels modern day Japan. The Japanese stock market has lost 75% of its value since 1989 and property values have tumbled over 50%, despite very aggressive easing by the Bank of Japan. Short-term interest rates have been less than 1% for over five years. Ten-year Japanese government bonds have yielded under 2%. All the while, the Japanese government continues to run massive budget deficits (fiscal stimulus). Japan's government debt now totals 140% of GDP. Most industrialized nations consider any government debt level in excess of 60% to be dangerous.

Today's Fed is further weakened in that the banking system currently accounts for less than 25% of credit market debt, versus close to 40% in the early 1980's.

Anticipating an enormous economic recovery by the second half of this year, the markets expect the Fed to raise rates by mid-year. Futures markets expect short-term interest rates at nearly 4% by the close of 2002 and 6% by 2003.

Here is the quandary. We know that P/E expansion from 8 times to over 30 times accounted for over 60% of the market advance from 1982. If the market is right and short rates are much higher 12 to 24 months out, what would happen to P/E's? They would likely fall, muting any advance in stock prices. On the other hand, what if we face deflation and start to resemble the Japanese situation over the last twelve years? Lower rates reflect deflation. We do not believe P/E's would expand in a deflationary environment, but would rather contract. Our economy is built on firm prices. A decline in price levels, and even in nominal GDP, would result in a collapse in P/E's and profit margins. Corporate America is highly leveraged. Very small declines in leveraged sales are already having disastrous effects on profits. At a point, low interest rates should not equate to high P/E's. In 1942, U.S. interest rates were at their lowest level during the most recent century. The P/E multiple was 8. In 1948, rates were low and P/E multiples were still in the single digits.

By lowering rates so aggressively, the Fed is attempting to prevent market forces from working against weak, high cost and leveraged enterprises. Recessions and depressions are necessary. Bailouts of governments, lenders, investors and companies fosters overbuilding and mal-investment. Why not build, regardless of unacceptable returns, if you know a bailout is right around the corner when times get tough? The lesson the Fed is re-learning, and it will be Greenspan's legacy, is that no level of interest rates can permanently prevent market cycles from doing their job. They can only protract the day of reckoning. That day may be close at hand, despite 1.75% or lower Fed funds.

Bursting the Debt Bubble

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The secular decline in interest rates has encouraged an unprecedented leveraging of corporate and household balance sheets. Twenty years of declines in interest rates and overly easy monetary policy cause a lack of sleep and unnecessary graying of the temples. We worry about how the system will deal with enormous debt loads.

From 158% of GDP in 1982 to 278% today, total credit market debt grew from $5.1 trillion to $28.3 trillion. GDP grew by $6.9 trillion over the same period, while requiring $23.2 trillion in additional debt to perpetuate its growth. GDP grew at a 6% annual rate while debt ballooned at a 9.2% annual rate. In another 20 years at the same progression, GDP would grow to $32.7 trillion with total credit market debt swelling to $165 trillion, 5 times the size of GDP. At an average 7% rate of interest for all borrowers -- corporations, governments, and households, the interest alone would consume over 1/3 of GDP. Interest already consumes nearly 20% of GDP. Debt growth must slow.

The problem with slowing lending is the resultant bugs which creep out of the economic woodwork. If bad debts grow at a slower rate than new loan creation, everything can appear calm and fine on the surface. When loan growth slows, bad debts, which had been there all along, begin to overwhelm lenders. Slowing loan growth is generally the result of the realization by lenders that past loans are poorly performing. The marginal loan may be perceived as unwise and therefore is not extended. A calling in of loans is not required for problems to surface. A simple slowdown in the rate of debt creation can do the trick.

The last five years of the debt bubble do not paint a pretty picture. Since 1995, corporations took on debt to invest in capital assets and to repurchase shares. Since 1995, corporations doubled their stated debt levels from $2.5 trillion to $5 trillion (it took the prior 30 years, since 1965, for corporate debt to grow by $2.5 trillion). Corporate debt doubled while GDP only grew 39%, from $7.4 trillion to $10.3 trillion. At its peak in 2000, capital expenditures exceeded $1 trillion, 10% of GDP. In that year alone, capital expenditures exceeded free cash flows by over $500 billion. Corporate debt, not including off-balance sheet liabilities and debt of financial companies (which generate 24% of S&P 500 profits) has grown to 50% of GDP, up from 30% in 1982 and 22% in the early 1950's. Capital expenditures have exceeded free cash flow in every year since 1982, the difference funded by new debt.

Households increased their debt levels as well. During the 1950's the average family had a single wage earner. By the early 1980's, dual wages maintained the standard of living. In 1982, household debt was $1.5 trillion, 48% of GDP. Households today carry $7.7 trillion in debt on a $10.3 trillion GDP. Household debt now exceeds annual personal income for the first time in history. Households leveraged their homes, reducing owner's equity from 85% in 1945 to 70% in 1982 to 54% today. In fact, from March 2000 to March 2001, homeowners reduced equity in their homes by $175 billion while increasing installment loans by $140 billion. This is amazing given the high number of older families who own their homes outright.

As the economic slowdown unfolds, household and corporate liabilities have grown at over 20% per year as debt piles on, partly to service current obligations. Heaven forbid the economy should stay soft (which we think likely). Debt levels have grown to levels exceedingly difficult to service in good times, perhaps impossible in bad times.

