

LUMBAR D
INVESTMENT
COUNSELING

INSIGHT

Nasdaq Composite 1,315.45 * Dow Jones Industrial 8,581.17 * 30 year U.S. Treasury bond 4.88%

SAY GOODNIGHT TO THE DAY TRADERS

The Dow goes up, and the Dow goes down. And up, and down, and up-and-down. Mostly down. This tremendous volatility can be unsettling, but it's also an opportunity to increase your returns: if you like to buy low and sell high, you can't be unhappy about an opportunity to buy lower and sell higher. All you need is a firm idea of the fair price for each stock, and a willingness to act when investors become overwhelmed by greed or fear.

Those words are small comfort to day traders and momentum investors, because they aren't even *trying* to identify a fair price. They're looking for a trend; if a stock is rising they buy, and if it's falling they sell. Throughout the Nineties traders made a fortune by latching on to any rising stock and holding it for a few hours, days, or weeks. When the bubble burst, the day traders simply switched sides—betting on declining prices by selling short. Again they prospered, and again their herd increased and multiplied. Today, day trading is big industry, with day-trading gurus, day-trading hedge funds, and a panoply of day-trading products and services that help you to do exactly what all the

other day traders are doing. Staying with the herd.

That herd is already thinning. Mother Market is creating traps and tricks and surprises; a sharp August rally blew many traders right out of their shorts, but stocks turned down again on the very day that they established a "new bull market" by rising 20%. September—always the market's worst month of the year!!—opened with a sharp drop, but a powerful rally followed the very next day. Traders covered their shorts, and the Dow immediately took another sharp turn to the downside. So it will go until day trading fades from the scene.

The market has a mean streak, and it always finds a way to foil a black-box strategy or a new technique. Any strategy can be successful as long as it is attracting more and more investors, but eventually the herd reaches its maximum size, and the leaders quietly begin to bet against their followers.

Does this also mean that the bear market is bottoming? It's entirely possible that some stocks have already seen their lows; certain

pharmaceutical and telephone stocks come immediately to mind. But it's unlikely that the high-tech stocks will bottom before they reach bargain prices. Ridiculous prices, driven by fear and loathing. The price-earnings ratios of the Nasdaq companies will surely return to the levels of 1990 and 1991, when high technology companies were seen as risky and cyclical and capital intensive; because the earnings of today's tech companies are poor, their accounting is still questionable, they pay no dividends, their assets depreciate quickly, and there's too much competition. Legions of investors have yet to open their brokerage statements, acknowledge the loss, and sell.

In the meantime, Mother Market will focus her attention on the day traders. She'll whip them up and down and back and forth until they

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"When the tide goes out,
you know who has been
swimming naked."

—Warren Buffett

...Traders *(continued from page 1)*

lose all confidence in Bollinger Bands, moving average convergence/divergence, stochastics, Fibonacci retracements, TA analysis, and channelingstocks.com. Every time stocks go down Wall Street will worry that impoverished investors will stop participating in the economy, and traders will bet on economic weakness and falling prices. Every time stocks rise a bit they'll bet on a widespread rebound. Mother Market will shake them like a dog with a rag doll in its teeth.

The rest of us have to find ways to make money in this volatile environment. We can buy stocks that pay big dividends, and companies selling for less than their liquidation (auction) value. We can buy the high-yield bonds of companies that seem sure to avoid bankruptcy, and we can profit from a declining dollar by buying the bonds of foreign governments. There's still plenty of money to be made, and the market is bouncing so low and so high that we're able to buy lower and sell with bigger, quicker profits than before.

In a few months we'll be able to buy anything and everything with gusto.



"Like the Stock Market, only Faster."
– A 1999 Connecticut Billboard touting off-track betting.

UPLIFTING WORDS FOR BABY BOOMERS
who now expect to retire at the age of 80...
"To travel hopefully is a better thing than to arrive; and the true success is to labour."
– Robert Louis Stevenson

Osama Bin Laden's diabolical plan is to get Americans to use more oil, and pump our domestic reserves dry. Then he can blow up the Saudi Arabian oil fields.

Our plan is to offer 0% financing on SUVs, and hold gasoline prices low by increasing domestic production. Then we're going to blow up Iraq's oil fields. . . .

