Portfolio Strategy Update

April 5, 2002

** This document, jointly written by Shane Hoover and his previous business partner, was originally published on April 5th, 2002 at RBC Dain Rauscher. It has been reproduced in its entirety, and only changed to provide the current contact information for Shane Hoover and Hoover Capital, L.L.C.

Market Performance

	YTD	From Market Top
S&P 500	- 1.9%	- 27.5%
NASDAQ	- 8.5%	- 65.2%
Dow Jones	2.9%	- 12.3%

As of 4/5/02

We have recommended a cautious stance toward the stock market for over a year now, with client portfolios heavily weighted toward cash and other lower risk securities. Our desire to reduce clients' market exposure was based upon the deteriorating corporate earnings and economic environment, in conjunction with high market valuation. We currently believe the S&P 500 as a whole is still overvalued, and the widely broadcast economic recovery may be premature, particularly as it may translate into higher corporate profitability. As this opinion is contrary to many market participants, including the current media consensus, we felt this would be a good time to update you on our current thinking. As you may know we held a client seminar at the Seattle Art Museum in April 2001 explaining our transition to a more conservative portfolio allocation, which included a detailed discussion of what created the stock market bubble, why it popped, and where clients should focus their investment capital. (VHS tape and seminar handouts of this event are available upon request.)

A few clients have recently asked us why we continue to have our dour market opinion in light of the post 9/11 market rally, Wall Street analysts' upbeat prognostications for the economy and corporate profitability, and economic data apparently indicating the US economy is no longer in recession. (In fact, the Bush administration has even suggested we were never in a recession, as the technical definition requires two successive quarters of declining Gross Domestic Product (GDP), which has not happened.)

This letter is not only intended to describe our market views, but also educate clients on market history and functionality, and where we see opportunities in 2002 and beyond. We apologize in advance for the length, but we feel all investors must understand the concepts presented. You may disagree with our conclusions, but as always, we will endeavor to provide what we feel are the relevant facts. We would be happy to discuss any of these issues further.

Bull Markets

The US Stock Market has just experienced the longest bull market in history, beginning in August of 1982, peaking on March 24th 2000, after increasing over 22 fold in 18 years. It is important to understand all bull markets, by their very nature, create self-reinforcing myths about how investing works. Like most myths, stock market myths are based upon a kernel of reality, but are then extrapolated creating potentially dangerous beliefs in the hands of inexperienced participants. Are US investors inexperienced? Consider this fact. Over 90% of all mutual fund dollars were invested since the last recession in 1990. The vast majority of investment players, on a dollar-weighted basis, have never seen a recession, let alone a bear market.

1982-2000 Bull Market Investment Myths

-Stock market rises on average 10% per year.

-Market declines are always temporary while gains are permanent.

-The market rises when the Federal Reserve lowers interest rates.

-There is more risk being out of the stock market than being in the market.

-To increase portfolio performance, an investor simply has to increase their willingness to take risk (i.e. increase volatility).

-Buy and hold is always a viable investment strategy.

-Stocks always outperform all other asset classes (cash, bonds, real estate).

What is wrong with everyone having common market beliefs?

Many investors fail to see the problem with investors all thinking the same way. I believe this dissidence is due to two factors; first, the reinforcing effect that the current underlying market myths have worked for so long that they must be true. And secondly, if everyone believes something, it would be fairly foolish to think otherwise.

Fish do not see the water and most investors do not examine the underlying principles on which they make investment decisions. Genetically, this decision-making methodology works perfectly well. If your tribe thinks eating a certain kind of berry will make you sick, it would be foolish to question this premise. However, markets of all kinds function counter to our innate desire to follow the crowd. In a ***market***, price is determined by supply and demand. Therefore all common knowledge is already reflected in market prices. If everyone believes something to be true, it is impossible to profit from this same information. Think about the horse track. It may be common knowledge a certain horse will win a race. While the horse may win, the odds reflect this certainty, so you won't make any money.

The stock market works the same way. The price of each stock is determined by the market clearing effect of supply and demand. Once everyone on the planet believed Cisco Systems (CSCO) was a good investment, who was left to buy the stock? As there

were no net buyers (everyone already owned it), the stock had to fall, simply because everyone "liked" the stock. This process works in reverse as well. Banking stocks were left for dead in the early 1990's due to the S&L crisis that forced a government bailout. Most large banks subsequently rose 10 fold during the past decade after a consensus was reached that banks were bad investments.