An interesting aspect of the debt bubble is another comparison to the 1930's. According to Benjamin Graham (from a book on our altar), the stock market bubble of the late 1920's was financed with household borrowing. Individuals borrowed to invest in stocks. While those households speculating in stocks were leveraged, only 1.6 million active brokerage accounts existed, of which 600,000 were margin accounts. The U.S. population was 120 million.

Corporations generally entered the depression flush with the cash raised from the public in the late 1920's. Companies sold equity shares to the public, they did not take on debt. We know that corporations lost money during the depression. After-tax corporate profits peaked in 1929 at $9.2 billion, fell to $3.4 billion in 1930, to losses of $100 million in 1931 and losses of $1.9 billion in 1932. While cash on the balance sheet did not prevent losses, it did ensure corporate survival. Many companies' stocks traded at discounts to their net working capital. In other words, their stocks were basically worth less than their cash in the bank, even after paying off all their debts.

Households didn't fare so well. Disposable personal income fell from $83.2 billion in 1929 to $45.9 billion in 1933. Unemployment jumped from 2.3% in 1929 to 25% by 1933. Fast forward to today. Should unemployment continue rising as companies slash production, expect continued weakness. Unemployment jumped from 3.9% to 5.8% as employers slashed over 2 million jobs. Personal and corporate bankruptcy filings surged.

The process of unwinding the debt bubble has begun. We worry about the solution and just hope the result is not a Weimar Republic or 1990's Japan-like scenario.

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Foreigners, like Billy Joe and Bobby Sue Down in Texas, May Take the Money and Run

Foreign investors have become substantial holders of U.S. financial assets, with holdings of $4.4 trillion. Should they sell assets to repatriate capital, weakness in U.S. asset prices would be profound. These foreign investors financed our debt bubble with surplus dollars generated in international trade with the U.S.

Beginning in 1975, the U.S. became a net importer of goods and services on a consistent basis. In absolute terms, international trade now comprises a much higher share of the economy than it had prior to the late 1970's. Imports made up 5% of GDP in 1929, 4% in 1950, 4% in 1965, 7.5% in 1975 and never dropped below 10% beginning in 1979. In 2000, the U.S. imported $1.46 trillion in goods and services, 15% of GDP, while exporting $990 billion, 10.7% of GDP. Our net trade position amounts to $364 billion, or 3.7% of GDP. By importing more than we export (current account deficit), a surplus of dollars are left in our trading partners' hands each year. On a regular basis, foreigners invested their capital surplus back into the U.S. (capital account surplus) in the form of stocks, bonds, and money market instruments.

At June 30, 2001, foreigners owned $3.2 trillion of U.S. debt instruments, 31% of GDP and 11.3% of total credit market debt. In 1970, they owned a mere $20 billion in U.S. fixed income securities, or 2% of GDP. Foreigners now own 40% of U.S. Treasury debt outstanding, 20% of U.S. corporate debt and 8% of our $14 trillion stock market. On a net basis, foreign-owned assets in the U.S. exceed U.S. owned assets abroad by $2.2 trillion, or 21% of GDP. As recently as 1988, the U.S. net international position was positive.

On a stand-alone basis, the fact that we run trade deficits, financed from abroad, is not a problem. Trouble stems from the likelihood that at some point these foreign investors may decide to take their capital home. We would then expect downward pressure on bond and stock prices and extreme pressure against the dollar. Should the Fed intervene by raising interest rates to defend the dollar (as it did briefly, but sharply, in 1931) at a time of extreme price instability, the dollar's status as the world's reserve currency may be jeopardized. A mere $440 billion, 1/10 of foreign financial holdings of U.S. assets, in selling pressure on our stock and bond markets would exert staggering pressure on the prices of financial assets. Compare that sum to net equity mutual fund purchases of over $200 billion per year during the boom years of 1999 and 2000.

Why would foreigners pull capital out of our market? Perhaps for the same reason they invested here in the first place -- to chase higher yields and returns. Ask yourselves this question. If the United States has the safest investment markets in the world, why had U.S. interest rates been higher than those throughout the industrialized world until late last year? Did the U.S. need to attract capital to sustain our current account imbalance? With U.S. Treasury yields having fallen so far, foreigners are selling U.S. Treasuries. They are chasing higher returns, buying agencies, corporate bonds and stocks. Net foreign selling of U.S. financial assets, not mere reallocation, would be disastrous for our financial assets. Remember, Billy Joe and Bobby Sue are still running down south of El Paso today.

The Tradeoff Between Labor and Capital -- Workers of the World Unite

Related to our discussion of profit margins, we believe labor has begun a secular claim against the cash flows of corporate America. A nearly perfect inverse correlation exists between labor costs and profits. As corporate net income increases, the portion of sales rewarding labor becomes smaller. Conversely, during periods of reduced corporate profits, labor's claim against the cash flows of business are the highest. For over twenty years, profits commanded an increasingly large slice of the economic pie. Some real, some perceived.

Wage growth did not keep up with the stock market, the value of GDP or corporate profits during the bull market that began in 1982. Wages barely kept up with the 3.5% annual rise in inflation. Hourly wages relative to virtually any cost were much higher 20 years ago. The value of an hour of wages is at a record low relative to barometers such as median housing prices, a share of the S&P 500, average automobile prices, and football tickets. Among the few items outstripped by wages have been the Big Mac and Coca-Cola. Bon appetit.