BILLIONS

Today Nortel (a supplier to telephone utilities and other customers) is worth about \$4 billion, or four thousand millions. Some would argue that Nortel is worth more than \$4 billion, but in hindsight—now that a billion dollars is once again a big number—there's no question about the company's nutty valuation at the peak of the market. It reached an incredible \$334 billion, or 83 times today's value.

How big is a billion? A billion seconds are equal to 32 years.



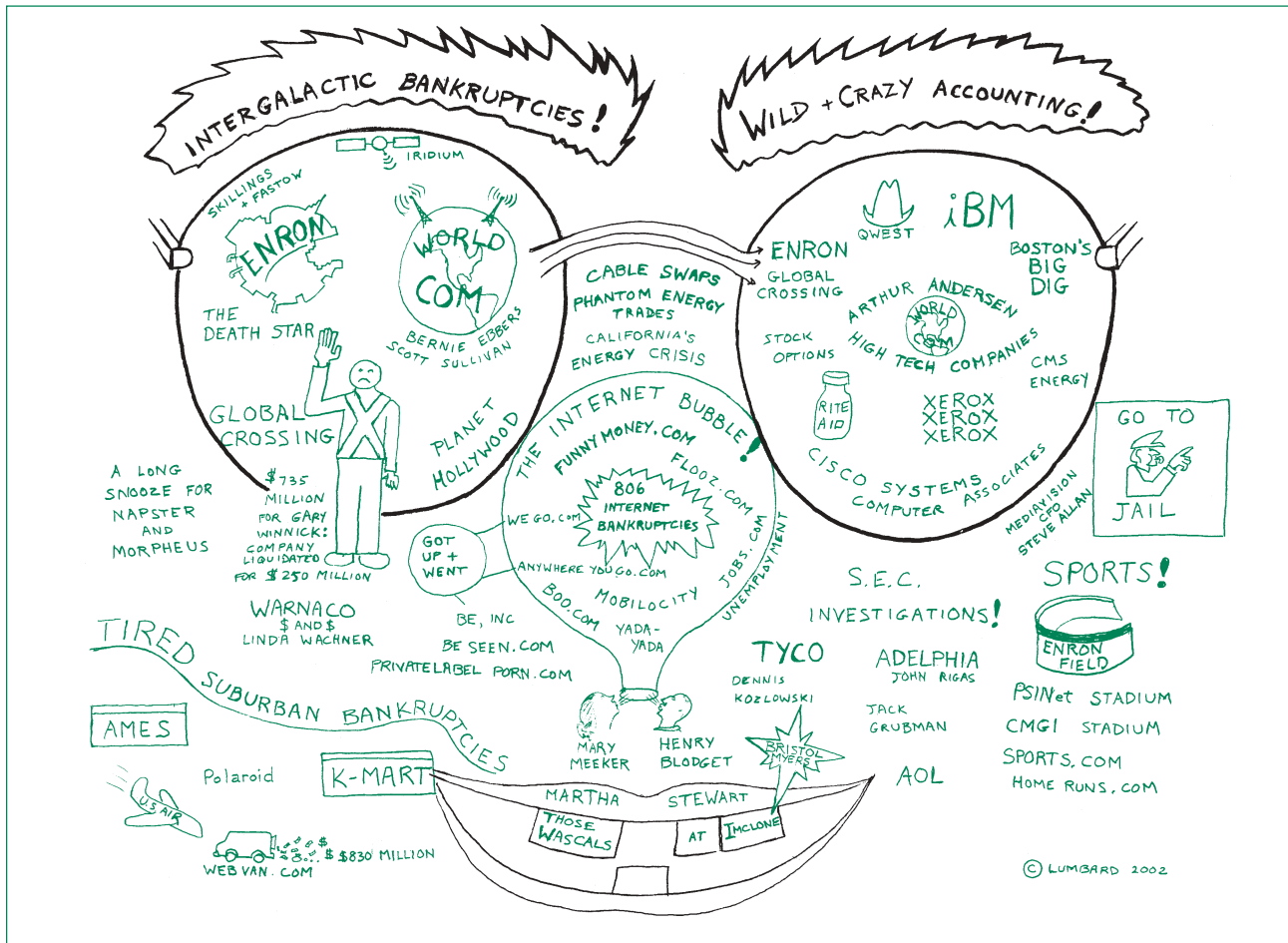
RARE BOOKS

Alan Murray of CNBC has a terrific, simple way to clean up the accounting mess; simply insist that Corporations use the same set of books for the IRS that they use for reporting to shareholders.

