

Spring Commentary 2003

MARKET UPDATE

Since our last newsletter we have invaded Iraq, and the war has moved towards a victory for the U.S. and coalition forces. The market in the last month has moved more on emotional sentiment concerning the war, rather than investing fundamentals. The market has moved upwards by 1,000 points in little more than one week, reflecting the public's perception of a positive outcome to the war. On the economic front, the economy's growth remains relatively flat, with a 1.4% rise in the GDP for the 4th quarter of 2002, and a rise in Corporate Profits of 3.2% versus a decline of 1.8% in the 3rd quarter of 2002. The economy is generally stable with little increase in inflation, a stable interest rate and unemployment remaining relatively unchanged at 5.8% as of February 2003.

We at Lehrer Management, echo the concerns of the nation, in hoping for a quick end to the war, the safe return of our troops and peace in Iraq.

LMC INVESTMENT STRATEGY

In our previous newsletter, we provided you with our view on the market and the economy. In this issue we will provide insight into one of our investment methodologies.

There are various paths to successful investing. We will explore here, in a

generalized outline, one of the approaches employed at LMC, usually called a "bottom up," fundamental approach. This approach is characterized by a focus on the company's financial statements. The company's performance must always be evaluated within its industry context, i.e. manufacturing, retail, financial services, etc. We will use the example of the retailer, Home Depot (HD), to illustrate, in brief, our analysis.

The first item we look for in a company is

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growth. Are the revenues and profits of the company growing? For the past three years HD has grown sales approximately 15% and earnings approximately 16%. For the next two years, HD's growth is expected to slow to approximately 10% for sales and earnings. This slowing growth is likely one of the

key causes of the stock price's decline from \$50 a year ago to roughly half of that today.

Next, we will examine the company's cash and debt position. HD has about \$2.3 billion in cash reserves. It is generating more than \$5 billion in cash from its operations while its capital expenditures and dividends total just a little over \$2 billion a year. That leaves roughly \$3 billion for management to use to the benefit of the shareholder. Management could pay out more dividends, buy back shares, or reinvest the money to grow the company. HD has approximately \$1.3 billion in debt, which is minimal compared with HD's market value of \$56 billion. It is reassuring for management of a retail business to have a large cash cushion to enable it to survive the ups and downs of an economy and consumer spending, as well as their own occasional,



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inevitable missteps. A negligible amount of debt also provides management the flexibility to maneuver in a competitive marketplace.

Now we will examine management's performance and efficiency. One of the indicators we utilize is the company's pretax margin. This number will tell us how consistently management is able to extract profits from the company's operations for the shareholders. HD has posted respectable, and apparently sustainable, pretax margins of 10% for the last few years. Another indicator we use to track how a company's management is performing on our behalf is their return on equity or return on invested capital. This number tells us roughly what management is able to earn on the money we invest with them and provides some insight into the company's potential growth. HD has earned, on average, 15%-19% for the last five years. Also, when we analyze a company's numbers it is critical to note the trend over time.

We also want to know whether management has a vested interest in the future success of the company. In other words, do they own stock in the company or have the proper incentives to motivate them to perform? Two of the founders of HD are active board members and own 78 million shares, worth almost \$2 billion today, but half of its worth of one year ago. The president has been awarded stock option grants that will vest over the next couple of years at exercise prices 50% and higher than the current stock price. In addition, to the prestige (bragging rights) associated with running one of the country's premier retailers, we believe management must have sufficient incentive to improve the stock price.

Another factor in examining a stock for purchase is the amount of shares held by institutions. Institutions are the mutual funds, pension plans, and other large money managers that typically are able to move the price of the stock with their large purchases and sales. Institutions own 57% of HD's shares. There is considerable room for

additional institutions to own shares and drive up the price of the stock.

One of the keys to determining whether a good company is also a good stock is to compare the current stock price to historical valuations. We use the P/E (price/earnings), P/S (price/sales), and/or P/B (price/book) ratios depending on the company and industry we are examining. Obviously, the goal is to buy the stock when it is trading at historically low valuations and sell the stock when it is trading at historically high valuations. For HD we will look at the P/E and P/S ratios. HD is trading at its historically low end for both measures, which suggests that now might be a good time to initiate a position in its stock. If the company meets its growth targets and the market assesses a historically average valuation, the stock could double in three years.

After a fuller review of the company's numbers from its SEC filed financial statements, we then step back and digest everything the company has said and done. We want to ensure management's credibility, understand the company's competitive position and its market drivers, be comfortable with the assumptions underlying company projections, as well as understand the interest rate environment and market sentiment in which the company operates. These items are among a host of factors necessary to make an investment decision. It is as much art as it is science to master the investment process.

Finally, once we decide we like a stock's prospects we must determine for which accounts it is appropriate, mindful of risk profiles, tax status, and other factors particular to an account. So, some clients may hold the stock, while others do not.

This has been a brief, generalized outline of one approach we use to investigate stocks. We hope this narrative has been helpful to illuminate what is often an opaque field to those outside the process.

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