In the stock market, once everyone believes anything, it is wrong.

Today many believe the market myths outlined above. That does not mean the market has to immediately collapse, as these same beliefs have been held for years during the bull market. However, history brutally illustrates bear markets do not end until all previous myths have been erased (to be replaced with new myths). Is this a bear market? The official definition is a 20% decline from a market top. We view this definition as rather simplistic. We feel a bear market can only be labeled after the fact. If the market declines, but then rebounds with the same investor myths, we would consider it a continuation of the same bull market.

Has the bull market ended? We don't know, but we continue to have a number of specific concerns, which we feel create substantial risk, or may hinder future stock market performance.

Many of the leading investment minds in the country have articulated their thoughts, on many of the issues we will discuss, better than we ever could. As Picasso once said, "Good artists ***copy*** (ideas). Great artists steal." Our objective is simply, to organize their voices to explain the current market condition. We have "stolen" from Warren Buffett, Ken Fisher, Robert Shiller, Jeremy Siegel, Bill Fleckenstein, and many more.

We hope you find this discussion useful. Let's begin with a quote by Warren Buffett in this year's Berkshire Hathaway annual report. Why is he "lukewarm" on the prospects for stocks? Answer: Valuation.

"…(We have) decidedly lukewarm feelings about the prospects for stocks in general over the next decade or so… I believe that American business will do fine over time but think that today's equity prices presage only moderate returns for investors. The market outperformed business for a very long period, and that phenomenon had to end. A market that no more than parallels business progress, however, is likely to leave many investors disappointed, particularly those relatively new to the game."
(For full text: http://www.berkshirehathaway.com/2001ar/2001letter.html)

2/28/2002
Warren E. Buffett, Chairman Berkshire Hathaway

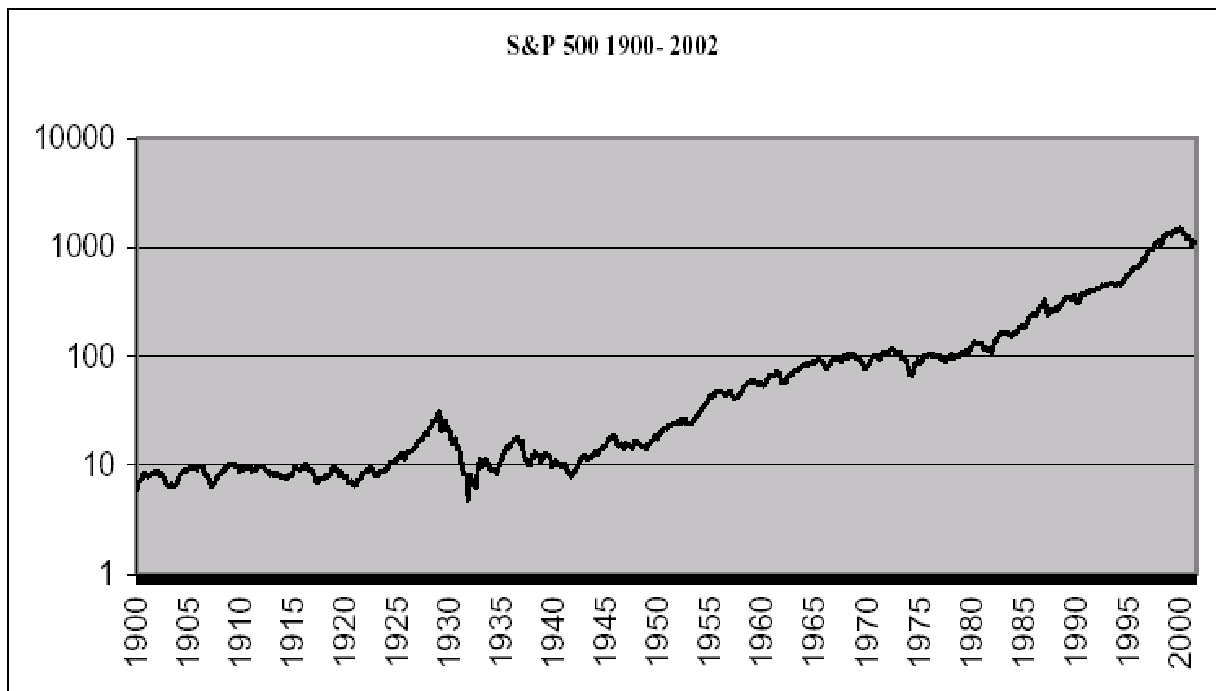
Valuation vs. "Stock Market rises 10% per year" Myth

Empirical studies indicate one of the largest determinants of the future performance of an individual security or market index is the initial price paid to purchase the investment. By price, we mean dollars paid to acquire a certain earnings stream. In other words: The PE ratio of assets purchased.