Changes in pension plans and with stock option compensation should exact downward pressure against corporate profitability going forward. Regarding pensions, a major reversal from non-cash credits to cash expenses may transpire over the next few years. As for options, with stock prices having fallen so far at many companies, employees may prefer good old cash at some point. Other pension and stock option changes are afoot. We elaborate on both of these themes in the next section on accounting adjustments.

Many firms recently slashed or eliminated optional profit sharing and 401(k) matching contributions. Labor will ultimately demand a reward due to this bit of management parsimony when the economy ultimately recovers.

Consumption vs. Savings -- A Bird in the Hand or Two in the Bush

Everyone understands that a household can save or spend. It's a simple, yet important, trade-off. Consumer spending comprises nearly 70% of GDP. As stocks advanced at nearly 20% for many years, households let the market do their saving for them. With market declines, households are apt to reign in spending and increase savings. Bull markets, especially in boom phases, are accompanied by a declining savings rate. Bear markets are accompanied and followed by many years of increases in savings. Witness Japan, where the government is unsuccessfully doing everything it its power to get the consumer to loosen the purse strings, yet savings still dominate consumption.

In the U.S., households saved 10.9% of disposable personal income in 1982. The percentage steadily declined over the past 19 years, with the notable exception of the two years following the 1990 mini-bear market and the 1990-91 recession. By 1999, the savings rate dropped to 2.4% and fell to 1.0% in 2000. Only 1932, 1933, and 1934 saw a lower savings rate (two years of negative savings). Recently, some calculations indicate a negative savings rate. While technically correct, the negative number mistreats the reinvestment of capital gains, primarily those realized and distributed by mutual funds.

The significance of an increase in savings from 1% of personal income to a more normal 5% would be monumental. The hit to industries catering to household consumption would come with great pain. A 4% swing out of consumption and into savings would amount to almost $300 billion, 3% of GDP, or 4% of personal spending and over half of corporate profits.

Capital Spending Weakness -- This is Not Your Father's Recession

A decline in household consumption led every post-WWII recession. This time is different. The profit cycle drives the capital spending cycle. Capital spending drives the economy.

Our past discussions of capital spending budgets in the oil and gas industry serve as a good example of capital decisions in the broad economy. Recall that oil and gas companies generally increase their exploration and production budgets only *after* periods of price weakness and *after prices and profits rise for a period.* They typically slash capital spending after surplus capacity drives prices and profits down. The cycle completes once enough capacity is taken out of production and demand again exceeds supply for an extended period.

Capital spending in the broad economy behaves the same way. We make a distinction, however, between cyclical and secular capital spending cycles. Excess capacity created by high capital spending for extended periods is a hugely deflationary force. When debt is incurred to finance a capital spending boom, high interest costs keep returns on capital, profits, and equity markets under pressure for long secular periods.

Some of the overbuilding can be attributed to recent (now gone) government budget surpluses. As the government reduced its annual borrowing and actually refunded debt (read: returned money back to lenders), an army of natural lenders (bond buyers) were left with cash that needed to go somewhere. Pension funds, banks, insurance companies, bond and balanced mutual funds, foreigners, and the handful of fixed-income buying households needed a home for their capital. Corporate America came to their rescue.

The overbuilding in the capital stock became excessive in the mid-1990's. In five short years through 2000, corporations doubled the leverage on their aggregate balance sheet. The debt largely found its way to projects of unrealistically high returns. Telecommunications equipment, fiber-optic networks, satellite networks, gypsum wallboard plants, cement plants, movie theaters, retail outlets, hotels, assisted living facilities, manufactured homes, cruise ships, airplanes and myriad other capital intensive assets were financed, much of which now sit idle or underutilized. In fact, capacity utilization rates are under 75% at a 19-year low. As demand growth falls or slows down, capital spending plummets. Capital equipment manufacturers are particularly hard hit.

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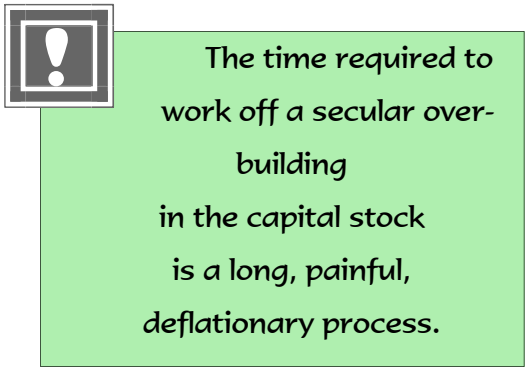
Related to our prior discussion of profits, another way to measure profitability is as a percentage of invested capital. Capital represents the combination of the equity and debt in a business. Without an elaborate analysis, a company should ideally earn a return (profits) higher than its cost of debt and its cost of equity.

Given the notion that as an economy we have massively overbuilt our capital stock (too much capital expenditure for too many years), returns at some point must fall. We are past that point. The laws of economics mandate that a simple slowdown in the rate of sales growth by the users of capital assets can yield disastrous declines in business for capital goods manufacturers.

The time required to work off a secular overbuilding in the capital stock is a long, painful, deflationary process. Examples can be found in the U.S. in the 1930's and in Japan for the past 12 years. We do not expect a material rebound in capital spending any time soon.



Equity Allocation -- Buy High, Sell Low

One of the most reliable, contrary and counter-intuitive gauges for the prospects of stocks is the psychology of investors, professional and amateur alike. When investors are the most bullish and committed to equities, the market is most ripe for a decline. Conversely, low allocations and pessimism are generally associated with market troughs.

