

LUMBAR D
INVESTMENT
COUNSELING

INSIGHT

Dow Jones Industrials 10,035 • 30 Year U.S. Tsy Bond 5.45% • Nasdaq Composite: 1,945

WHAT WE BOUGHT ON SEPTEMBER 17

It was nearly a week before the stock market opened after the World Trade Center disaster, and when it did it sank like a stone. Many stocks declined for days, but the very best opportunities were found in the confusion of the first hour of trading. Investors were trying to throw out the baby with the bath water.

Our first and biggest prize that morning was the purchase of 14,000 shares of Nationwide Health Properties (NHP - \$19), a real estate investment trust that owns nursing homes. Recessions have little bearing on the success or failure of the company; you might worry about Medicare and Medicaid reimbursement, but that hurricane has already blown through. We bought our shares, down a couple of dollars at \$16.50, with a dividend yield of 11.2%!!

The information coming from the floor of the New York Stock Exchange was very poor, and by the time we learned that our limit order to buy shares of American International Group (at \$66.50) was too low, the stock had bounced off its bottom (at \$66.60) and moved above \$70. We put in

a market order at that price, because it seemed clear that the demand for insurance would go up, and that the strongest companies would be able to demand premium prices. AIG (AIG - \$80) is the strongest company.

Last on the list was Avon (AVP-\$47). The stock refused to decline more than a couple of dollars, and we finally bought a modest number of shares at \$44.50. Like the other two stocks, Avon feels little impact from recessions. In fact, hard times allow the company to recruit more Avon reps, and attract customers who are newly appreciative of Avon's low prices, high quality, home delivery, and newly-broadened product line.

Avon and AIG are both global companies with most of their sales and earnings—and

growth—coming from outside the United States. For years these companies have suffered from translating their foreign earnings back into an ever-rising dollar, and now that the dollar has stopped rising they are no longer suffering that penalty. When the dollar finally starts declining in earnest AIG and AVP will gain a windfall.

Like most of our holdings, these companies had no reason to decline sharply in September. They don't depend on airplane travel, or retail sales, or the level of consumer excitement about personal computers and cell phones. Emotion can make big waves in the stock market—and that means opportunity. Be skeptical, do your homework, and keep a steady course.

— £ —

In January Enron had a market value of \$63 billion. Today it stands at \$438 million, which is still a lot of money—but it would have to multiply 144 times to get back to the January price. If you're going to buy a speculative stock, pay close attention to the total market value; never spend more than 2% of your portfolio; and don't forget that the difference between "down 80%" and "down 90%" is that the stock gets cut in half.

A FAREWELL TO MATERIALISM

The oversized generation known as the Baby Boomers made its first big splash in the Sixties and Seventies with anti-war protests, environmentalism and energy conservation. Small is Beautiful. When the exuberant Eighties came along, the 'Boomers labeled them the Decade of Greed.

Then a funny thing happened on the way to the circus. The 'Boomers have always moved as a herd, changing perceptions and reality as they moved from fad to fad. Somehow, somewhere between 1985 and 1995, conspicuous consumption came into style. And did it ever: when was the last time you heard or saw the words "conspicuous consumption"?

If you could round up some of the protesters of the Seventies and bring them to 2002 in a time machine, they would be horrified to see themselves driving gas guzzlers and living in mansions and repudiating all their old ideals. Some of those ideals were swept away by greater maturity and deeper understanding, but few would try to defend the frenzy of consumption that marks American life today. It's not even much fun anymore; we binge until our homes can no longer hold any more toys, clothes, and gizmos, and then purge by shipping another carload to the Goodwill store.

Sociologists call the disease Affluenza. The enablers are retailers who have convinced us that consumption is a form of savings ("save 40% on all cashmere sweaters!"), and banks with lending practices that can only be described as kooky. During the Nineties irresponsible loans were

showered on consumers like rain, and credit cards were regularly issued to dogs and fictitious persons. Even to college students.

In 2000 the top 20% of wage-earners spent more than they earned, with a *negative* 2.1% savings rate. It's true that this statistic does not include savings in 401K plans, but that was also true in 1992, when Americans with incomes in the top 20% saved 8.5% of their income.

That's a massive, once-in-a-lifetime swing, and there are signs that the pendulum is already swinging back. Sure, we're in a recession, and things will look different when the recession ends. But the events of 9/11 gave voice to the many Americans who were already beginning to notice that there are gifts more important than money and material goods.

Americans feel entitled to luxury, because we work the longest hours in the industrialized world. But that is also about to change, because we're beginning to realize that time is a great treasure. Family, friends, church and leisure are suddenly taking precedence over status symbols and luxury goods. We're going to work less and spend a lot less, in favor of financial security—freedom from want—and free time. Freedom.

