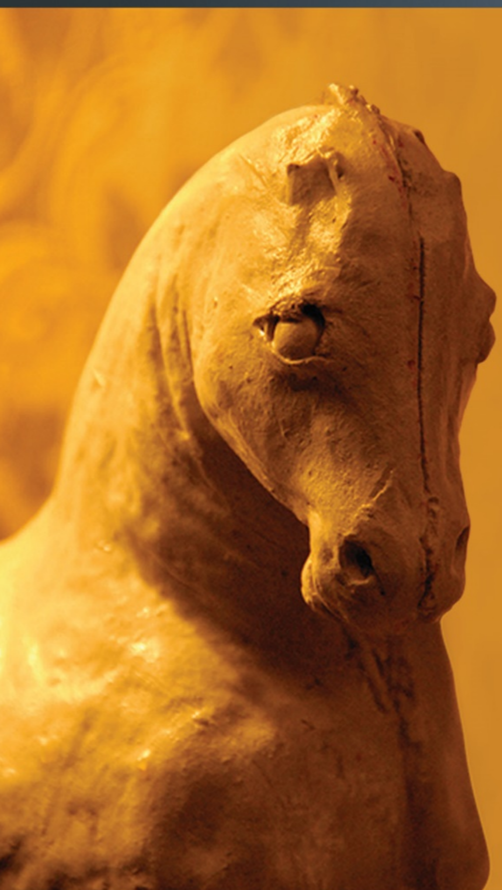

The Equus Report

—BY BARNABY LEVIN

WRONG WAY CORRIGAN

October 18, 2002

Wrong Way Corrigan

Not much has changed since my last report.[1] We're still being bombarded by wave after wave of threats, scandal, fraud and the country's crisis in confidence is as widespread now as it was then. Well, maybe there's been a little progress. Some of the people under investigation have actually pleaded guilty or been indicted and New York's attorney general is on the case. Congress has given President Bush strong bipartisan authority to attack Iraq – with or without UN consent – if Iraq doesn't agree to unrestricted inspections in the search for weapons of mass destruction.[2] And the Fed, while keeping rates unchanged, has moved to an easing bias, clearly signaling their intent to act if necessary.

So there has been progress. But, in my opinion, we're still nowhere near the kind of "closure" that will encourage this country's companies to spend again. Having listened to countless conference calls, I know how the vast majority of money managers are feeling. Whether their focus is Large Cap or Small; Growth or Value; domestic or international – this is the worst market they've seen in years, if not their career. Year-to-date, the S&P 500, Dow Jones and NASDAQ are down 28.2%, 24.2% and 39.9%, respectively. And what I keep hearing is "hope," wishful thinking and comments like "oversold," "washed out" and "this can't last forever."

Maybe that's true. But, while the forces of Supply and Demand are still hard at work, their process for finding the price at which buyers and sellers achieve that state of equilibrium commonly known as "Fair Market Value" is made more difficult due to the rising influence of other factors. As George Soros points out, "What happens in financial markets affects the economic 'fundamentals' that those markets are supposed to reflect."[3] In other words, market prices and investor psychology themselves alter the conditions of Supply and Demand. In fact, a Nobel Prize was recently awarded to economist Daniel Kahneman for his research concerning human judgment and decision-making in times of uncertainty. Referring to a well-known gambler's fallacy, he points out: "After observing a long run of red on the roulette

[1] "A (Sad) State of Mind," July 1, 2002
[2] "U.S. Congress Gives Bush Power to Wage War on Iraq," William Roberts, Bloomberg, Oct 11, 2002. The resolution passed the Senate 77-23; the House 296-133.
[3] "Busted: Why the Markets Can't Fix Themselves," George Soros, New Republic Online, Aug 21, 2002

wheel, most people erroneously believe that black is now due, presumably because the occurrence of black will result in a more representative sequence than the occurrence of an additional red. Change is commonly viewed as a self-correcting process in which a deviation in one direction induces a deviation in the opposite direction to restore equilibrium. In fact, deviations are not 'corrected'; they are merely diluted."[4]