Common market "wisdom" says the market increases on average 10% per year. This fact is based on the long-term S&P 500 performance since 1926, but is fairly misleading. Most investors take this fact to mean the market will increase 10% this year, or at least over every 5 year period. Closer inspection reveals very interesting nuances to this market myth. What is not discussed is that the future return is highly dependent on when you decide to begin measuring.

1926 is usually picked because it encompasses the 1929 crash, 1930's worldwide depression, and provides an answer Wall Street would like to disseminate. The old saying, "one hand in boiling water, and the other in ice water, on average you're doing fine" applies very well to the market's historical performance.

The chart below graphs the progress of the S&P 500 since 1900. If you hold this page an arms length away and squint, the line appears to be roughly a straight line. Closer examination will show very long periods the market has simply gone nowhere, or actually declined.



Source: Robert Shiller, Yale Professor.
http://www.econ.yale.edu/~shiller/data/ie_data.htm

If American output and world power increased, quarter-by-quarter, and year-by-year during the last century (other than relatively brief recessions), how come the stock market had very long periods of stagnation? The answer is valuation. At different periods of time, investors were willing to pay more for the same earnings stream. The chart below depicts investor's valuation of one dollar of earnings for the S&P 500 over the past 100 years.

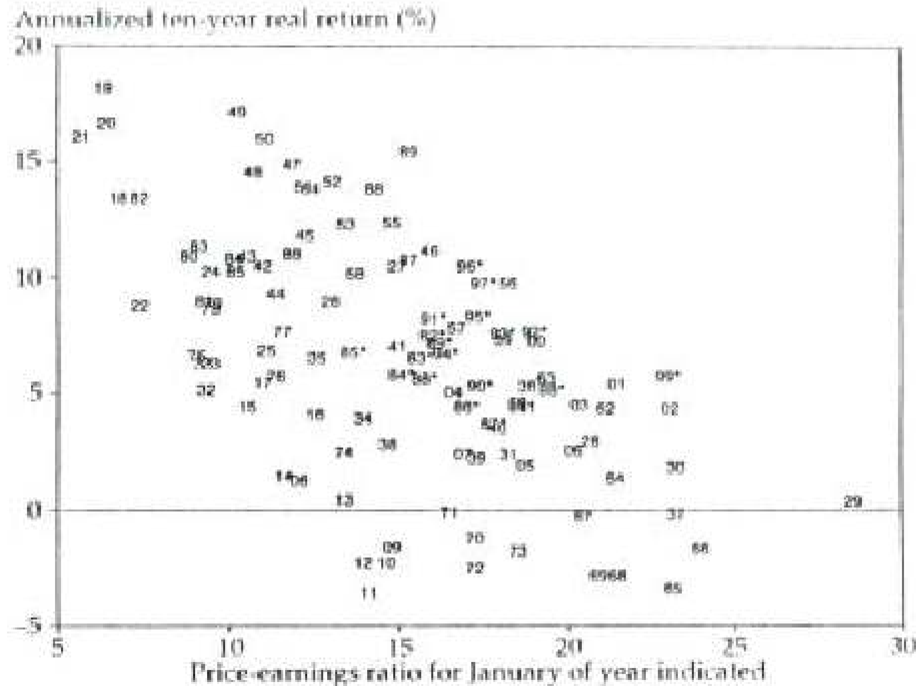
Source: Robert Shiller, Yale Professor. Author Irrational Exuberance
http://www.econ.yale.edu/~shiller/data/ie_data.htm

This chart clearly has four PE ratio peaks: 1901, 1929, 1966 and 2000.

It is interesting to note the S&P 500's subsequent performance after each valuation peak. Investing at any one of these previous valuation peaks was not a pleasant experience. The table below illustrates the time required to break even on your peak valuation investment (assuming all dividends reinvested).