Traders use sentiment gauges to measure short-term swings in the market. Sentiment gauges are even better from a long-term standpoint. Without quantifying the various sentiment measures we follow (for the sake of space), suffice it to say that institutional investors, households, foreigners, and strategists are now more fully invested in stocks than at any time. Prior periods of full commitment, 1929, the late 1960's and 1987 all ended badly.

Conversely, investors were very under-invested during periods of low equity prices, generally those periods when bull markets are born. Richard Bernstein, Chief Quantitative Investment Strategist at Merrill Lynch, tracks Wall Street strategists' level of recommended stock allocations. Since 1985, the combined strategists' target equity allocation ranged from 50% to 60% and averaged 55.2%. At 72%, the number is currently at an extreme all time high allocation to stocks. The indicator flashes caution to those who use it in a contrary fashion. We heed these signs of extreme investor optimism with long-term caution. Investors maintained their optimism after the initial market crash and economic softness in 1929. Their resiliency cost them dearly.

ADJUSTMENTS TO PROFITS FROM ACCOUNTING AND CONSIDERATION OF INVESTMENT COSTS: 2+2=5 AND THERE IS NO FREE LUNCH

The following is an estimate of three aggregate accounting adjustments for the broad market which we make when analyzing individual companies. Also, we try to estimate aggregate investment costs borne by investors in the stock market. Through this analysis, we attempt to quantify what portion of operational profits, reported by publicly traded companies, actually inure for the benefit of shareholders. Our conclusions are mind boggling. Perhaps our math is too aggressive on both counts. We welcome any insight into flaws in our assumptions. At a minimum, however, accounting machinations and investment costs are clearly eating away at whatever profits actually accrue to shareholders.

Fatally Flawed Accounting

Accounting for corporate profits has never been worse, only close in the late 1920's. The short-sighted need to inflate current reported profits pushed the envelope. We make profit adjustments to every company we look at closely. We wrote extensively about accounting shenanigans in the past, and we will in the near future as well. For this aggregate analysis, we adjust corporate profits for costs associated with stock options, recurring one-time write-offs, and the normalization of long-term pension costs.

We think profits at public companies, which make up over 80% of aggregate U.S. national income, have been entirely overstated. In other words, publicly traded companies in recent years may not be generating any profits at all.

Absurdly, with exceptions like Enron, profits have been legally reported. However, the vast majority of investors who do not make accounting adjustments place an extraordinary amount of confidence in a mirage.

As more investors begin to awaken to reality, the accounting profession and corporate managements should have no choice but to become more conservative in their financial reporting. It may take numerous bankruptcies and lawsuits to accomplish this. *Caveat emptor.*

Remember our definition of investing: The outlay of cash today for the present value of a discounted stream of expected profits. So the big question becomes, how much of those future profits will actually flow to owners (stockholders) in the form of dividends or capital appreciation?

One of the most intriguing and shocking ways to answer that question is to quantify how much of recent operating profits are real and will actually accrue for shareholder benefit. Our take on the answer is frightening.

Employee stock options: The increased use of stock options has materially allowed companies to overstate profits. Stock options are not an expense item on the income statement. Yet, employees recognize and count on stock options as compensation. Options have replaced and supplemented cash compensation at public companies to a great extent. In fact, in a perverse twist, companies actually get a tax credit for the difference between the strike price and the exercise price of an option upon exercise and exclude the social security company match from operating earnings.

Roughly 2% of outstanding shares are issued by public companies as stock options (significantly higher in industries like high-tech). This percentage was only 1% percent five years ago and virtually nil in 1982. We estimate in 1982, fewer than 300,000 employees received stock options. By 1990, nearly 1 million options were granted to employees. In 2000, over 11 million employees received options. Issued, but unexercised options amount to an overhang of nearly 15% of total shares outstanding, up from 5% ten years ago.

The dilution, combined with the cash cost to repurchase shares to offset dilution, allows corporate profits to be overstated by over 40%. Corporations grew at roughly 5.5% per year for the past 10 years. In 2000, operating profits for the members of the S&P 500 totaled $487 billion, 85% of U.S. national profits. At recent market prices over 140% of sales, a 2% dilution rate implies at either extreme:

5.5% long-term growth, if companies do not repurchase option shares to prevent dilution, drops to 3.5% due to dilution.

OR

If all option shares exercised are repurchased by companies to prevent dilution, the cash cost at current prices would consume over $200 billion, net of cash receipts from employees upon exercise.

Either way, we need to shave either 2% from growth or reduce pretax profits by $200 billion. The result is often a combination, perhaps a 1% decline in growth and a $100 billion overstatement in profits.

$200 billion = 36% of peak 2000 operating profits.

$100 billion = 18% of peak 2000 operating profits.

The dollar adjustment to profits would shrink as stock prices fall and approach exercise prices. However, experience leads us to believe that dilution actually accelerates as stock prices fall (i.e. companies reprice, reissue or accelerate the use of options to offset the "losses" to employees).

Further complicating the profit picture regarding options is the treatment of tax credits recognized by companies upon exercise. The credit, which represents the difference between the exercise (strike) price paid by the employee upon exercise to the company and the market price of the stock at the time of exercise. In 2000, S&P 500 firms recognized a tax benefit of $35 billion, growing rapidly year over year as the size of option programs grow. The credit is treated as operational, reducing tax rates and enhancing profits despite the lack of expense on the income statement for the cost of the option grant itself. One tangential question becomes, should the government be subsidizing unexpensed compensation programs of the nation's largest firms?