Perhaps, after witnessing the failure of most analysts to accurately forecast earnings over the past couple of years, this may shed some light: "When predictability is nil, the same prediction should be made in all cases (and) the same value should be predicted for all companies." Given the economy's current state of flux, analyst estimates seem little more than a guess and, for the time being, perhaps they shouldn't even try. "Could Falling Stock Prices Derail the Economic Recovery?"[5] The answer, of course, is "yes." Do they have to? Of course not. But instead of trying to predict "the turn," I would rather focus on individual companies. With regard to the markets, we will simply reach equilibrium, one day at a time, whether that day's outcome is "out of sync with the economy"[6] or not.

Finally, while it should certainly have been predictable that the internet bubble would one day burst, it was not predictable when or from what level. Today, selling short is all the rage. But not so long ago, some of the world's most successful hedge funds – including those of George Soros, Stan Druckenmiller and Julian Robertson – were closing their doors scant weeks before the downturn began. After five years of relentlessly escalating valuations – and of wracking up losses to the point where they just couldn't take it anymore – in Q1 2000, they couldn't make sense of things and were calling it quits.

The same is as true today as it was then with Soros – except in reverse. Arguably, we know how oversold the market is – with record short interest,[7] volatility and bearish sentiment matched only by "cry uncle" lows in 90-day to 10-year Treasury

[4] "Judgment under Uncertainty: Heuristics and Biases," by Daniel Kahneman, Paul Slovic, Amos Tversky
[5] "Economic Brief: Could Falling Stock Prices Derail the Economic Recovery?" Tim O'Neill, Chief Economist, Bank of Montreal, Aug 7, 2002
[6] "Buffett Says He Remains Bullish on US Stocks, Economy," CNNfn, Sep 25, 2002
[7] "Shorts' Stature Keeps Growing," Rebecca Byrne, TheStreet.com, Oct 10, 2002

yields.[8] But, once again, it is virtually impossible to know when it will end and the only real question is how long can we last before throwing in the towel and deciding that we never want to play again. Who can blame a guy for giving up? If, every night, when you got home from work, you walked in the door and Bam! got hit in the head with a frying pan -- as much as you love your wife, one day you would finally wake up and decide either to find a different way of getting into your home; a different home to get into; or you'd learn to love getting hit in the head with a frying pan!

The fact is that, since March 2001, the basic structure of the equity market has changed from an underlying bias of upward-trending prices to one of downward-trending prices. And even the strongest companies – those which have continued to meet or exceed expectations; maintained strong balance sheets; invested in their future through expansion, acquisition and innovation; and continued to gain market share – even they have been powerless to prevent their own stock from being pulled down by the force of a sinking tide.

Let me tell you my biggest concern. I believe that many things are going right. We have low interest rates; stable consumer spending that confounds even the brightest economists; improving productivity;[9] and lean inventories.[10] Even within some of the worst-performing sectors from semiconductor to automotive manufacturing, many of the leading companies appear to be at or close to breakeven – at least on an operating basis – if only through a relentless focus on cutting costs. The problem is with top-line revenue growth. It is still stubbornly elusive and, as so many CEOs are saying, "visibility" is nil. As a result, many companies still limit their spending to only the most pressing needs and, as Intel's Craig Barrett recently said: "Only when consumer demand boosts company profits will those companies then invest in more

[8] See attached charts

[9] "As Work Goes On, Shippers, Union Still Deadlocked on Computers," Liz Enochs, Bloomberg, Oct 11, 2002. As an example of industries in which there is still room for plenty of improvement: "In Kaohsiung, Taiwan, the world's fourth busiest port, computers automatically download data on ship cargo. When the ship arrives, software shows the placement of each container onboard to devise a plan for unloading. Crane operators get instructions by computer, then move the containers onto trucks. Drivers take the cargo to a predetermined spot in the yard and trucks going in and out of shipyard gates are processed with optical scanners that read container numbers and input them into the computer system." In stark contrast to this, in West Coast shipyards, much of this work is still done by hand with a clipboard.