PE Peak	Break Even	Time to Break Even
June 1901	December 1907	7 years, 6 months
September 1929	September 1947	18 years
January 1966	May 1978	12 years, 4 months
March 2000	?	?

In fact, historically, future market performance has been very inversely correlated to current market valuations. Typically, the higher the current market valuation, the lower future performance. The chart below is a scattergram depicting the future 10-year annualized return for each year since 1880 versus the beginning PE ratio.



Source: Robert Shiller, Irrational exuberance
* Indicates date is in 1800's

The number on the chart indicates the year in question. Note 1929 (29) and 1966 (66) in the bottom right, and 1920 (20) and 1982 (82) at the top left. Every long-term bull market has started in the top left of this chart (low PE) and every decline began at the bottom right (high PE).

Even after the market's recent decline, the S&P 500 still trades at 29 times earnings. As the chart shows, the market has never achieved a 10 year annualized return greater than 5% when beginning above 20 times earnings, let alone 29.

Although the long-term implications of high market valuation are very clear, the short-term implications are uncertain. Even though the S&P 500 may have a low 10-year annualized return, it may rise in any given month, quarter, or year.

> "Though the stock market functions as a voting machine in the short run, it acts as a weighing machine in the long run".
>
> **Warren E. Buffett**, Chairman Berkshire Hathaway

If you are thinking the market dynamics have completely changed since 1929, Ruben C. Trevino, PhD and Fiona Robertson, PhD., both professors at Seattle University, conducted the same type of study covering the period of time post World War II. More recent data, but the same conclusion; high current valuation correlates with lower future market return. See Journal of Financial Planning link.
http://www.journalfp.net/fpajournal/jfp0202-art10.cfm

Does this surprise you? Were you aware that within the 10% per year historical performance propaganda (since 1926), there were periods of time where you're invested dollar would have been under water for over 12 years? While the market may rebound quickly from its recent malaise, at some point, history suggests it will take longer than market participants anticipate, to rebound to new highs.

Viewing historical performance in this manner, you can see how quaint the notion that the market "rises 10% per year on average" really is. Some data just can't effectively be averaged.

The discussion so far has focused upon a macro view of the S&P 500 as a whole. This same valuation concept can also be used to analyze any individual company as well. In her book Buffettology, Mary Buffett described the valuation methodology below, as how Warren views security valuation.

General Electric – "We bring good things to life" (i.e. high valuations)

General Electric is the most valuable company in the S&P 500, based upon total market capitalization (price per share times number of shares outstanding). As such, it represents 4% of the S&P 500, a market capitalization weighted index. General Electric is an excellent company, which is undisputed by virtually everyone. But more importantly, is General Electric a good stock at $40 per share?

Over time, stocks will only increase in value for one of two reasons. Earnings increase, or the amount investors are willing to pay for those earnings increases. If an investor knew with certainty what a company's future earnings were, and how much investors were willing to pay for those earnings, they could very accurately determine what the future stock price would be. Then, based upon the current price, the annualized return would be known. Sounds simple enough, but determining future earnings, let alone fickle investor willingness to pay for those earnings, is very difficult. As Warren Buffett has said, if "history was the key to wealth, the Forbes 400 would be filled with librarians."

As the future is unknowable, investors must make reasonable and conservative assumptions. By reviewing GE's Valueline report (report is attached) we see they have increased earnings at 12% per year for the past 10 years (left hand side, middle, under title "Annual Rates"). As the 10 years in question, 1991-2001, began in the middle of a recession and GE is now a much larger company, I would think growing earnings at 10% per year during the next 10 years would be about the maximum reasonable assumption. To determine how much investors may be willing to pay for those earnings, let's review

their historic valuation (8th line item in the data table on right hand side). As the Valueline indicates, prior to 1995 GE's stock topped out at 15 times earnings. We think it would be reasonable to assume GE will trade again at 15 times earnings at some point in the next 10 years. (The previous high water mark that investors were willing to pay.)

The table below allows you to make your own assumptions. GE is currently $40 per share and earned $1.41 per share in 2001. If you assume GE grows earnings at 10% per annum, and is valued at 15 times earnings, your annualized return for the next 10 years will be 3.2%. For proper perspective, the 10-year risk free Treasury note is currently yielding 5.4%.

