

“Whenever you find yourself on the side of the majority, it is time to pause and reflect.”

-- Mark Twain

Since the recession of 2002, we’ve been having fun, in our contrarian way, writing about the specter of inflation, strong commodity prices and higher interest rates, even as the conventional wisdom at the time was diametrically opposed to this point of view. One vivid but not exceptional memory of that period was a speech delivered by Federal Reserve Governor Ben Bernanke on November 21, 2002, entitled “Making Sure ‘It’ Doesn’t Happen Here.” The *It* to which he was referring was, of all things, *deflation*. At that time, the economy was soft; the market was down almost 30% for the year (its third straight annual decline); oil was \$25.50 a barrel; and mortgage rates were at 40 year lows. Still, in 2002 the world seemed to us poised to ‘reflate’, and we believed we had the evidence to back that contrarian view: Ill-timed tax cuts combined with already anemic government revenue due to the poor economy to create massive budget deficits where there had been surpluses two years earlier. Gold had risen from \$250 to \$320 an ounce. The dollar had begun its decline, and the (inflationary) drums of war were beating loudly at the United Nations. The Federal Reserve had driven the funds rate to record lows to spur an economy that probably didn’t need much spurring. The pump was over-primed.

For those reasons, we believed that worrying about ‘deflation’ was like focusing on the distracting hand of a magician who was set to deliver the goods from a different direction. All the ingredients were in place in 2002 to produce old-fashioned, 1970’s-style inflation, and we invested accordingly. More than half the companies we purchased since then have been in economically sensitive categories: Dow Chemical, Premcor (oil refining), TK Shipping, Encana (Canadian oil and gas), Anglo Gold, American Barrick (gold), Chevron Texaco, Peabody Coal, Arch Coal, Consol Energy (coal), Diamond Offshore Drilling, Transocean Drilling, Wheeling Pittsburgh Steel, Cleveland Cliffs (iron ore), and Burlington Northern Railroad have been among our large holdings since late 2002.

These investments have for the most part worked out quite well. The crucial factor in the success of this strategy was not only being correct in assessing future trends, but also being in the minority. In late 2002 the consensus was, like Governor Bernanke, talking about deflation. In a free and fair market, the consensus sets prices. When the consensus is wrong, it creates opportunity. We were in a small minority at the time that believed in a reflationary future. In short, we had the good fortune to be both correct *and* lonely.

We report this bit of recent history not (so much) to ring our own bell, but sadly to report that we are no longer in the minority. Now virtually *everyone* believes that higher energy and hard commodity prices are here to stay. This is not to say that the consensus is wrong. In fact, in this case we think it may be correct. But, when the consensus rolls into town, superior investment returns generally depart by nightfall. Over the last two years, as investors came to adopt our view, we made terrific returns on many economically sensitive stocks — and we still own a fair number — but future returns are

not likely to be what they were. There are just too many people who already believe in the secular inflation thesis. Now we need to find some additional catalyst or hidden asset for each economically sensitive stock we own in order to offset the additional risk of holding such a stock when the consensus view looks for inflation and worldwide economic growth. For those names that we continue to hold, like Wheeling Pittsburgh Steel or Temple Inland (paper), we believe certain hidden assets and corporate events that loom in the future will allow such firms to realize shareholder value even if the now-consensus view of strong economic growth fails to materialize. Even so, we believe we are in the autumn of this cyclical investment cycle, and the leaves are fast turning red. Previously forlorn sectors as coal, steel, iron ore, natural gas and tankers have enjoyed an extended season in the sun. For most of these groups, the last balmy period they enjoyed was a generation ago. Price appreciation of 100% or even 200% in less than a year reflects underinvestment at the beginning of their run, but probably also *over*-investment right now.