Write-offs: In 2001, a staggering $165 billion (at least) was written off by S&P 500 firms. We assume write-offs generally increase during recessions. Perhaps a logical way to measure "normalized" write-offs is to use an average over several years. If we average write-offs over the past 5 years, incorporating charges taken in both healthy and weak economies, the result averages over $60 billion per year. $60 billion represents 12% of peak 2000 operating profits, 18% of 2001 operating profits, and nearly 20% of our calculation of "normalized" profits.

Companies use one-time write-offs, also known as big baths, to reduce the carrying value of goodwill and other assets. The effect understates economic expenses and overstates profits. Write-offs should reflect past poor decisions by management. Past and future profits are often overstated by burying cash expenses, past and future, in the write-off.

Pension accounting: Rising stock and bond prices and increased actuarial rate of return assumptions (and other actuarial gimmicks) have allowed older companies with defined benefit retirement plans and health plans to reduce or eliminate pension contributions. The trend has gone so long to where nearly 10% of profit growth generated by companies in the S&P 500 in recent years has come from the non-cash pension credit.

We estimate S&P 500 companies have shifted pension expense to pension credit by a net $50 billion over the last 5 years. Companies now recognize an aggregate non-cash pension credit. Actual cash outlays and expenses for pension plans were the norm 5 years back. A rising stock market allowed companies to earn returns above their already aggressive rate of return assumptions. Stock market declines, lower interest rates, and a sustained period where companies earn less on their pension investments than they are assuming will again lead to pension expenses. If pension rate of return assumptions were reduced from 10% to a more realistic (and perhaps still too aggressive) 6%, we estimate pension expense would total nearly $75 billion.

Companies raised the expected rate of return actuarial assumption within their defined benefit plans even as stock prices rose above historic levels of fair value. The increase in the average earnings assumption from around 7.5% in 1982 to around 10% today, coupled with rising asset values, served to reduce or eliminate the funding requirements of most older companies with defined benefit plans. Further, when a plan is actuarially overfunded, companies can book non-cash credits as profits on the income statement from their plans. If we are right that the stock market will be flat to down for the next ten years, companies will not earn their rate of return assumptions.

The earnings assumptions are unrealistically high with bond yields in the 5-7% range and the average pension plan 35-40% committed to bonds. The implication is stocks would have to return 13-15% per year to average a 10% return. The heady days of pension credits may be ending and the days of pension expense returning. Plans may revert from actuarially overfunded to underfunded as realized returns lag return assumptions. Coupled with the likelihood of reductions in the rate of return assumptions, the net swing may be as much as 20% of net profit margins at many large old companies (in other words a 5% margin may become 4%).

Companies have aggressively made other more technical changes with pension assumptions, which we make necessary adjustments to. Their aggressiveness continues. Note the intense lobbying taking place today by executives at large old companies, like Fred Smith at FedEx, with large defined benefit and health plans and large numbers of older and retired workers. The issue at hand is raising the discount rate used to calculate the present value of future pension obligations (some companies are already reducing the discount rate). The rate is currently benchmarked to long-term U.S. government bond yields. Executives would prefer using higher yielding investment grade corporate bonds for the discount rate. Raising the rate from 5% to 7% has the same net effect as raising the rate of return assumption. It lowers pension expense (or increases the pension credit) and makes the funded status of plan assets appear higher than it would appear using more conservative assumptions. Again, this action would only defer the day of reckoning when companies again have to fund their pension obligations in the aggregate, putting downward pressure on profits.

Other accounting adjustments: Depreciation normalization (including the accretive elimination of goodwill amortization), executive debt forgiveness, sales recognition issues, unreserved losses in insurance and lending, and merger accounting are other areas where we make accounting adjustments to arrive at cash earnings when analyzing individual companies. We do not include an additional adjustment for this paper because most are covered under write-offs or are timing issues.

Total Accounting Reduction in Profits

Total normal reduction in operating earnings:

$200 billion from options (assuming no dilution)
$35 billion for option tax credits
$60 billion for average write-offs
$50 billion in pension accounting adjustments

Thus we make $345 billion in normalized ongoing reductions from corporate profits.

For 2000, those adjustments would reduce S&P 500 peak operating profits from $487 billion ($56.13 per share) to $142 billion ($16.37 per share).

For 2001, the downward adjustment reduces S&P 500 operating profits from $329 billion ($38.00 per share) to a loss of $16 billion (-$1.84 per share).

A reduction in profits from the levels reported to us by the most esteemed companies in America in 2000 and an elimination of profits in 2001 demonstrates the quality of earnings has never been worse.

Now for the bad news: By reducing annual corporate profits to reflect economic reality by $345 billion per year, how much of the remaining sliver of cash profits will accrue to shareholders in the form of dividends or enhanced shareholder value? Dividends for S&P 500 firms total approximately $135 billion. However, to answer the question, an investor needs to consider the costs of investing.

Aggregate Investing Costs

In the aggregate, investors incur numerous costs, both seen and unseen.
They pay:

- brokerage commissions
- spreads between bid and ask prices
- SEC transaction based fees
- management fees by advisors
- bank custodial fees
- wrap fees in the brokerage world
- account maintenance fees
- statement charges
- mutual fund management fees
- marketing charges and other fund expenses
- sweep fees
- option and futures brokerage and spread costs
- financial planning charges
- consulting fees
- actuarial fees
- sales loads and variable fund sales costs

In total, and we are probably conservative, investors part with at least $200 billion per year. This cost works out to 1.4% of the current value of the stock market. Many of these charges are based on the size of assets, such as management fees and sales charges. Mutual fund advisory fees actually rose as a percentage of assets in the past 10 years. Others costs are fixed. We began analyzing aggregate investment costs several years ago. Clearly decimalization and the commodtization of brokerage costs have lowered trading costs. However, it still amazes us the stock market turnover rate is now in excess of 100% per year. The New York Stock Exchange turns over once per year. The Nasdaq turns over more than twice, even adjusting for double counting.