Every investor explicitly or implicitly makes their own assumptions when they invest in any company. This GE example indicates the possibly unreasonable assumptions inherent in the current stock price. In fact, based upon the assumptions above, if an investor wished to enjoy a 10% or more return on their capital, GE could only be purchased below $21.10 per share.

General Electric	$40.00
2001 Earnings	1.41

10 Year Annualized Return — 10 Years

Assumed PE Ratio	Assumed Future Growth Rate 0%	5%	10%	15%	20%	25%	30%	35%
5	-15.9%	-11.7%	-7.5%	-3.3%	0.9%	5.1%	9.3%	13.5%
10	-9.9%	-5.4%	-0.9%	3.6%	8.1%	12.6%	17.1%	21.6%
15	-6.2%	-1.5%	3.2%	7.9%	12.6%	17.3%	22.0%	26.7%
20	-3.4%	1.4%	6.2%	11.0%	15.9%	20.7%	25.5%	30.4%
25	-1.3%	3.7%	8.6%	13.6%	18.5%	23.4%	28.4%	33.3%
30	0.6%	5.6%	10.6%	15.6%	20.7%	25.7%	30.7%	35.8%
35	2.1%	7.2%	12.3%	17.4%	22.5%	27.7%	32.8%	37.9%

Valuation Matters (or will again, someday)

With the market, as measured by the S&P 500, currently trading at 29 times earnings, and many individual stocks priced at levels which imply extraordinary future growth (or poor future performance) we believe individual stock selection will be critical in the years ahead. While the macro data paints a bleak picture of overall market returns, some companies are priced reasonably and will make outstanding investments in all market conditions. The investment process will undoubtedly be more difficult in the years ahead, without the "rising tide lifts all boats" tailwind. (To mix a metaphor.)

PE Ratio Always Looks High at an Earnings Trough

Many investors argue that today's high PE ratio is irrelevant because PE ratios are always high at trough earnings, and will fall as earnings rise with the economy's recovery. This may be true. However, the same three peaks seen on the previous PE charts during the past 100 years still occurred if you measure the total value of U.S. securities versus Gross National Product (GNP is the same as GDP). The market was certainly overvalued in the late 30's and mid-sixties. As measured by value of US stock to GNP, the market is now in uncharted territory. To simply return to other historical ***peaks,*** the market would have to fall another 18%. Any way you wish to rationalize prices, the current market is very expensive relative to history.

Source:
http://www.fortune.com/indext.jhtml?channel=print_article.jhtml&doc_id=205324

Partying Like it's 1999

History indicates the market would be fully valued even if the economy and corporate profits were growing. The valuation issues discussed above were just as relevant in the late 90's while the market was on fire, but high valuations were easier to justify when many large companies were reporting 20%-60% per annum earnings growth. The world has now changed. Corporate America is currently experiencing the worst profit recession since the Great Depression.

Our gloomy market outlook is not only based upon market valuation, but also concerns with the quality of earnings which are reported, and skepticism with the consensus view that the economy is out of the woods and thus, will experience robust future earnings growth.

Accounting Unveiled – "Quality of Earnings"

In the stock market, nothing matters, until it matters. Investors didn't care that Internet companies were not making money. Until, of course, they did care. Off-balance sheet financing with special purpose entities (think Enron) didn't matter, until of course, it did matter. Insider sales at Tyco International (TYC) didn't matter, until of course, it did matter. Wall Street is replete with examples of issues, which everyone knows exist, but they just don't matter. That is: they just don't matter now, until they do matter.

While nothing can be done to predict, and therefore fully protect, your portfolio from outright fraudulent corporate actions (which appears likely to be the root cause of Enron), we can identify what issues may come to the forefront of investors' concerns. We see a number of material accounting "games" which companies have recently been playing, which call into question the entire validity of their recently reported earnings (or lack thereof). The three most troubling issues from our perspective are corporate accounting treatment for employee stock options, pension benefits, and use of "pro forma earnings."

What is particularly frightening about each of these accounting issues is that it is all perfectly legal, and in our opinion, has created very misleading financial results. Should these issues matter? We will let you decide for yourself.

"Pro-Forma Earnings"

Many companies report four different earnings numbers each quarter: traditional Net Income, Operating Income, Pro-Forma earnings and Taxable Income.

