A.R.Schmeidler & Co., Inc.
The Outlook

March 2002

As of March 14, 2002	
Index	**YTD % Change**
Dow Jones Industrials	4.9
S&P 500	0.4
Nasdaq Composite	-4.9

It appears that investors are seeking to make rational investment decisions in companies that have business clarity, possess strong balance sheets and pay dividends. The dot-com boom/bust and the collapse of many of the technology and telecommunications companies' equity values have fostered a more value-conscious investor mind-set. September 2001's great fear and pain over terrorism and the economy have also slowly given way to anxiety over financial statements and their accounting integrity. Enron, portrayed as the seventh largest company in the U.S. by revenues, was forced to seek bankruptcy court protection after disclosing questionable accounting practices, previously undisclosed liabilities, and overstated assets and earnings on their financial statements.

U.S. Economic Recovery

A U.S. economic recovery is gaining momentum as inventories are being rebuilt, and this could mean the recession may turn out to be shorter than originally feared. Gross Domestic Product showed a faster-than-expected 1.4% annual growth rate in the fourth quarter of 2001 propelled by consumers and a big rise in government spending. The Labor Department's statistics on U.S. workers filing first-time applications for unemployment benefits has shown some improvement. Separately, the Commerce Department's statistics indicate that more sales are now being filled from new production rather than out of existing inventory. Some economists believe the data suggests that the job market is improving, and companies are increasing production and successfully matching supply with demand. Despite some favorable developments suggesting an economic recovery for both Gross Domestic Product and profits, major market indexes have generally been mixed in the first quarter of 2002. The economy will continue to battle numerous headwinds against economic growth. **However the more positive growth outlook, coupled with investors' more rigorous reviews of corporate accounting and disclosure, should make the next**

several months an important window of opportunity for sector selection and stock picking.

Fixing the Accounting System

Not long ago, accounting was considered a highly technical and somewhat boring subject. Today, with the controversy swirling around the Enron collapse, it is now an important fundamental investment consideration. Arthur Andersen LLP, Enron's outside auditor, has begun the arduous task of negotiating a settlement with Enron's angry shareholders, creditors and employees. Arthur Andersen LLP is also facing a credibility crisis, a justice department indictment and an investor revolt that threatens both Andersen's survival and their clients' equity valuations. Unfortunately, the accounting profession with the help of the Wall Street investment banking community has often been adept at defeating needed reforms. The industry's current practice of providing clients with both auditing and consulting services has a conflicted and checkered past. A forced breakup of the accounting profession's auditing and consulting functions now seems likely to occur. Congress, government agencies, investors and the big accounting firms themselves have begun to call for a major government mandated reform. **Companies are being forced to open their books and issue clearer and more detailed disclosures of what they are doing both on and off their balance sheets and through their income statements.**

Fixing the accounting industry's flawed system of self-regulation will almost certainly be done through both Congressional and SEC action. The road to reform will pass through Norwalk, Connecticut where the Financial Accounting Standards Board, a private sector body that is funded largely by the accounting industry itself, sets standards for the financial statements upon which investors currently must rely. Many people both in and out of the government feel that accounting standards need to be carefully monitored by the federal government. **It comes as a surprise to many investors that the accounting rules for the preparation of financial statements allow wide latitude in how they are applied.** If investors have their way, the SEC and other federal agencies would place rule-making powers of the Financial Accounting Standards Board under tighter control.

The Economy of the 1990's

The economy of the 1990's was not as good as it seemed. It is clear that the economy and business investment in technology and telecommunications grew at an unsustainable pace. Investors have also learned that Enron, Global Crossing, Computer Associates, Lucent, Tyco, Sprint PCS, Waste Management and others did not earn as much money as they said they did. The dot-com boom/bust continues to work its way back through the economy. It hurt the PC makers and their suppliers and Internet device companies like Cisco and semiconductor equipment manufacturers.

It is now next to impossible in this environment for many information-technology companies to raise new capital. The storm is threatening companies with solid long-term business plans that may be in need of additional capital. The situation is not helped by the fact that some companies in the industry are being probed for erroneous accounting of their revenues and costs during the 1990's. Regulators suspect the way they booked certain items may have inflated revenues and depressed costs thereby boosting reported profits. It is hard to predict for example when the debt crisis for companies that spent to build costly broadband networks will end. Growth of new cell phone users has also slowed. It will probably take a sustained pickup in the economy to improve credit quality and restore investor confidence in the telecommunications industry. The overabundance of capital spending in the 1990's on information-technology contributed to the sharp downturn in the U.S. economy.