Consumer spending will be very soft in the year ahead. You should expect a slow economic recovery, and it will seem all the softer and slower because we'll be comparing it to the biggest boom—the wildest party—of our lifetimes.



FRIGHTFULLY HELPFUL

Americans are more-easily scared than they used to be. Television is the obvious culprit, with daily images of the worst things that happen each day in a nation of almost 300 million people.

Of course, the TV news scaremongers get plenty of help. In the middle of the anthrax scare our offices received an official bulletin from the U.S. Post Office, warning us to be suspicious of any mail that was handwritten, or marked "personal". We were also—surprisingly—asked to avoid any mail carrying excessive postage. And you can't be too careful with envelopes marked "confidential", especially if they are sealed with excessive amounts of tape. Lastly, never open any mail from "someone you don't know."

So what should you do with all the credit-card solicitations and America Online diskettes that arrive in your mailbox each day? "Wash your hands thoroughly" and deliver them to "local law enforcement authorities." They're looking forward to your visit.

THE DOLLAR

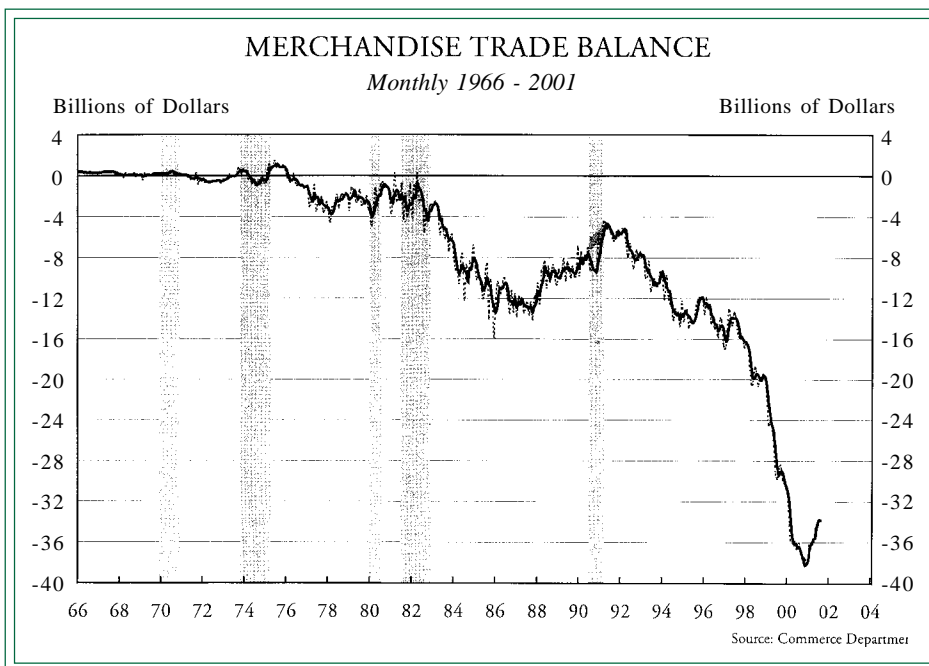
The graph at right shows the long decline in our Merchandise Trade balance that started in the 1970s. In the first half of the 1980s a rising dollar allowed imports to flood into our markets, and made life very difficult for American manufacturers trying to sell goods overseas.

The situation improved in the next seven years as the dollar declined sharply, but our manufacturing sector never fully recovered---and the 90s brought an Asian invasion and an excruciating rise in the dollar.

The greenback went up because foreign investors were eager to buy our stocks and bonds, and as the dollar rose they became even more eager; they were making money on the currency as well as on their investments. That's why the dollar always rises too high and falls too far.

At the outset of 2001 our cover story touted European bonds as "The Best Investment Idea of 2001." We were wrong, but you would have suffered much worse in most stock market investments. And we'll stay with the idea for 2002, because sooner or later the world's investors will stop pouring all their savings into American investments.

Some pundits have been saying that the euro *deserves* to be weak, because the European Central Bank is holding interest rates so high that it's restraining growth. The odd thing is that investors used to buy the German mark *because* the Germans were tough on inflation. And, for the record, the nations of Europe have been growing



America's imports are now equal to 6% of the output of the entire world.

faster than the United States, with lower inflation, for more than a year.

We expect to see the euro appreciate 25% or more, and we'll collect interest while we wait. There's also a chance to make a profit on the bonds themselves, because long-term bonds appreciate significantly when interest

rates decline. About a year after the last recession the Federal Reserve began to raise short term interest rates, but bond yields continued to decline—and bonds continued to rise in value—until the middle of 1993.



PHARMACEUTICALS ON SALE

Taxol, the famous cancer-fighting drug derived from the Pacific Yew tree, is losing its patent protection. So is BuSpar, the tranquilizer that says "abuse", and Glucophage, which is one of the world's best-selling diabetes drugs. Bristol-Myers (BMY - \$51) is on the ropes.