Traditional Net Income is defined by General Accepted Account Principals (GAAP), and is the final fully diluted audited earnings per share. Operating Income is the ongoing operations of the corporation, which has historically been Net Income, adjusted to exclude "unusual non-recurring expenses or gains." Pro-forma earnings are un-audited, and simply reflect what the company thinks their earnings should really be (I am not kidding). Pro-forma is sarcastically referred to as "earnings before the bad stuff." Taxable Income is determined by rules created by congress and the IRS.

Wall Street typically focuses attention on Operating Income, and increasingly Pro-Forma earnings, when discussing the performance expectations for a particular company. The typical analyst report, news article, or CNBC commentary now refers to a company in relation to their reported "pro-forma" earnings, where applicable, rather than referring to the (less bullish) GAAP numbers.

Because higher reported earnings translates to higher stock value, you can see why corporations have incentive to report more favorable numbers. Every dollar they can increase reported earnings has an X times (PE ratio) effect to the stock price and consequently management's stock option valuation.

Companies have always pushed as hard as possible to shift as much income to "Operating Income" at the expense of GAAP Net Income. A rather benign example is Coca-Cola's

(KO) historic practice to include the gain on sale of bottling plants as an operating income item. By very definition this gain is non-recurring, but they have argued they sell bottling plants as "a regular course of business." Perhaps, but with their total number of bottling plants being finite, should an investor be willing to pay 34 times (Coke's current PE ratio) the gain made on the sale as part of the corporations valuation?

Motorola (MOT) is another, slightly more egregious offender. In a valiant attempt to prop up operating income, Motorola has announced the same "one time, non-recurring charge" (in excess of $100 million in each case) nine quarters in a row. At what point do "one time, non-recurring charges" simply become a normal operating expense?

Our current favorite offender is Intel (INTC). In the golden years of the 1990's, Intel said they invested in small start-up companies as a normal course of business. When these investments where sold, Intel took the position that this was normal Operating Income when reporting to the Wall Street community. In 2000, Intel reported a net gain on investment sales of $3.8 billion, or 34% of their total annual profit. In 2001 the gravy train ended, and Intel was forced to book $466 million of net investment losses. Were the losses an operating expense? No. The losses were announced as "one time, non-operating charges." Frankly, it surprises us that analysts and the media give these kinds of "free passes" whereby investors are supposed to "count it" if it is favorable, but exclude it if it is not. Perhaps we are making too much of this, but we don't think we could get away with convincing our clients to "asterisk" any investment losses they received in the last couple years as "not counting." But somehow, Intel (and most companies) is afforded such luxury.

Intel 2001 Annual Report filed with SEC
http://www.edgar-online.com/bin/edgardoc/finSys_main.asp?dcn=0000912057-02-009698

Intel's financial games directly overstated their apparent profitability and investors have paid the price. Adjusting Intel's earnings to excluded investment profits and losses fundamentally changes their actual performance.

Intel is viewed as the one of the quintessential American growth companies. The problem is they have not been growing. The table on the next page shows what earnings would have been if they didn't include gains or losses from investments in reported earnings. In 1997 Intel earned 97 cents per share. Then during one of the greatest technology booms ever, they managed to grow earnings in 2000 to 97 cents per share. **That's right. They didn't grow earnings at all between 1997 and 2000!** No wonder Intel wanted the world to view investment gains as reoccurring Operating Income.

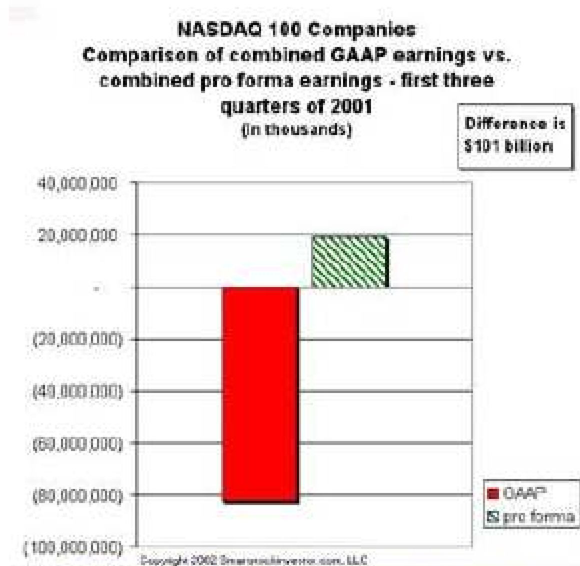
As we sit now in April 2002, Intel is not expected to earn $1.00 per share until 2003. That means they will not have increased earnings for 6 years, yet the stock is currently at $30, or 30 times **Best Ever** earnings. Intel is expected to earn 67 cents per share in 2002, or roughly 1995-1996 type earnings, when Intel traded at $6/ share. Is Intel overvalued? You decide.