[10] "U.S. Economy: Jobless Claims Fall, Growth Seen Rising," Bloomberg, Oct 10, 2002. "The strength in demand pushed the inventory-to-sales ratio, a measure of the time goods sit unsold on store shelves, to a record-low 1.22 months' worth in August."

high technology products."[11] This sounds like a case of the chicken or the egg. After all the refinancing has run its course and everyone has an interest-free car, the economy needs something else to keep the consumer going. In the meantime, the big question is whether companies have right-sized enough to avoid many more layoffs. If so, there is a good chance that we will muddle through as we have until the "Next Big Thing."

Yes, we will continue to be inundated by mountains of conflicting information, as we recently were when looking at last month's employment data. Payrolls (as tracked by the U.S. government) declined by 43,000 in August; yet the unemployment rate itself (based on a survey of households) actually fell to 5.6%.[12] According to Gregory Miller at SunTrusts Banks, "the household survey is giving us a clearer picture of how employment is filtering down to the man on the street. The labor force actually got bigger, and fewer people lost their jobs."[13] While industries from retail to telecom were laying people off, the federal government (whose outlays already account for 35% of GDP),[14] healthcare and the service sectors were continuing to hire.

The media highlights our country's increasing household debt-burden. Yet, according to the Federal Reserve Board, debt-service as a percent of disposable personal income is within 1% of where it has been since 1997.[15] And, at 2.09% for the 100 largest banks, the same is true of delinquency rates.[16] Perhaps this is a result of changes in the makeup of the U.S. labor force, which is getting older, more diversified and increasingly made up of woman.[17] We certainly hear of companies missing estimates. But what about PetSmart, Pepsi, Mattel, Federal Express, or even hi-tech

[11] "U.S. September ISM Manufacturing Index Falls toe 49.5," Carlos Torres, Bloomberg News, Oct 4, 2002
[12] "U.S. September jobless Rate Fell to 5.6%," Siobhan Hughes, Bloomberg News, Oct 4, 2002
[13] "U.S. September Jobless Rate Fell to 5.6%," Siobhan Hughes, Bloomberg News, Oct 4, 2002
[14] "The Most Expensive Government in World History," Stephen Moore, IPI Publications, Feb 2, 2002
[15] "Household Debt-Service Burden," www.federalreserve.gov/releases/housedebt, Sept 30, 2002. Percent, by quarter, Q1'97 through Q1'02: 13.34, 13.44, 13.45, 13.39, 13.31, 13.34, 13.37, 13.40, 13.44, 13.55, 13.66, 13.70, 13.60, 13.66, 13.76, 13.92, 14.05, 14.16, 13.94, 14.39, 14.09
[16] "Delinquency Rates: 100 largest Banks, SA," www.federalreserve.gov/releases/housedebt, Sept 30, 2002. Percent by quarter, Q1'97 thru Q2'02, all real estate (commercial and residential) and consumer (credit card, NSA leases, C&I and Agricultural loans): 2.69,2.52, 2.42, 2.42, 2.36, 2.26, 2.23, 2.20, 2.06, 2.08, 2.22, 1.97, 2.02, 1.97, 2.02, 2.15, 2.13, 2.27, 2.21, 2.21, 2.20, 2.06, 2.08, 2.22, 1.97, 2.02, 1.97, 2.02, 2.15, 2.13, 2.27, 2.21, 2.21,.16, 2.09.
[17] "A century of change: the U.S. labor force 1950-2050," Mitra Toossi, Monthly Labor, May 2002.

companies like IBM, Dell and SanDisk?[18] Each of them has exceeded estimates by comfortable margins. From fiscal Q4'01 through Q4'02, Cisco's year-over-year revenues are up 12% versus the average of their top ten competitors, whose revenues are down 44%.[19] And, on October 4, a company called Mentor Graphics announced that it expects Q3 to exceed Wall Street consensus. Their CEO, Walden Rhines, said: "This is only the second time in the last decade of the company's history that we have had a positive book-to-bill in a third quarter. Remarkably, we saw software bookings grow in all regions, with particular strength in North America and the Pacific Rim. And a strong sales channel exiting the quarter gives us a great start into the fourth quarter."[20] You don't hear comments like that very often any more.