The Combined Effect of Accounting Adjustments and Investment Costs on Cash Profits for Shareholders

Again reverting to our definition of investing as the outlay of cash for future cash flows, investing costs must be considered. It is entirely appropriate to subtract these costs from corporate profits in the aggregate. This is truly cash out the door each year. Think of it this way. If you pay a "professional" a 5% annual fee to invest in a one-year fixed-income security yielding 5%, your net return before tax would be 0% (you would really have a problem if the interest was taxable but your fee was not). The same logic applies to the ownership of stocks. Assume you buy a stock with a steady earnings yield of 4% (P/E averages 25 over time). Further assume you incur investment costs equal to 4% of the value of your investment each year. The annual investment costs would offset your share of the profits of the company (which should ultimately inure for your benefit). It is really tough to make money this way.

By adding $200 billion in investing costs to our $345 billion reduction in profits from accounting conventions, the aggregation of stock market investors lose $545 billion per year relative to reported operating profits.

Dividends total roughly $135 billion for S&P 500 companies, *pre-tax* to investors. By adding $135 billion in dividends back, the annual reduction from accounting and investment costs reduces corporate profits by $410 billion per year.

For 2000, this reduction would leave investors with $77 billion instead of the $487 billion reported. For 2001, by reducing $329 billion in operating profits by $410 billion in accounting and investment adjustments, investors are left with losses of $81 billion. We find capitalization of losses challenging, at a minimum.

Looking out ten years, many of the accounting excesses of the last six or seven years -- options, write-offs, pensions, and many others -- may be cleansed from the system. The only way for this to unfold would be for the market and the economy to cleanse itself of the excesses fostered by the bubble. This process needs to take longer and inflict more pain than many investors would like. Aggregate investment costs should also decline in an environment of reduced or negative returns over a period of many years. Indeed, several money market funds have recently lowered their fees because the fees were higher than the yields on the funds. We suppose the funds would have had a difficult go of it asking shareholders to send in checks to make up the difference.

Should the cleansing of excesses transpire, sales growth and profitability will be muted over the next 10 years. Companies and businesses need to clean up their balance sheets, either with cash flow or through restructuring (bankruptcy). Expectations regarding output and investment returns need to be drastically scaled back. The overbuilt capital stock needs to be utilized or eliminated. All of this will take time. All of this is necessary, however, for the long-term health of our economy and our way of life.

WHAT ARE WE DOING IF OUR PROJECTIONS ARE SO DOUR FOR THE STOCK MARKET AND FOR THE ECONOMY?

We need to consider what we deem to be important when it comes to investments.

After reading this paper, you may think we spend more time thinking about the stock market and the economy than we actually do. We do spend significant hours looking at, reading about and thinking about companies. Individual businesses and the industries they participate in are our focus.

We attempt to identify companies with favorable characteristics and buy those companies at prices less than our estimate of the fair value of the business. Companies with a competitive advantage versus their peers and those that generate cash instead of consume it are attractive. We assess the abilities and the honesty of management. We **must** understand how a company works not only today, but how it will in the future. We avoid complicated businesses which must be reinvented with frequency. Waking up to find your product or service has become obsolete is not conducive to making money. We like companies that can grow internally faster than GDP. Growth can bail an investor out of trouble, unless the price paid was way too high.

We like companies that can operationally function over long periods of time with an intelligent capital structure. Debt is fine, but it needs to be managed and reasonable. Our companies should service debt out of cash flow, in any kind of economic environment. A lousy way to make money is to stay one short step ahead of your creditors. They invariably catch those who dangle on a thread. We are truly surprised how few of the companies we analyze meet our set of investment criteria, perhaps 5 out of every 100. But simply identifying and buying good businesses is not enough.

We incorporate a dual margin of safety in our process by buying good companies at a discount to our measure of intrinsic value. By estimating a company's worth, after accounting adjustments, and assuming what price an intelligent investor armed with honest data would pay for that business, we put a price tag on the company. We think the capital markets are extremely efficient in the long run, but inefficient in the short-term.

From time to time, the market offers up an outstanding company at a giveaway price. That's when we try to buy. If we determine the fair value of a good company to be $50 and we can buy that company for $25, that's how we attempt to deploy capital. If that company grows its fair value at 8% per year, next year the fair value will be $54. In ten years, if the business executes and grows its franchise value at 8% per year, the value in 10 years will be $100 (assuming the same set of expectations 10 years from now).

We apply the same technique of identifying good companies as we do in this analysis of the aggregate stock market.

From a total return standpoint, if the efficiency of the market takes hold of our $25 stock price, and we recognize our fair value estimate, then here is what we would earn if our stock trades at fair value in each of the next 10 years. Beginning with a purchase price of $25:

Years Out	Fair Price	Total Return	Annualized Return
Current Price: $25	$50.00	100%	100%
1	$54.00	116%	47%
2	$58.32	133%	33%
3	$62.99	152%	25.5%
4	$68.02	172%	22.2%
5	$73.47	194%	19.7%
6	$79.34	217%	17.9%
7	$85.69	243%	16.7%
8	$92.55	270%	15.6%
9	$99.95	300%	14.9%
10	$107.95	332%	14.2%

The longer it takes for our stock to trade at fair value, the lower the annual return. As long as our growth rate remains at 8% per year, our total return, assuming we paid less than fair value, would always be over 8% per year.