Intel Reported Income Vs. Excluding Investment gains

	Reported Income	EPS from Gain on investment	EPS X-Gains
2003*	$1.00	$0.00	$1.00
2002*	$0.67	$0.00	$0.67
2001	$0.19	-$0.07	$0.26
2000	$1.51	$0.54	$0.97
1999	$1.05	$0.13	$0.92
1998	$0.86	$0.03	$0.83
1997	$0.97	$0.00	$0.97
1996	$0.73	$0.00	$0.73
1995	$0.50	$0.00	$0.50
1994	$0.33	$0.00	$0.33
1993	$0.33	$0.00	$0.33
1992	$0.16	$0.00	$0.16
1991	$0.12	$0.00	$0.12

* Analyst consensus estimate

The net effect of Pro-forma accounting is a massive overstatement of reported earnings. Technology companies are particularly addicted to pro-forma reporting. During the first 3 quarters of 2001 alone, the technology filled NASDAQ 100 companies reported aggregate Net Pro-Forma **"profits"** of $19.1 billion while simultaneously reporting aggregate Net Income **loss** of $82.3 billion to the SEC. True alchemy. Lead has finally been converted into (pro-forma) gold.



Source: http://www.smartstockinvestor.com/commentary.html

"If options aren't a form of compensation, what are they? If compensation isn't an expense, what is it? And, if expenses shouldn't go into the calculation of earnings, where in the world should they go?"

Warren E. Buffett
1998 Berkshire Hathaway Annual Report
http://www.berkshirehathaway.com/1998ar/1998final.html

Employee Stock Options

If you were the CEO of a company, wouldn't it be great to find a way to excluded a major expense from the income statement, effectively increasing reported income?

Behold employee stock options.

Unbelievably, stock option compensation is not currently required to be included as an expense in the calculation of Net Income. The Financial Accounting Standards Board (FASB) allows companies to choose to expense the cost of stock options when exercised or disclose in a footnote what earnings would have been if option costs were deducted. The only major corporation we are aware of that expenses stock option costs is Boeing (BA).

Although stock option costs are not included as an expense for financial reporting purposes, they are deductible for tax purposes.

If the true cost of providing employees with stock options were included as part of earnings many corporation's reported income would drop dramatically. According to Jeffrey Applegate of Lehman Brothers research, the Standard & Poor's 500 companies, "pretax profits would have been reduced on average by 8% in 2000."

The impact on each industry is detailed below. Technology company earnings are the most affected, due to their predilection to issuing stock options.

Reduction in reported Operating Income if Stock Option costs were expensed

Fiscal 2000

S&P 500 Industry Group	
Consumer Discretionary	6.3%
Consumer Staples	3.4%
Energy	1.8%
Finance	3.2%
Health Care	9.3%
Industrials	3.1%
Information Technology	28.5%
Basic Materials	3.9%
Telecommunication Services	11.6%
Utilities	1.2%

Senators John McCain and Carl Levin currently have legislation before the Finance Committee, which would require corporations to include stock option costs as part of Net Income. The influential Standard & Poor's company has voiced their opinion supporting this treatment of option costs.

For obvious reasons, technology companies have been bitterly opposed to this legislation and are actively working to kill the idea.

Our opinion, is that it really doesn't matter if stock option costs are "officially" expensed or not. In either case, a proper analysis of any company would include these costs.

If Ford Motor Company exchanged company shares for the motors they buy from suppliers instead of cash, should that cost be excluded? If not, why for labor costs?

Links to articles on this subject:
http://www.forbes.com/forbes/2002/0304/106.html
http://www.usatoday.com/life/cyber/invest/2001-06-20-tech-accounting.htm
http://www.redherring.com/insider/2002/0322/2308.html
http://www.nationalreview.com/nrof_comment/comment-reynolds040202.asp

Pension Benefits

Many companies provide employees with pensions upon retirement, particularly older blue chip companies. A typical employee may receive 60%-80% of their salary for life when they retire. To fund this future liability, corporations contribute to a separate employee pension fund invested to pay future pension obligations. The annual pension cost is determined with the help of actuaries, who calculate how much money needs to be salted away today to meet the future liabilities. The determination of future benefit costs is dependent upon how much each employee will receive, average lifespan, and expected return on invested assets. On an annual basis, the company then contributes the difference between dollars required today to meet future obligations, and the current value of the pension plan.