Between 1996 and 2000, Worldcom reported a total of \$16 billion of earnings to Wall Street, but less than a billion dollars to the IRS. Investors never saw the tax return, which might have raised a few questions. But why do we even *have* two sets of books? If corporations had to use the same accounting rules and calculations for all purposes, they wouldn't be able to reduce their taxes without also reducing the income they reported to shareholders. If the CEO wanted to inflate earnings to make his stock options go up, he'd have to pay more taxes than the corporation actually owed.



"A great industry that's growing fast, such as computers . . . attracts too much attention and too many competitors. As Yogi Berra once said about a famous Miami Beach restaurant, "It's so popular, nobody goes there anymore." When an industry gets too popular, nobody makes money there anymore."
– Peter Lynch, in Beating The Street



HIGH YIELD

If you're having a tough time trying to find good stocks to buy, there are many ways to diversify—and one of the most interesting can be found in a corner of the market that we've been ignoring for years. High yield bonds often deserve to be called "junk", but they also include thousands of companies that will still be going strong 30 years from now. If you can identify those companies, and find safe bonds at yields above 10%, you'll reap a stock-market investor's return—or more—while taking on less risk.

Less risk? How can junk bonds be less risky than stocks?

In the last two years we've all been

reminded that stocks do *not* "pay" 10% a year. Stocks with 0% yields don't pay anything, and the buyer can only hope that their prices will somehow go up as earnings go up, *if* earnings go up. On the other hand, a bond paying 12% is going to give you 24% of your investment back in the first two years, and if you've done your homework well you'll get *all* your money back at maturity, with a huge pile of interest *and* a large, long-term capital gain. You don't have to be right about the company's earnings trends, or the level of the Dow and the Nasdaq, or the tastes and interests and optimism of future investors. You just have to avoid the bonds of companies that are going to go bankrupt.

There are plenty of legitimate questions about the music business and the future profitability of America Online, but AOL Time Warner is not about to disappear. Most of the company's bonds reflect that fact, but recent market turmoil has created an opportunity in the company's 0% bonds of 2019, which can be redeemed (or "put") on December 6 of 2004. If you compare the redemption value to today's purchase price you'll find that you can snare an annual return of 12% on a very safe bond that "matures" in just a bit more than 2 years.

Even higher yields are available to those who recognize that there are

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John Lumbar, CFA

...Yield (continued from page 3)

sharp differences among the companies that you see every day in the headlines. Enron, Worldcom, Global Crossing, Qwest, and Tyco have all been fingered for executive indiscretions, boardroom negligence, and varying degrees of sharp or fraudulent accounting, but only the first three have gone bankrupt. There's no sign whatsoever that either Qwest or Tyco will go out of business, but their names have appeared so many times alongside those of the bankrupt that most investors are emotionally unable to make the distinction.

The real bargain (a 15% yield!!) is Qwest. The company just agreed to sell its Yellow Pages business for \$7 billion, and it will use the proceeds to reduce and restructure its debt. The new CEO (Richard Notebaert of Ameritech fame) will then cut costs, jettison money-losing businesses, and unwind the worst of the nonsense wrought by his predecessor. No matter what you read in the headlines, U.S. West is still a Baby Bell, and it's the closest thing to a monopoly that you can find these days.

Buy low, and sell high.

One of our clients wrote to suggest that the government should invest in stocks and bonds; a few sets of wooden stocks in lower Manhattan for CEOs and investment bankers, and bonds to keep them restrained in the paddy wagon on the way down ...

“The Korean team has pulled the country out of a long period of frustration, trials, tension, resignation, passivity, defeatism, original sin, confrontation, irresponsibility, corruption, and political ennui.”

—An editor of the Korea Times, writing about his nation's World Cup soccer team.