So it seems that, as bad as things are, the strong are getting stronger; competitors are beginning to merge; and customers are giving their preferred vendors an increasing percent of their business. In other words, rewarding those who have the best product, at the best price, and in whom they have the highest confidence. However it's manifested, we are witnessing the long-awaited Darwinian process of industry consolidation. Excess capacity, which is much to blame for the current recession in hi-tech and telecom, is getting eliminated. And, while there still seems to be a sort of paralysis on the part of buyers making decisions, the pipeline of mega-deals – in outsourcing, for example – has been growing.[21] Perhaps when the dam breaks, in certain sectors at least, there will be a flood.

With respect to funding future growth, new venture capital commitments (at $8.3 billion in the first half of this year) are down from the record $89.9 billion of 2000 and last year's $48.5 billion. Yet investment itself seems to be stabilizing.[22] In the first quarter, $5.4 billion was invested in 521 companies; in the second quarter, $5.1 billion was invested in 538 companies. Over 80% of those investments were directed at second and later stage rounds. And almost half of that was directed at West Coast companies. After clearing the litter of failed companies from their portfolios

[18] "Dell Computer's 3rd Quarter Sales to Exceed Forecast," Peter J. Brennan, Bloomberg News, Oct 1, 2002. Dell "said third-quarter sales will rise more than forecast, as the world's second-biggest personal-computer maker takes business from rivals and sells more corporate data-storage devices."
[19] Source: Compustat
[20] "Mentor Graphics Provides 3Q View," Press Release, Business Wire, Oct 4, 2002.
[21] "Outsourcers in Search of mega-Deals," Peter Loftus, Dow Jones, Oct 1, 2002.
[22] Source: Menlo Ventures' Annual Meeting of Limited Partners, Sept 19, 2002.

throughout last year and this, it appears that VC's are beginning to take a deeper stake in those that remain and have cautiously begun looking again for opportunity. Just like the "good old days."

At the same time, buyout firms like Kohlberg Kravis and the Carlyle Group have already announced "transactions worth $41.8 billion – more than double the $18.5 billion in the year-earlier period."[23] As other sources of corporate funding – from bond and equity markets to banks – have dried up, buyout firms are sitting on an estimated $100 billion in cash that had piled up after a year spent mostly sitting on the sidelines.[24]

The challenge, again, is to sift through all of the conflicting information and to draw some sort of conclusion with confidence.

There are certainly people – including Pimco's Bill Gross, who manages the world's biggest bond fund – that are beginning to step up and once again make controversial bets. Brazil's bonds have lost more than a third of their value over the last six months as other investors pulled out, fearing that, under presidential frontrunner Luiz Ignacio Lula da Silva, Brazil would stand a "45% chance of defaulting within a year."[25] But Gross and company are betting that Brazilian bonds will rebound as a surge in exports leads the $513 billion economy out of recession. They believe that the next president will keep his promises to control spending and make debt payments that are linked to the IMF bailout. Only time will tell.

But it reminds me of a man named Doug Corrigan who, in 1938, filed a flight plan for California and, after taking off from a Brooklyn airfield in his tiny, single-engine plane, arrived twenty-nine hours later… in Ireland?! Till the day he died, "Wrong Way Corrigan" claimed his compass had failed. But most people came to believe that his 'mistake' was merely a ruse to circumvent the aviation authorities that had turned down his request to make a Trans-Atlantic flight. Whatever the case, his stunt caught

[23] "U.S. Buyout Firms Find That Cash Talks When Stock Markets Slump," Randy Whitestone, Bloomberg News, Oct 4, 2002
[24] "U.S. Buyout Firms Find That Cash Talks When Stock Markets Slump," Randy Whitestone, Bloomberg News, Oct 4, 2002
[25] "Pimco, Manager of Biggest Bond Fund, Bets on Brazil," Tom Vogel, Bloomberg News, Oct 4, 2002

the public fancy; he was given a hero's welcome on his return to New York;[26] and it proves that, sometimes, you see someone doing something that looks controversial or confusing and one day realize just how brilliant and courageous that person truly was. And when this happens, you wish that you'd had the foresight to join in when everyone else was staring in disbelief.

