A.R.Schmeidler & Co., Inc.

The Outlook

April 2002

As of April 11, 2002		
Index	**YTD % Change**	**Market Value**
Dow Jones Industrials	1.5	10,176.08
S&P 500	-3.9	1,103.69
Nasdaq Composite	-11.5	1,725.24

Corporate Profits & Enterprise Value

While the U.S. economy is coming out of the recession much sooner than many expected, business profits are not likely to show a significant improvement in the first quarter. The recession masked a serious corporate profit problem that started in the 1990's and accelerated during the recession. Most companies expect profits to slowly improve later this year, but across many industries the profit picture still remains difficult. Business investment in new technology remains weak, and many technology companies are now signaling that revenues and earnings will fall below market expectations.

After-Tax Corporate Profits

The recession was one of the worst in memory when measured in terms of after-tax corporate profits. The Commerce Department calculates that after-tax U.S. corporate profits on average declined 15.9%, one of the worst declines since World War II; however, the recession of 2001 will probably turn out to have been one of the mildest on record in terms of its impact on the real Gross Domestic Product. The real Gross Domestic Product is the market value of goods and services produced by labor and property located in the U.S. when adjusted for inflation. **The after-tax corporate profits plunge was especially severe among the large capitalization companies that make-up the S&P 500 stock index and the Nasdaq Composite.** In the S&P 500 stock index and the Nasdaq Composite a significant portion of the profit drop has been caused by companies implementing more conservative accounting policies associated with correcting aggressive past practices.

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Accounting Practices

Companies are coming to grips with a culture of pushing the edge of the envelope on accounting practices to lower costs and inflate earnings. The Enron Corp. scandal is now forcing many companies to report their results in more realistic terms. Xerox recently was forced to restate earnings covering a four-year period and agreed to pay a $10 million civil penalty to settle SEC charges that it engaged in fraudulent accounting practices. The fine is the largest the agency has ever levied against a public firm in connection with financial-reporting violations.

The profit pressures that existed in the 2000-2001 period will not cease to exist for many U.S. companies when the recession ends. Intense global competition makes it difficult to raise prices and recover higher costs. The costs of wages, healthcare and insurance have proven difficult to bring under control. The strong U.S. dollar continues to hurt overseas profits because foreign earnings must be reported in U.S. dollars. **Many companies are also being hurt by the high debt levels they incurred in the 1990's, and are now being forced by concerned creditors to find ways to improve their balance sheets and reduce interest expense.** They must continue to trim capital spending and plan additional employee layoffs. Taking on so much debt does not seem so wise in hindsight. Companies must also persist with a shift of large portions of their manufacturing facilities to China, Mexico, Eastern Europe and other low-cost countries.

Companies are now being required by outside auditors and government regulators to immediately disclose any expected charges relating to the decline in the value of assets that they carry on their balance sheets. The SEC staff has recommended enforcement action against companies that fail to provide financial information in a timely manner linked to assets whose values are known to be seriously impaired. The SEC wants companies to write-off in lump sum the assets that have fallen in value. The new rules will allow companies to stop making deductions from earnings each year for amortizing goodwill. **Nevertheless many companies are facing huge goodwill write-downs after paying large premiums for acquisitions, many of which turned out to be speculative, during the technology frenzy of the late 1990's.** Qwest Communications International Inc. recently announced that it expects to take a charge of $20 billion to $30 billion stemming from changes in goodwill accounting which revealed a fall in the value of assets it acquired.

Off-Balance Sheet Liabilities

In light of the Enron collapse investors have also become skeptical about off-balance sheet items. They no longer feel confident that they know all the facts

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about what is going on inside a company when off-balance sheet liabilities exist that are not fully disclosed. Questions about Enron's accounting practices led to a sudden decline in the value of the company's stock. This in turn had serious implications for both its shareholders and its debt-holders, and the company immediately had trouble meeting all its financial obligations. **When you add the off-balance sheet debt to overall debt, the most salient question becomes whether the higher figure exceeds the debt to cash flow limits of covenants with lenders.** If so, lenders could decide they are not comfortable with the higher debt levels. In Enron's case this resulted in loan calls that forced the Houston-based company into the largest U.S. protective bankruptcy filing ever.

Corporate Enterprise Value

The standard which should apply when making an equity investment is what the entire business costs on the basis of its current market value and financial commitments rather than just whether the stock price is up or down over a given time period. The basic measurement for determining this value is the market value of the company based on the stock price multiplied by the number of shares outstanding plus the debt that the company owes to its creditors. **This measurement is commonly referred to as the enterprise value of the company; it is what you would have to pay to buy the entire company and assume the debt obligations**. Before major investors make an assessment to acquire a company they have to feel comfortable with the assets, revenues, profits and free cash flow that the business can generate in the future relative to the business's current enterprise value. The accurate financial reporting of corporate operating performance and the proper disclosure of assets and liabilities are fundamental to settling on the worth of a business.