NUTS AND BOLTS

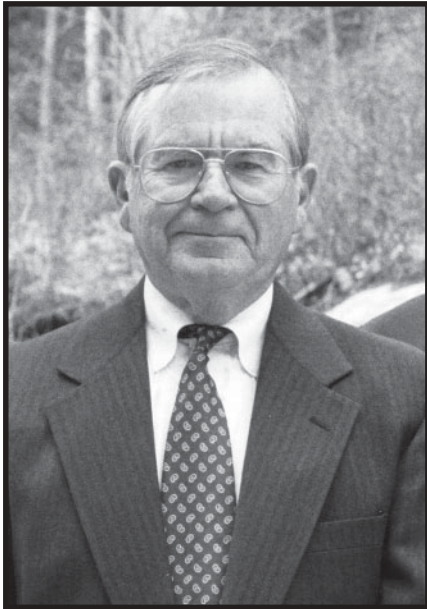
Fees, Custody, and Minimums at Lumbar Investment Counseling.

We can't claim to have escaped all the accounting scandals and stock-market declines unscathed, but in the past two years we stayed far from the herd; and added another two years of solid returns and low risk onto a track record that now spans almost 12 years. The keys to this record have been diversification, value, and a “bird in hand” philosophy that emphasizes dividends and interest.

Our client accounts are held in custody at the U.S. Bank, State Street, and other major institutions. Each client has a custodial account at the bank in his or her own name, and Lumbar Investment Counseling covers the cost. The result is the ability to use multiple stockbrokers, and “block trade” in a way that brings great flexibility and extremely low commissions on trades.

Our annual fee is 1.1% of the first \$500,000 in assets, 0.85% of the next \$500,000, 0.7% of the second million dollars, and one-half of 1% of any assets above \$2 million. In a world in which most investment advisers insist on a minimum portfolio of \$1,000,000 or even \$5,000,000, we're still holding our minimum at a reasonable \$350,000. If you would like further details, please call us at 1 (800) LUMBARD.

MONEY IN YOUR POCKET



John Convery, CFA

Over the course of the last 80 years, the stock market has appreciated 5.8% per year. Any investor will tell you that the average return on stocks has been 10% or 11% per year, but that total included dividends of 4.4%, on average, that compounded over time. And those dividends were always growing, at an average rate of 4.8% per year.

Today, the dividend yield on stocks is just 1.8%. That might seem surprising, after the enormous stock-market decline of the past two years, but stocks are still somewhat high by historical standards. And most corporations have turned away from the practice of paying dividends to their shareholders. That is, they have stopped giving the owners a piece of the profits.

This is not a new strategy. It first appeared in the popular “growth”

companies of the early 1970’s, with very poor results, and returned in the 1980’s . . . just before the 1990 bear market. Even so, the dividend yields of blue-chip stocks in those years averaged nearly 4%. In the Nineties the concept became dominant, and the results have been nothing short of disastrous. I have always wondered why it was deemed intelligent to reward only those shareholders who were willing to sell their shares.

Today’s chief executive officers are quick to point out that our tax laws discriminate against dividends. They say that they can “get money to the shareholders” by spending the cash to buy shares of stock. But in the real world, all that extra cash is soaked up by stock option programs and foolish acquisitions. There is no evidence whatsoever that today’s “no dividend” strategy can make corporate earnings grow faster than the 5.4% rate at which they’ve grown, on average, over the course of the last 80 years.

As we look ahead at the next 80 years, it seems likely that stock prices will continue to rise more or less in step with corporate earnings. The 5.8% and 5.4% numbers quoted above are probably a good guide. And it’s a certainty that future stock-market returns will be the total of that appreciation and the dividends paid to future investors. If stocks rise 5.8% per year, and pay dividends at today’s 1.8% rate, you’ll have a total return of 7.6%. In that case, mutual funds which have “expense ratios” of 1% should return about 6.6%.

When seen in this light, it’s clear that dividends matter a great deal. John Lumbard and I believe that a well-diversified stock portfolio which yields 4% has a tremendous advantage over a well-diversified stock portfolio yielding 1%. And at a time when the accounting profession is in an uproar and corporate earnings are a big question mark, dividends offer a solid and reassuring life raft that investors can hang onto.

A company that pays a dividend of 5%—in real cash—is probably earning at least that much, in real cash. It’s not at all hard to imagine that dividend-free stocks will continue to decline, while dividend-paying stocks slowly appreciate. And at the very least, you’ll get 5% of your money back in the first year.