All this begs the question, though, if it is autumn in the land of cyclical stocks, where is it early Spring (other than New York)? One group, the financial stocks, typically a favorite of ours, has been hard hit of late. In fact, for the first time in our history, energy made up a larger segment of your portfolio in the first quarter than did the financials. Since Ben Bernache gave his deflation speech, sentiment has completely reversed. Inflation is the new watch word, and higher interest rates are as sure to come as night follows day. Just ask anyone. Again, we think this over-assurance creates opportunity. Historically financial stocks do poorly as interest rates start to rise, and then they tend to trough about half-way through the rate-hiking cycle as pessimism peaks and investors slowly start to look ahead to the end of the higher rate cycle. We believe we are nearing that point now. For that reason we have initiated a new position in J.P. Morgan, a money center bank with a 3.8% yield.

J.P. Morgan is the second largest bank in the United States with over \$1 trillion in assets and roughly 7% of the domestic deposit market. Like most of our investment ideas, it fits with our theme of being in the right area (financials) but also possesses its own special investment thesis, which makes it particularly attractive. In this case the bank is in the midst of integrating its operations with Bank One, which it bought in 2004. JPM has targeted \$3 billion in cost savings by the end of 2006, and new CEO Jamie Dimon is known as a very cost-conscious manager dating back to his days at Citigroup. JP Morgan's revenue is well diversified: retail financial services are 26%; investment banking 23%; credit cards 27%; asset and wealth management 9%; treasury and securities services 10%; and commercial banking 6%. The U.S. market makes up three-quarters of the business, and international operations represent a potential growth area. We believe JPM will earn close to \$3.00 per share in 2005 and about \$3.50 in 2006, which would imply a price-to-earnings ratio of 12 and 10.3 respectively. Historically the company has traded at 11.5x forward earnings; however, we believe as the integration process shows signs of success the shares will be given a higher multiple. We feel that our downside is limited both by the high yield and because JPM is trading at 2.4x tangible book versus 3.6x for Citigroup, 3.6x Bank of America and 3.3x for Wachovia. Recall that our investment horizon is three years. If, then, in 2008 the company earns about \$4.50, it could easily sell above \$50. Together with the high dividend, we anticipate more than a 50% return for shareholders during this period.

We also purchased shares of Time Warner in the quarter, another non-economically-sensitive investment, in this case one that illustrates our belief that the cable business is under-appreciated. It joins Comcast in the portfolio, and replaces Cox Communications, which we purchased last summer only to have the management quickly execute a leveraged-buyout of the company. That leveraged buyout underscored to us that cable stocks remain depressed and those who know them the best — in Cox's case, its own management — are buyers, not sellers. Time Warner is a complex company. In some ways we joke that it represents the combination of portfolio holdings Disney and Comcast, the first having content (movies, ABC network, ESPN) while the second is primarily a delivery (cable) company. Time Warner has cable properties that produce a third of its earnings, films and other content (like HBO) produce roughly another third and publishing and AOL deliver the rest. We like most of those businesses. Even AOL, which is a mere shadow of what it used to be, we think is under-appreciated. To quote Mark Twain again, we believe reports of its demise are greatly exaggerated.

So, to summarize, we believe that the market has come to adopt our worldview — namely, that higher worldwide prices are here to stay — and commodity stocks have reaped much of the benefit. Thus it is time for us to look for a new worldview. This process of change is always awkward and we are often early to the table (as we may be with JP Morgan, for example). Still, we believe that evolution away from the consensus is essential for good portfolio returns over the long-term. There will be periods (like 1997-1999) when the consensus drives stocks to ever more ridiculous heights, and indeed the consensus may yet do that with the cyclical stocks that we are now selling, but our valuation parameters should not change with sentiment and the risk of absolute dollar loss has clearly increased.

During this transition period as new stocks become leaders in place of those that drove the market higher over the past 30 months, we anticipate volatility and would not be surprised to see the overall market continue to struggle. Also, the first year of a second presidential term seems typically to have more uncertainty as the Administration's agenda evolves. As we indicated in our year-end letter, a year of modest gains would not be surprising, especially following two full years of strong gains.

We appreciate your business and look forward to a successful and prosperous second quarter.

Spears Grisanti & Brown