The enterprise value that the market places on a company obviously requires a judgment that the company's current stock price properly reflects forecasted asset values, revenues, profits and cash flow and the risk of error in the forecast. While analysts have their preferences for testing enterprise valuation, the most pragmatic approach in our opinion uses price to sales, price to earnings and price to free cash flow as the key appraisal measures. Price to sales is an important litmus test in the valuation of a company, since the price that a businessman would pay for ownership of a company is rarely more than several times annual revenues. However price to earnings is the most commonly used approach to measure market valuation, and it is often compared to the company's projected annual earnings per share growth rate. From a purely historical perspective it is generally a bad choice to invest in stocks that are selling at price to earnings ratios that are significantly higher than their sustainable earnings growth rate. Finally, we recognize that companies need to generate free cash flow to remain competitive and grow the business. A growing, profitable firm will likely need to borrow capital for

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investments in plant & equipment, receivables and inventories. Debt unfortunately carries with it commitments and covenants that can easily place a business in mortal danger if its operating cash flow is suddenly not sufficient to service the debt. Price to free cash flow is undoubtedly one of the single most important measures of valuation.

The Equity Market is a Medium of Exchange

The equity market is a medium of exchange where cash is exchanged for ownership in what is presumed to be successful ongoing businesses. The equity investor must have confidence in the company's business model, revenues, profits, cash flow and assets in order to make the exchange. The decision that ownership in a company is a better value than a risk free investment in cash is fundamental to the viability of the equity markets. Cash is defined here as government securities or other forms of relatively safe assets in which the principal and interest are assured. **Investors have relied upon the accounting industry to set strict standards for the preparation of the financial statements that allows them to make intelligent decisions as to the desirability of substituting cash for ownership.** Arthur Andersen LLP's audits of Enron, Waste Management and others continue to soil the accounting industries' reputation. Andersen allowed Enron to overstate earnings back to 1999 by almost $600 million. In the case of Waste Management, the SEC alleges in a lawsuit that former Waste Management officers, aided by Andersen, concocted "a systematic scheme to falsify Waste Management's earnings and other measures of financial performance", under which the company overstated its pretax profits by more than $1.7 billion from 1992 through 1997**. Disclosures of impropriety in the preparation of financial statements have damaged investor confidence in the equity market as a medium of exchange and made it more difficult to measure the worth of a business.**

Equity Risk

Equity risk is not an easy concept to grasp, and a great deal of controversy has surrounded attempts to define and measure it in the 1990's**. However, the most common definition of equity risk, and one that is best for our purposes, is to define risk around the likely variability of the company's forecast of future asset values, revenues, profits and free cash flow.** Any equity investment decision implies a forecast of future events that are most likely to happen; it is the best estimate after considering the competitive business environment and the state of the economy. The risk of not achieving a satisfactory rate of return on an equity investment relative to a risk free return on cash is greatest when the equity's enterprise value is lofty and the expectation of a higher return is being forecast out into the distant future. Most individuals prefer a modest level of risk in exchange for a higher rate of return, but both logic

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and observation suggests that investors can tolerate only minor and infrequent losses. The desirability of equity investments to other potential opportunities involves carefully balancing the tradeoff between risk and return; and it ultimately always boils down to the investment's current enterprise value. In the final analysis investors are really looking for compound rates of return, so minimizing losses becomes vital to achieving investment results.

Chronic Overvaluation

We believe that parts of the equity market are currently overvalued based on our enterprise value calculations. **The market's chronic overvaluation stems from the philosophy that above-average earnings growth over time will produce above-average returns regardless of valuation.** The idea had considerable appeal in the 1990's and resulted in the payments of excessive prices for companies that appeared to have extraordinary growth prospects. The idea has recently had a serious setback particularly in the technology and telecommunications sectors. Great companies selling at high prices are not great investments. Excessive prices were clearly based on a gradual build-up of unrealistic future growth expectations. Stocks become very popular or unpopular over time because high valuations unfortunately convey an impression that everything is fine and low valuations often have the opposite effect that something must be wrong. The objective is to achieve a satisfactory rate of return relative to a risk free return on cash. **In an acknowledged partly-overvalued market we can still find sensibly valued stocks across diverse market sectors that have business clarity, possess strong balance sheets and pay dividends, but currently are not so popular and can produce satisfactory compound rates of return.**

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