— John M. Convery, Jr., CFA



“It will take them 100 years to break even!”

— John Convery, on learning that Web MD lost \$16 a share in 2001, and expects to earn 16 cents a share in 2002.

War, terrorism, famine or flood; never forget that the stock market doesn’t give a hoot about anything except corporate earnings and interest rates.

HEALTH CARE: A GROWTH INDUSTRY

To hear some economists talk, you'd think that "unproductive" health-care spending is sucking the life out of our economy. Clearly, these guys and gals are so lost in the data that they've forgotten what economic growth is *for*. The purpose of economic growth is to give us a better quality of life, and if health doesn't govern quality of life, it's hard to know what does. Would you rather be healthy and technologically backward—or savvy, productive, and in a coma?

The latest projections show that health-care spending will continue to grow, from 14% of GDP today to 17% of GDP ten years from now. Our population is aging, and those citizens will have no better use for their dollars than maintaining their youth. There will be huge battles about who will pay the bills, and the resources of government will almost certainly run dry; but health-care spending *will* grow, and it will grow a lot.

Corporations *advertise* their earnings power via their financial statements. But they *prove* that they have earnings when they pay dividends. If you owned 50% of a hardware store, you'd certainly expect to receive an annual check for your share of the profits. How can a large corporation be any different?

Only 21% of the companies on the major stock exchanges now pay dividends, down from 67% in 1978.



The Boston Globe estimates that the average resident of Dorchester, Mass now discards 28 pounds of trash per week. The average resident of Oslo, Norway discards less than a pound per week.

Our clients are heavily invested in health care; Johnson & Johnson, Healthcare Realty, Health Care Properties, Novartis, Bristol-Myers, Schering Plough, Elan, Merck . . . we "backed up the truck" when the stocks fell to irresistible lows in July. Patent expirations, a tougher FDA, and calls for drug-price controls have dimmed the luster of these stocks, but most of the companies now offer significant dividend yields, and the flow of new products has started up again.

In fact, many of the negative comments about the industry contradict each other. Those who think drug prices are too high should simply rejoice in the number of drugs that have come off patent. Generic drugs now cover nearly the full range of the medical care that was available ten years ago, and in many cases they cover the blockbuster miracle cures of just last year.

Those who want new cures need to recognize that the cost of FDA-mandated testing keeps going up. More testing and greater safety simply means higher prices, and if you don't think the process is expensive just take a look at the hundreds of biotech companies dying on the vine.

Health care is relatively immune to the vicissitudes of the economy, so it's more than a little unusual that the stocks in this group struggled in the past year. We were too early in buying, just as we were too early in buying real estate investment trusts and foreign bonds, and too early in saying that accounting fraud would become a big issue in the stock market. But today the euro *is* up, and the dollar is down. The mutual fund that bets against the Nasdaq 100 has been a big winner for us; not once, but twice. And the real estate investment trusts have moved higher in an historic bear market. The pharmaceuticals will rise again.

John Lumbard, CFA

Performance Results:

The performance results presented below are for our “Benchmark Account”, using January 1, 1998 as the date of inception. The performance results for the Benchmark Account are calculated by Lumbard & Kellner, LLC’s current custodian, U.S. Bank (prior to 2004 State Street was the custodian). The account pays fees based on our firm’s fee schedule from the 1990s (top rate of 1%), and the percentages shown are net of fees and expenses—that is, the returns shown would have been higher if fees had not been deducted. The performance results for the Benchmark Account include the reinvestment of dividends and other earnings, but there have not been any other additions or withdrawals since inception. The comparative indexes shown are the S&P 500 Composite Index, Dow Jones Industrial Average, NASDAQ Composite, Barclays U.S. Aggregate Bond Index, and the Citigroup 3 Mo T-Bill Index.

Actual returns for individual client portfolios managed by Lumbard & Kellner, LLC may vary and will not necessarily coincide exactly with the returns for the “Benchmark Account.” Past performance of the “Benchmark Account” does not guarantee future results. No assurances or guarantees can be given or implied concerning future investment results for Lumbard & Kellner, LLC or any investment index. Future returns may differ significantly from the past due to materially different economic and market conditions and other factors. Investments within portfolios, and therefore, portfolios, involve risk and the possibility of loss, including a permanent loss of principal.

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