Semiconductor Industry

The U.S. business-led decline in technology spending had sharply reduced the need for semiconductors and new semiconductor manufacturing equipment. However, demand for leading-edge equipment is beginning to increase. Wall Street is now anticipating a recovery in technology spending and in turn, the semiconductor industry. The glimmers of hope in the economy have resulted in a big run-up in semiconductor industry stock prices. The key consideration for investors at this juncture, however, is whether expectations have become overly bullish. For our part, we suspect that may be the case in the short-term. **The stock market seems to be pricing semiconductor stocks as if a strong recovery for the industry is in progress, when in fact, the near term outlook is still difficult.** It is unlikely that U.S. businesses will aggressively boost information-technology spending levels until more tangible signs of a sustainable rebound become more evident. The communications industry, an increasingly significant end market for semiconductor devices, could remain weak throughout 2002. Semiconductor stocks are super-cyclical and respond both on the upside and the downside way in advance of genuine changes in their revenues and profits. However, the opportunity is still greatest for those companies benefiting from increasing demand which is currently underway for leading-edge technology.

Money Center Banks

The mixture of leverage and deflation is causing the banking industry to reevaluate its credit risk tolerance. **Tight lending standards will retard loan growth for large money center banks and create potential risks for some**

highly leveraged industries. Investors are demanding that both the banks and their clients disclose financial data that may be relevant to credit quality and to identify triggers and other forms of conditionality in financial agreements. Additionally, investors are concerned that the Federal Reserve often does not appear to know what is happening at the banking institutions that they supervise. The heavy volume of trades between the offshore operations of a division of J.P. Morgan Chase & Co. called Mahonia Ltd. and Enron surfaced in litigation connected with Enron's bankruptcy-court filing. The trades have raised questions as to whether J.P. Morgan Chase & Co. was a vehicle for loans disguised as trades that helped Enron draw a misleading financial picture for investors. We have generally reduced our positions in large money center banks because of our concern that the global recession will ultimately lead to higher non-performing assets and charge-offs.

Defense Stocks

Defense companies remain attractive because military spending is climbing and is likely to do so for the foreseeable future. A dangerous enemy has attacked the U.S. and the government must provide the means to fight this enemy around the globe. With the combined market value of the nine largest U.S. defense contractors being less than $190 billion, the entire defense sector's representation in the S&P 500 index consisting of these nine companies is only 1.77%. The nine largest U.S. defense companies in the S&P 500 index had combined revenues of $183.6 billion in FY 2001. For comparison purposes Microsoft has a $336.5 billion market value on only $25.4 billion in revenues in FY 2001. Microsoft currently represents 3.13% of the S&P 500 index. Microsoft's price/earnings multiple is 34 X, assuming their costs are not understated, compared to the nine largest defense contractors' average market-weighted price/earnings multiple of 18 X. **It is clear that increased spending on national defense is the reality for years to come and the stock prices of the largest defense contractors do not fully reflect that reality or their hefty order backlogs and cash flows from operations.**

Property-Casualty Insurance

The tragic events of September 11th, the Enron collapse and a growing scrutiny of corporate America's balance sheets should have a positive effect on the property-casualty insurance industry's premiums and combined ratios. The industry has been hurt by exposure to asbestos claims, the attack on the World Trade Center, environmental issues and home repair inflation and mold contamination. Going forward we expect the property-casualty industry to benefit from higher pricing and better underwriting margins. **We expect rate increases of over 15% for the full year in 2002 and believe this pricing trend will continue for the next several years.** The industry will no longer provide terrorist-related catastrophe coverage as existing policies come up for renewal. In the few cases where an individual state might require them to offer coverage, the premiums will be prohibitively expensive. The federal government will ultimately have to pass legislation designed to provide excess liability coverage for terrorist-related catastrophes or affordable coverage will not be available. Without terrorist insurance legislation the banks could be assuming greater loan-loss liabilities.