Logically, if we pay exactly fair value, then our return over time would equal the growth rate, all else held constant.

Tragedy stems from overpaying. If fair value is $50 and the growth rate is 8%, then any price paid over $50 will result in long-term total returns at fair value under 8%. Legendary investor Peter Lynch advocated buying good companies. This advice served Peter and investors well during his days at the helm of Fidelity Magellan where he made the recommendation during a period of broad stock market *undervaluation*. By continuing to proffer the advice, with stock prices now *overvalued*, he has done a great disservice to the investing public. It is very difficult, if not impossible, to materially overpay for a company, even a good one, and expect to earn an excellent return over the long haul. The PRICE paid for a company is critical to the long-term return.

We apply the same technique of identifying good companies as we do in this analysis of the aggregate stock market. Typically, we expect a combination of margin expansion and p/e expansion to drive our growth, in addition to the underlying growth in the business. We search for hidden assets or unrecognized sources of earnings. We are often early relative to other investors in recognizing positive changes in a company or industry. A long-term view allows us to focus on criteria different from that used by the typical short-term investor. This is not bottom fishing, it is looking beyond the current industry situation.

In short, we think we identify and define risk differently than other investors. Risk to us is not underperforming some chosen benchmark. Risk to us is the loss of capital, a reduction in purchasing power. If the market shrinks by 70% and we "only" lose 60%, this may be moral victory to some, but a tragedy to us. Risk is a permanent impairment of capital. Many investors are led to believe that in order to earn a higher rate of return, an investor needs to assume more risk. The higher the risk, the higher the return. We find this notion ill conceived and not realistic in practice. We have seen investors ratchet up the risk spectrum only to permanently lose plenty of capital.

We believe that without taking undue risk, we can earn, over long periods of time, healthy and acceptable returns. This idea flies in the face of most investment logic, but the principle proves quite valid and demonstrable over time.

How Could Our Stock Market Forecast Be Wrong Over the Next Ten Years?

Our best case forecast of a zero percent aggregate return from stocks for 10 years, including dividends but excluding investment costs, incorporates forecasts with regard to normal corporate after-tax profit margins, P/E multiples, interest rates, and growth in business and industry. To peg fair value of the S&P 500 above or below 655 today and 970 ten years out leaves two alternatives. We could be too conservative, whereby stocks generate a positive total return, or we could be too optimistic, whereby returns are negative.

In fairness, we are not predicting that the S&P 500 will trade at exactly 970 exactly 10 years from now or at 655 in the next few months. We estimate fair value is roughly 45% below current market levels, and that it will take at least ten years of economic growth for the businesses that make up the market to catch-up with the current price of the market.

Alternative 1-The market generates a negative total return for 10 years.

In this scenario, the economy may approach depression levels, much like the United States in the 1930's or Japan in the 1990's. Nominal GDP would contract from today's $10.3 trillion level for a period of years. Corporate profit margins would hover at low levels, below 4% or even at losses for a period of years. P/E multiples would contract from today's record levels to single-digit or low double-digit levels. Interest rates would likely fall appreciably or rise appreciably from today's low level. Low rates would be indicative of a deflationary collapse in profits and prices while very high rates, like we had in the late 1970's and early 1980's, would be indicative of price inflation, a very weak dollar, and Fed monetization of our debt bubble.

The likelihood of a scenario involving some, or all, of these factors needs to be contemplated. After all, our expectation of a zero percent total return from the stock market over ten years simply take us back to *average* fundamental levels over the last 100 years. Of significant concern would be if the pendulum swung past fair value on the downside. It may be reasonable to expect that a stock market and economy, so replete with excesses, would only rid itself of these excesses at some level far below "average". The range of possibilities, depending on timing of course, would be a current drop below 655 on the S&P 500 or below 970 ten years out (low P/E's and low margins).

Alternative 2—The market generates a positive, perhaps healthy total return for the next 10 years.

Nearly every investor participating in the stock market today believes stocks are great for the long-term. In fact, we'd be surprised to find more than a handful of people who expect any less than 6-7% annual returns. The majority has been conditioned to expect 11% or so from stocks for the long-term. Even though stocks have declined for two years straight, a strong belief in the promise of the long-term is pervasive. We still read studies showing the vast majority of investors expect at least 15% per year from their stocks.

We would need to avoid a long, deep recession or depression to achieve moderately positive to very high positive gains over the next 10 years:

> Nominal GDP: Would need to grow at least as fast as it has for the past 10 years, 5.5% per year. To generate double digit performance we believe nominal GDP would need to grow faster than its 75 year trendline growth of 6.5%. It did grow at over 9% per year on two 10-year occasions; from the depths of the depression in the 1930's and during the highly inflationary 1970's. During the former, the economy had fallen nearly 50% from its high and the stock market nearly 90% from its high. During the 1970's, inflation averaged over 8% per year. However, stocks, expensive in the late 1960's and early 1970's, actually declined from 1966 to 1982, despite the high inflation. Inflation may have been a pass-through for businesses, but it, along with rising interest rates, sure didn't help stocks.

