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

May 2002

Risk and Return

As of May 20, 2002		
Index	**YTD % Change**	**Market Value**
Dow Jones Industrials	2.08	10,229.50
S&P 500	-4.90	1,091.88
Nasdaq Composite	-12.76	1,701.59

Portfolio management is both an art and a science. It is a decision-making process that requires sifting through large amounts of information and making a judgment as to what is really important. The decision-making process at the end of the day must determine the tradeoff between risk and return. Managing risk in pursuit of investment returns is a defensive process. The most difficult aspect to proper portfolio management is the integration of clients' unambiguous objectives, constraints, preferences and expectations with realistic and sustainable investment returns. **We have entered into a difficult market cycle where valuations are generally too high and market volatility reflects economic uncertainty, weak corporate profits, and unexpected negative announcements. For the average investor this will probably increase the frequency and severity of shortfalls in meeting expected investment returns.**

While high levels of risk should always be avoided, this is particularly true in the current market environment. Equity and fixed-income investments must stay well within an acceptable risk tolerance. We are concentrating on companies that can deliver earnings and dividend growth but are trading at prices that are reasonable in relation to revenues and cash flow. Faithfulness to this particular concept of investing has always required us to devote a considerable amount of time and energy to each investment decision which tended to reduce the need to revise opinions and change holdings because of disappointing new information**. Our in-house research capability has often been able to isolate superior values at depressed prices and achieve superior long-term goals for clients with relatively low risk. Lack of investor confidence in financial markets has clearly made us even more vigilant.**

Focus on Rapid Growth and Acquisitions

Senior management in the 1990's often failed to strike a proper balance between risks and return that protected the company's stockholders. Decisions relating to the extent to which debt was employed, aggressive capital spending and acquisition policies in hindsight now in many cases appear to be reckless. Management frequently had a single-minded focus on rapid growth both organically and through acquisitions. Financial leverage was used to increase revenues and raise the rate of return or profitability of a company. Insufficient attention was paid to return on invested capital, free cash flow and balance sheet issues. **Ultimately we must judge equity investments on the soundness of their business models, the return on invested capital, the free cash flows, the strength of the balance sheets and the character and ability of the management team.**

Management

Shareholders own companies and elect the Boards of Directors. Management, in turn, is supposed to operate the corporation in the best interests of the stockholders. We all know, however, that the stocks of most large firms are widely held, so the managers of such firms have a great deal of autonomy. This being the case, management may at times pursue goals that may not ultimately maximize stockholder wealth. It is extremely difficult to determine whether a particular management team is trying to maximize shareholder wealth or is merely attempting to enrich themselves while pursuing excessively aggressive goals. The big bonuses and generous stock options that are given out to attract and retain the managers who are responsible for protecting the interests of stockholders and keeping the company out of financial difficulty have not always delivered the desired results. **Some management teams failed to take into consideration that their forecasts might be imperfect and accepted high levels of financial risk in exchange for the dream of realizing extraordinary wealth for both themselves and shareholders.** Shareholders and Wall Street analysts often put too much trust in management and do not introduce uncertainty into their upside stock price assumptions or quantify downside risks.

Stock Option Grants

The current accounting rules do not require companies to count stock options granted to their management as an expense. The existence of low price stock options distorts the corporate profit picture and can increase investors' market risk. Federal Reserve Chairman Alan Greenspan believes companies should be required to list the cost of stock options with other operating expenses like salaries and cash bonuses. Most companies issuing stock options do not count them as a cost against profits but separately disclose their potential impact on share value in footnotes to their financial statements. In the Enron collapse and other incidents of management misconduct, the senior executives have been accused of pumping up their company's stock price by questionable means and then cashing in on their low-price stock options. **Stock option grants have grown with increasing popularity as a form of executive compensation and have simultaneously introduced a significant new distortion into the reported corporate earnings picture.**

The Leverage Factor

In theory whenever the returns on assets exceed the cost of debt, leverage is favorable, and the higher the leverage factor the higher the rate of return on common equity. In the 1990's the management of technology and telecommunication companies began to act as if they knew with certainty that sales would rise rapidly. Bonds became the preferred method of financing capital expenditures. Managements could not bring themselves to believe that their companies would not be generating enough free cash flow to cover the interest charges, and that the debt could jeopardize the very existence of their company. Generous stock option grants encouraged aggressiveness in the use of financial leverage to drive both top and bottom line growth. **Over confidence in the future level of sales and profits reflected both management's financial stake in driving up the equity value of the company and their belief in a continuation of positive economic conditions and industry trends.** Managers seemed to have forgotten that the increased leverage raised the probability of business failure.

WorldCom Inc.

On April 30th, Bernard J. Ebbers resigned as chief executive officer of WorldCom Inc., the once tiny long distance company that he built into one of the world's largest telecommunications empires, only to watch it fall into near bankruptcy. Since WorldCom hit a high of $64.50 in June 1999, it has lost more than 98% of its value. The company, started by Mr. Ebbers, is staggering under $28 billion of debt. The prospect of bankruptcy could potentially undo a series of more than seventy-five acquisitions over nineteen years that built WorldCom from a tiny phone company in Mississippi to a global giant. WorldCom is the subject of an SEC inquiry over the huge $366 million loan the firm granted Mr. Ebbers to cover margin calls on loans that he had personally backed with WorldCom stock obtained through stock option grants.