Or is it? The company is still forging ahead with the other cancer drugs that helped save Lance Armstrong, and Taxol itself still enjoys patent protection overseas. Pravachol (a cholesterol-fighting "statin") continues to grow its sales towards \$2 billion per year.

Plavix, a new anti-platelet drug that helps prevent strokes and heart attacks, looks to have an even bigger future. This year the FDA should approve the purchase of Vanlev, a potential blockbuster hypertension drug that sharply reduces both systolic and diastolic blood pressure, and Erbitux, a promising new drug for cancer.

Over at Merck (MRK - \$58) the patent expiration problem is even worse. Vasotec, Mevacor, Pepcid, and Prinivil have all lost their protection

Continued on page 4



John Lumbard, CFA

Picture by Hollis Photo

“If I’d known I was going to live so long, I’d have taken better care of myself.”

– Maine boat builder “Chummy” Spurling, shortly after his 100th birthday.

Pharmaceuticals on Sale - Continued from page 3

from generic competitors who are slashing prices 70% or more. In many cases Merck won’t even bother to compete, instead moving on to newer medications for high cholesterol, high blood pressure, asthma, osteoporosis, pain, depression, and diabetes.

We didn’t become interested in Merck until its stock took a licking in late December. That cut the price-earnings ratio to 16, and brought the dividend up to 2.4%, which is a lot these days—particularly for a blue-chip drug company.

NUTS AND BOLTS

Fees, Custody, and Minimums at Lumbard Investment Counseling.

Most of our client accounts are held in custody at the State Street Bank. Each client has a custodial account at the bank in his or her own name, and Lumbard Investment Counseling covers the cost. The result is the ability to use multiple stockbrokers, and “block trade” in a way that brings great flexibility (including the ability to buy foreign bonds), and extremely low commissions on trades.

Our annual fee for new accounts held at State Street 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 ½ of 1% of any assets above \$2 million. There is a modest fee discount (0.1% deducted from each of the percentages listed above) for assets held elsewhere; we’ve found that the best alternative is Leeb Brokerage, which keeps all its client holdings with the Bank of New York.

In a world in which most investment advisers insist on a minimum portfolio of \$1,000,000 or even \$5,000,000, we’re holding our minimum at a reasonable \$350,000. If you would like further details, please call us at 1 (800) LUMBARD.

Our interest in Schering Plough (SGP - \$35) is even newer. Zetia, a new cholesterol drug that will be used in combination with Merck’s Zocor, Pfizer’s Lipitor, Bristol’s Pravachol, and all the other statins, is actually a partnership between Merck and Schering. The two companies also share a far-reaching partnership in asthma and allergies, gaining significant benefit by merging sales forces and giving each salesperson a larger stable of drugs to offer to doctors. A merger seems inevitable; SGP would say goodbye to a legacy of embarrassing manufacturing problems, and the two companies could cut costs while forging the most powerful marketing effort in the business.

It’s always difficult to find companies with unique patents, or brand names so powerful that consumers will pay extra for them. It’s easy to think of brands and products that *used* to have this power but no longer do—film from Kodak, airplanes from Boeing, phone service from AT&T, computers from IBM, Digital, Wang, and Compaq, routers from Cisco, and computer printers from Hewlett-Packard. For all their celebrated troubles with patent expirations, the pharmaceuticals look like a tower of strength.



PRIDE

It's a great thing to have your name on a football stadium. You get your name mentioned for free on nationwide TV every week—for years. And it's a great status symbol.

Internet conglomerate CMGI has its name plastered on the future home of the New England Patriots. It's a marketing coup, as long as the announcers don't carp about the money they lost in the stock—which declined from \$150 to \$1.50 in the space of a few months. That's actually better than the performance of PSINet, proud (although bankrupt) sponsor of PSINet Stadium in Baltimore. In its December 10 issue, Forbes Magazine offered a round dozen of similar bad investments, including local favorite Compaq—which applied its name to Compaq Center in Houston.

However, Forbes was a bit too quick to the press, and published too early to capture the true horror of the Houston experience. Houston is also the home of Enron Field. May we suggest free tickets for shareholders?



Manufacturing is now just 16% of our gross domestic product. Is it possible to have a good economy when we don't produce anything at all? The good news is that American manufacturers—even the high-tech companies—will see their exports soar when the dollar drops 25%.

STRATEGIC RESERVES

We're putting our nation's energy security at risk, simply because we're not tough enough to do what needs to be done. We need to adopt a big gasoline tax, and use the revenue that results to increase the size of the "Strategic Petroleum Reserve". Those words are in quotes because it's not enough to fill the little hole in the ground we call The Reserve; we need at least a three month supply. And it makes little sense to pump the oil out of the ground in one place and then pump it back into the ground in another. Let's buy some reserves in the ground, set up the infrastructure needed to get the oil out, and then leave it there.