Homebuilders

We also have liked residential homebuilders because mortgage rates are still low, unemployment is easing and consumers remain confident about the future. Moreover, sales have been helped this year by a mild winter. The industry continues to benefit from improved efficiencies derived from increased worker productivity and aggressive cost cutting. **Homebuilders have the ability to raise average selling prices and improve profit margins because of the supply/demand imbalance created by a shortage of quality building sites and favorable U.S. demographics for home ownership.** The higher-than-expected margins on home building, coupled with favorable mortgage rates, should continue to drive bottom-line profits. The industry seems poised to have record earnings in both FY 2002 and FY 2003.

Health Care, Food and Beverage and Consumer Product Companies

In our opinion, many of the health care, food and beverage and consumer product companies are interesting as they have excellent cash flows, strong balance sheets, and pay attractive dividends that appeal to a market gripped by credit concerns. As a group they have solid earnings' visibility and often the capability to reduce costs or raise prices in a deflationary environment. However as has been the case for many years, these companies have generally only mid-single digit organic growth potential and relatively high price earnings multiples. New product introductions and meaningful stock repurchase programs are the other significant drivers of their positive earnings-per-share outlooks. Additionally, innovation and heavy research and development spending, as always, have been extremely important for their successes. We find investment opportunity at attractive valuations from time-to-time in this sector. **The single-minded focus on core businesses and strong free cash flow continue to be the chief reasons for the sector's impressive market performance.**

U.S. Natural Gas

As a final point the current valuation of the U.S. natural gas energy companies is too low in our view. **Our valuation assessment is based upon the strategic importance of North American natural gas and oil reserves, strong cash**

flows, and merger and acquisition activity. At issue with investors in the industry is the use of leverage and off-balance sheet financing-vehicles similar to the ones that contributed to the collapse of Enron. Unlike Enron, most of the natural gas companies in this industry are in excellent financial condition. Their obligations are secured by tangible assets operating under long-term contracts. The industry as a whole is taking the necessary steps to maintain investors' confidence by improving their financial accounting and reducing the overall leverage on balance sheets. Despite the recent pullback in natural gas prices, the industry should enjoy rising demand and good top-line revenue growth. Moreover America's energy dependence on foreign sources underscores the strategic value of domestic reserves.

After-Tax Corporate Profits

From 1996 to 2001 after-tax corporate profits relative to the Gross Domestic Product have declined. In 1996 the U.S. economy's Gross Domestic Product was $7.8 trillion and grew 19% to $9.3 trillion in 2001. At the same time after-tax U.S. corporate profits in 1996 were $502 billion and declined -5% to $475 billion in 2001. **The point being made is that after-tax corporate profits have continued to decline in both good and bad economic times relative to the Gross Domestic Product. The disinflation/deflation effect from low cost overseas manufacturing has put considerable pressure on pricing and U.S. corporate profits.** The market sectors that have been highlighted in this outlook are likely to have superior top-line growth with enhanced operating margins and solid bottom-line profits despite the pressures on overall after-tax corporate profits.

Summary and Conclusions

A U.S. economic recovery could be gaining momentum and the recession may turn out to be shorter than originally feared. Wall Street is now anticipating a recovery in technology spending and in turn, the semiconductor industry. Gross Domestic Product showed a faster-than-expected 1.4% annual growth rate in the fourth quarter of 2001, propelled by consumers and a big rise in government spending. In this environment we find defense stocks attractive as military spending is climbing and is likely to do so for the foreseeable future. The tragic events of September 11th, the Enron collapse and a growing scrutiny of corporate America's balance sheet should have a positive effect on the property-casualty insurance companies' premiums and combined ratios. We also like companies associated with the housing industry because mortgage rates are still low, unemployment is easing and consumers remain confident about the future. Additionally health care, food and beverage, and consumer product companies are interesting as they have excellent cash flows, strong balance sheets and pay attractive dividends that appeal to a market gripped by credit concerns. As a final point, the current valuation of the U.S. natural gas energy companies is too low. Our valuation assessment for natural gas energy companies is based upon the strategic importance of North American natural gas, rising demand and top-line revenue growth.

The forces at work in the economy and the equity markets are not all that difficult to see and understand. If corporate profits continue to weaken relative to the U.S. Gross Domestic Product, equity multiples are likely to remain under considerable pressure. **What is easier said than done for many investors is figuring out how to harness those forces and make them work in terms of superior equity investments that both protect and grow capital in what remains a difficult economic environment.** We are convinced that notable results can be achieved best by exercising a disciplined opportunistic approach to sector selection and selecting companies within those sectors that have business clarity, strong balance sheets and often pay attractive dividends.