Mr. Ebbers now finds himself out of work and hundreds of millions of dollars in debt because he was wrongly confident that WorldCom would never falter. **Looking beyond investor losses, there is a growing sense that WorldCom is an example of how companies should not be managed. Wall Street**

analysts continued to recommend the company to clients during the company's glory days, although they complained that the frantic pace of acquisitions made it difficult to understand the company's balance sheet, income and cash flow statements. The analysts' task was complicated by WorldCom's reliance on confusing accounting methods, financial engineering, pro forma figures in its financial reports and the analysts firms' desire for lucrative investment-banking business. Merrill Lynch & Co. and the New York Attorney General Eliot Spitzer are presently trying to agree on a deal that would allow Merrill Lynch to avoid criminal charges for issuing overly optimistic research reports to investors on stocks of companies that paid big fees for their investment-banking help. We should also point out that the total investor dollar losses from WorldCom's peak - based on the number of shares outstanding - were three times greater than from Enron's peak.

Investor Attitudes

Regardless of managements' analyses of the proper leverage factors for their company, Wall Street, banks and investor attitudes are an important determinant of the optimal financial structure. Those attitudes are subject to change based on market conditions, macro-economic factors and industry trends. **Companies must leave sufficient head room in their capital structure to accommodate major changes in investor attitudes. Neither theory nor empirical analysis has been able to specify precisely the optimal capital structure and leverage for an actual company.** Capital structure and leverage decisions are largely matters of informed judgment. An informed judgment requires that considerable analysis be undertaken, and there is an awareness that you cannot count on a continuation of favorable market attitudes toward leverage. Independent and realistic measures of assessment such as the probable cash return on invested capital are essential.

Dividends

Although both growth and dividends are desirable, these two goals in the 1990's were viewed as being in conflict. The starting point for controversy was the belief that investors should prefer to have the company retain and reinvest earnings rather than pay them out in dividends because the return on the company's reinvested earnings would far exceed the rate of return the investor could obtain on other investments of comparable risk. **The pundits refused to consider the viewpoint that even though dividends are taxed at a higher rate than long-term capital gains, they are still important and subject to far less uncertainty than the promise of a future capital gain**. We argue that the certainty factor under current market conditions should play a more significant role in investment decisions. Dividend income should be an ample component of the expected total annual rate of return in a portfolio.

Pension Funds

Almost every major pension fund in the nation has lost money in the recent stock market downturn. **Companies and major public pension funds in the nation adopted an unusually aggressive stock-market-based investment strategy, which served them well during the boom times of the 1990's but left them vulnerable to losses when the market declined.** Higher pension costs are now a serious problem for many corporations and municipalities who must contribute more money to their pension funds in order to offset stock market losses. Reported earnings in recent years benefited from the bull market of the 1990's that generated extraordinary performance for pension funds. **Companies did not have to contribute money to their pension funds, and were even able to move some of the over-sized pension fund gains to their income statements.** Pension-accounting rules allow companies to move excess profits in their pension funds to the income statement, even if they lose money in the current year, provided the three-year average return is above the preset three-year assumed rate of return. The mandated annual compound assumed rate of return for many corporate and municipal pension fund plans is currently pegged at 9.0% or more, which is a rate that cannot be achieved easily in the current market environment in our view.

Conclusion

Poor corporate profitability has received an enormous amount of attention in recent months with most of the blame attached to a weak U.S. economy. **Analysts fail to give sufficient weight to what may well have been erroneous forecasts of unsustainable high rates of growth for the global economy and the inevitability that such high growth forecasts would lead management to errors in the form of over-optimism and over-expansion.** Unfortunately attempts to reduce expectations and temper overly optimistic forecasts have spooked the security markets at a time when multiplying accounting scandals are creating a crisis of confidence among investors. The assault on Wall Street's equity research departments by regulators and prosecutors over allegations of overly-bullish recommendations during the technology-and-telecom stock bubble also could not have come at a worse time. We suspect that some investors now may be considering moving money to the sidelines because of their concern about Wall Street's bullish research, corporate balance sheets and pro forma accounting wizardry.

Pro forma profitability measures are calculated as if certain normal business items - usually expenses - do not exist. The wide variation in how such numbers are calculated often makes it difficult to understand a company's financial performance, and compare it to the company's peers. Standard & Poor's unveiled a new definition of so-called operating earnings on May 15, 2002 in an effort to improve the clarity of financial reporting. The new methodology excludes pension fund gains and includes the cost of stock option grants in the calculation of operating earnings. Restructuring costs and certain other "one-time-expenses" that are generally not included by many companies in their operating-earnings also will be included now. In establishing standards for how corporate earnings are calculated, Standard & Poor's is seeking to address investors' demands for uniform benchmarks for financial performance. The new standards will lower reported corporate earnings and raise their price/earnings multiple. Unfortunately deficiencies in reliable economic and financial information tend to make investors too cautious during bear markets and too confident and demanding in bull markets. We believe that in spite of the flawed economic forecasts and accounting methodology, our informed and rational approach to portfolio management can deliver satisfactory investment returns over time for a minimum level of risk**. While the severity of the economic downturn has affected almost every industry, we believe that technology-driven productivity gains likely will lead to higher earnings and revenue for many companies as the recovery begins to take hold.**