In the meantime, we should buy all the Middle Eastern oil we can, while it's

still a bargain. If the world economy stays weak, oil will continue to be a bargain for quite some time, but there's no question that rising consumption will eventually push prices sharply and permanently higher.

We'll have to cope with rising natural gas prices much sooner, because most of it comes from North America. Supertankers can easily ship oil across the world, but they can't carry natural gas unless it has been liquefied—at great expense. And our demand for gas is increasing rapidly, because the U.S. is responding to its electricity shortage by installing natural-gas-fired power plants in every back yard. Not coal, oil, nuclear, wind, or solar. Just gas.

Scott D. Sheffield, Pres. and CEO
Pioneer Natural Resources Company
Irving, TX 75039

November 23, 2001

Dear Scott,

My clients have held shares of your company's stock for eight months now, and in that time we've been very pleased to read of your numerous successes in finding new reserves of natural gas. Recent ("Hubbert's Peak") predictions that world oil and gas production will peak within eight years give us confidence that those reserves will have significant value.

However, the fact that the industry's success rate will inevitably dwindle implies that your success rate will also dwindle. And it's easy to imagine a future in which you continually reinvest all your earnings in new wells until the game ends, many years down the road. If you don't pay any dividends along the way, it's entirely possible that the ultimate return to shareholders will be minimal.

Investors are quickly gaining a new appreciation for dividends, as they lose confidence in the "dependable" capital gains that were supposed to replace them. I'm sure I speak for many shareholders when I ask that you publicly sketch out a road map for future dividends, share re-purchase, and debt paydown. Or perhaps you plan to sell the company. In the language of the venture capital investor, what is our exit strategy?

Sincerely, John Lumbard, CFA

WHAT DO YOU DO NOW?

The prices of tech and telecom stocks have been rising in anticipation of the next boom. As Warren Buffett says, investors always drive with their eyes glued to the rear-view mirror; and today they're hoping that 2003 will somehow resemble the overheated, extraordinary boom of 1999.

They'll need an extraordinary boom, because the optimism of the Nineties created far too many of these companies. They have to compete with each other for business, and compete with each other for employees; paying high wages even as they struggle with brutal price competition. The result is either razor-thin margins or big losses. Many have resorted to accounting gimmicks to make the ends meet, and nearly all have resorted to paying their employees under the table and off the books with options instead of cash wages.

We don't have our 2001 performance numbers yet, but we had another good year. It looks like the State Street accounts produced a double-digit return, with overall returns in the high single digits. Call and we'll send you the actual numbers, along with our excellent 1990 - 2000 performance figures.

"I just had this feeling they were peeing on my boots and telling me it was rain."

- David Anderson, a physicist at Fermilab and co-author of a book debunking the "Bernoulli's theorem" explanation of airplane flight which has been taught in physics classes for half a century. Airplanes fly because the front edge of the wing is tilted upward, forcing air down.

Of course, the collapse of Enron shows us that it's not just tech and telecom companies that have been lying to investors. Sometimes it seems that most of the profits in America are coming from financial engineering rather than product engineering, and—as usual—the blame lies with investors. Today's accounting standards and investment information are bad because we gave CEOs an incentive—often, an enormous incentive—to make them bad. The problems are greatest at the most-celebrated companies, because they feel the greatest pressure to tell a good story to their shareholders. The best-loved, most-admired companies in America are cooking the books.

You can't trust Wall Street analysts to help you, and you can't even expect that the company's auditors will give you the unvarnished truth. Arthur Andersen alone has been tarred by the accounting scandals at Enron, Sunbeam, and Waste Management, and the other Big Five accounting firms don't look much better. These firms are making most of their money by offering consulting services to the companies that they audit. The average investor has no way of knowing whether the earnings reported by his companies are a bold lie, and he's not going to find much comfort in mutual funds. They've been enthusiastic buyers of each of the companies that later revealed accounting scandals.

In this environment, it's remarkable that stock prices are still high by most measures. There are still good opportunities available, but investors should avoid companies that need a strong economy to do well. Most importantly, they need to delve deeply into accounting practices, and invest only in companies that they fully understand.

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.

General Disclosures:

Statements in this communication are the opinions of Lumbard & Kellner, LLC and are not to be construed as guarantees, warranties or predictions of future events, portfolio allocations, portfolio results, investment returns, or other outcomes. None of this material is intended as a solicitation or offer to purchase or sell a specific investment. Readers should not assume that all recommendations will be profitable or that future investment and/or portfolio performance will be profitable or favorable.