As I mentioned in one of my earlier reports, Xerox remains a highly controversial story and, as an investment, speculative. It is a "turnaround" and, after doing a great job of getting the company refocused and back to profitability, they must still prove that they can be a growth company again. Yet the CEO's words at a recent technology conference are inspiring: "Some people have asked me how we managed to dramatically reduce costs in order to survive, [while at the same time] protecting the research and development community to insure a steady stream of new products and technology today and tomorrow. To me, there is no real choice. What kind of a victory would it have been to save the company, but trade off our future? What kind of victory would it be to avoid financial bankruptcy, only to face a technological drought? No, the answer was to do both – to save Xerox today and position it for success tomorrow."[27] That is what the very best companies are doing: they are aggressively moving forward and investing in the future.

Perhaps you can understand that I am not very bullish on the broader market. Due to an overwhelming amount of data, conflicting opinions and erratic investor psychology, the market itself is simply too unpredictable and seems to be anything but "efficient" at the moment. Nor am I paying overly much attention to analysts these days. They seem as stymied as everyone else and now must contend with rules requiring them, not only to qualify their opinions as being free of conflict, but also fear the repercussions of not having downgraded their stocks when they should have. As a result, I feel that many are now going to the opposite extreme and are being overly conservative, especially when looking out two and three years into the future. A lot can happen in one year, let alone two or three. So the bottom line, for me, is that analysts are not adding much value and it will take a lot of effort for them to restore a sense of confidence in the quality of their research.

[26] Who2 Profile: Wrong Way Corrigan
[27] "Xerox CEO Defends R&D Spending," PRESS RELEASE, Rochester, NY, Oct 17, 2002

But I do believe in individual companies and, more importantly, in the **managers** of those companies. Contrary to the popular press, there are those who know exactly what they are doing and who are doing it day in and day out, without bravado or fanfare. First, I'm guessing that they don't want to attract too much attention to themselves. Second, they probably wouldn't be rewarded for it even if they did, especially in today's markets. But one day, they will be rewarded and, in the meantime, a number of these very same insiders are busy buying their own company stock and to a meaningful degree.[28]

So what are we to do? When it comes to Cash Management and to the money we've kept in Reserve, we should still keep it there. When it comes to maturity, I want to shorten our time frame even more so that we remain essentially liquid and uncommitted. When it comes to stock and to the allocation that we have already made to date, we clearly need to extend our time frame and to recognize that the current turmoil will drag on for however long it takes. Perhaps we could dollar-cost average, a little at a time, over the next several months.[29] But going back to an analogy that I used earlier – when finding oneself in the middle of a frying pan – the thing I am doing different this time around is to tighten my focus more and more as time goes on. I am building larger positions in those companies that are fundamentally confirming the strength of their business by meeting or beating expectations and by winning market share. I am deeply driven by value – meaning those stocks that seem most undervalued, on a relative and absolute basis – but primarily on the basis of price-to-sales. My objective is to be increasingly leveraged to an eventual economic and psychological recovery in the equity markets by accumulating even-more meaningful positions in the very best, most undervalued, earnings-driven, industry-leading companies that I can find. Like a sling shot, it is my aim to benefit disproportionately when things ultimately improve, as they will.

[28] As examples: Michael Marks, Chairman/CEO of Flextronics, purchased 300,000 shares on 9/23/02 at $7.00 per share, plus 200,000 on 10/08/02 at $6.00 per share, for a total cost of $3.3 Million. David Quinn, a Vice President of PetSmart, bought 32,146 shares from 3/19/02 – 3/25/02 at prices ranging from $12.98 to $13.20 per share, for a cost of ~$420,000. Meanwhile Robert Morgan, President of PetsMart, increased his stake 16% when buying 50,000 shares on 10/09/02 at $17.15 per share, for a total of $857,500. Source: Bloomberg News, Sep 27, 2002

[29] Note: Dollar Cost Averaging does not protect or guarantee against loss in a declining market.

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