Profit margins: Corporate net after-tax profit margins would need to recover quickly from 2001's "depressed" level back to the 7% range. Wall Street expects this scenario in 2002. Margins would need to stay at the 7% range, or higher, to achieve a return commensurate with sales growth of perhaps 5-6%. As demonstrated elsewhere, to reach the 15% per year return levels; profit margins would need to move up to double-digit levels. The all-time high profit margin (taxes were low) was 1929 at 9%.

P/E Multiples: To achieve returns commensurate with sales growth, again 5-6% per year, P/E's would need to stay north of 20 times. A 7% margin multiplied by a 20 P/E equals 140% of sales. The market is currently above this level. For double-digit returns, P/E's would need to expand past 30 times. To achieve a 15% return per year, a P/E of 70 times or profit margins of over 15% would be required.

Sales growth: Like GDP, top line growth would need to accelerate beyond the 5.5% annual growth of the last 10 years. Non-dilutive acquisitions at very favorable prices could get us there. Required, however, would be an inordinate number of medium and small size firms willing to sell to larger companies at prices far **below** intrinsic value. Again, were sales levels now extremely depressed, this feat would be attainable. Inflationary growth in the economy would need to translate into inflationary growth in stock prices and nominal growth above the rate of inflation.

Debt: The debt bubble in corporate America and at the household level can't burst. We would need to service current debt plus continue to add to debt loads, likely at faster rates than sales and profits grow, to keep stock prices growing. Devaluing the dollar, i.e. producing hyperinflation may solve the debt problem. The likely result wouldn't be terrific for the recovery of stock prices, though.

Monetary and fiscal stimulus works: Most investors want to believe that lower short-term interest rates and stimulative fiscal policy (lower taxes) always invigorate a slumping economy. While the policy may work in the short-term, we believe that the overbuilt capital stock keeps the upside in check. Investors cannot see how 20% growth in the broad money aggregates (M3 and MZM) would fail to turn the economy on a dime. Should the economy turn up, rising rates could not be passed through by pushing P/E's down. Doubtful.

Energy prices stay low: Goldman Sachs recently estimated that 2001's drop in energy prices cuts $40 billion from the nation's heating bill. Energy prices would need to stay in check.

In sum, we find the case for stock prices exceeding mid-single digits a virtual impossibility. Little margin for error exists for returns to even approach the 6-7% levels now expected by the brightest and wisest investors.

How could the investment actions taken by Semper Augustus be wrong?

Above all else, we consider ourselves stock pickers. Despite all of the risks that we address related to the broad stock market and the economy, we think, perhaps naively, that there are always good companies available at good prices. We are confident in our ability and our patience to find these companies at the right price.

We could be wrong on two counts. One, the economy and the stock market are as bad as they were in the early 1930's, that no stock escapes the downward market pull and no business is immune from the retrenchment by households and industry. Two, we wind up not being very good stock pickers.

Regarding the first point, our portfolio of stocks is trading at roughly 66 cents on the dollar of our conservative measure of intrinsic value. Our portfolio is trading at 14 times our estimates of normalized earnings and we project the growth rate of our businesses at over 8%, over twice the rate of our forecast for nominal GDP growth over the next ten years. In other words, our stocks are high quality and undervalued. The market, on the other hand, needs to decline 45% just to reach fair value.

However, we do absolutely worry about the macro-economic climate. The parallels between the present situation and the U.S. in the early 1930's or in Japan for the past 12 years is striking. While we think we are armed with a dual margin of safety, with good businesses purchased at favorable prices, there is no guarantee that we are immune from a horrible environment.

Regarding the second point, while our track record can by no means be considered long-term, nor can our gains to date be considered permanent, we do think we come to the party with some advantages. For starters, our philosophy appears to be consistent with that of those investors who have generated impressive long-term performance and taken little risk along the way. We are cognizant of investment costs, keeping our sliver of the pie low and minimizing transaction costs and taxes. We believe that no one works harder, yet certainly there are those who work smarter. We only buy companies we think we understand. There can be no doubt that we are cynical and contrarian, two traits indispensable to the investment process.

Yet despite all these so-called advantages, we absolutely make our share of mistakes. We will be discussing our situation with Williams Communications with all of you as it unfolds this year. We were nearly buried by Service Corp. We often own too few shares of good performing stocks, stubbornly refusing to pay an extra nickel for a dollar bill that can be had for fifty cents. Should our mistakes compound, or our philosophy be plain wrong, we may post a poor or mediocre long-term result.

If we fall short, take some comfort in the fact that the principals of Semper Augustus, our families and our clients own the same companies and the same time at the same prices. Bill Clinton felt your pain. We share it. Our clients can rest assured, however, that we will continue doing everything in our power to achieve an acceptable, if not an excellent long-term result. We will let you know a couple decades from now (and along the way) how we did.

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SAI results are time-weighted returns that are gross of management fees and taxes, but inclusive of trading costs and commissions paid. Client accounts are equal weighted in the composite. Returns include the reinvestment of income. SAI published fee of 1.25% would reduce the annual return by 1.25% per year . SAI has clients that pay less than the standard fee and certain performance accounts may pay more than the standard fee. Based on fee, asset allocation, commencement of a client relationship, taxability, risk factors, and other factors; returns may differ from the composite returns. January 1, 1999 is the inception for performance returns and includes terminated, taxable, tax-exempt, and leveraged portfolios above a minimum threshold. Cash and cash equivalents were a significant investment during the period presented.

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