As the average life expectancy of a group of thousands of employees can be determined with great accuracy, the largest determinate of annual pension cost is the aging of employee population, and most importantly, performance of pension assets.

If the pension plan assets grow as expected, a company's annual pension cost is simply the cost associated with the fact they are one year closer to paying out pension benefits (plus net new employees and other reconciling items). However, if the market performance greatly exceeds expectations, then accounting rules allow companies to actually book a "pension gain", which increases net income. The reverse would happen if the pension plan assets fell dramatically.

IBM Case Study

Jeff Matthews of hedge fund Ram Partners in Greenwich, Conn., notes "from 1995 to 2001, when earnings per share rose 68% to $4.35 from $2.58, IBM's pretax profit rose only 8.9% to $11 billion from $10.1 billion. All of that gain -- and more -- can be accounted for via pension-fund gains."

Mr. Matthews thinks IBM wasn't really the success many think it was under Lou Gerstner, who stepped down as chief executive officer on March 1. Mr. Matthews said, "Pretax profit from selling goods and services actually dropped. They missed the entire technology market" boom from 1995 to 2001, says Mr. Matthews. Another value analyst, Ned Davis of Atlanta, looks at book value. He says that after a decade of "growth," IBM's book value is down 15% to $23.6 billion from $27.6 billion. During the 1990s, "little real value was built up in IBM," he concludes.

Other things that boosted earnings per share in the Gerstner years have little to do with operations. Mr. Milunovich, who follows IBM for Merrill Lynch, calculates that since 1995, 60% of IBM's earning-per-share gains came from having fewer shares outstanding as a result of stock buybacks, and 25% came from a lower tax rate.

IBM's overall pension-fund assets declined 12% last year, even though IBM's official assumption was that they would increase 10%. That drop, coupled with benefits paid during the year, reduced IBM's "cushion" of excess funds above expected obligations to just $686 million from a huge $10.74 billion the year before. (A large surplus increases the likelihood that a company will enjoy income from its pension plan, but it isn't always necessary.)

Still, "if the market turns down again…then you could be in a position where IBM has to start recording pension as an expense," says Fred Hickey, editor of High Tech Strategist, a Nashua, N.H., investment newsletter.

Excerpts from: 3/12/02 Wall Street Journal Article: IBM's Overfunded Pension Plan Won't Pump Up the Bottom Line**.** By WILLIAM M. BULKELEY. No link available without subscription.

The scariest consequence of pension accounting is the effective construction of virtuous cycles, and the real possibility of a vicious cycle.

The late 1990's was witness to a massive virtuous cycle. Corporate profits increased, which pushed the stock market higher. The explosive growth in pension assets directly increased corporate profitability, and the cycle is repeated.

What will happen when this process reverses course, with lower share prices lowering corporate profitability, etc.… We will see this play out sometime. Maybe not this year, or next, but with the heroic pension plan performance assumptions, it ***will*** happen someday.

Assumed future pension returns have ballooned along with the bull market. From the discussion above concerning the very likely possibility of lower future market returns at some point, and considering most pension plans have invested at least 40% of their assets in bonds, how realistic do the pension assumptions of the major corporations below appear?

Shifting Assumptions

	Expected pension fund returns		
	1975	1982	2000
Exxon	7.0%	7.8%	9.5%
General Electric	6.0%	7.5%	9.5%
General Motors	6.0%	7.0%	10.0%
IBM	4.8%	5.5%	10.0%
Yield on long-term government bonds	*8.0%*	*10.4%*	*5.5%*

Source:
http://www.fortune.com/indext.jhtml?channel=print_article.jhtml&doc_id=205324

The table below details the cumulative reduction in earnings between 1996 and 2000 for a number of companies, after adjusting for the option accounting and pension plan gains discussed above.

Forbes Magazine accounting sleuth Jack Ciesielski calculated the following impacts to corporate profits, sans pension and option dodges.

1996- 2000 Cumulative effect

	EARNINGS ($mil)	
Company	Reported	Recalculated
Allegheny Technologies	$764	$422
AOL Time Warner(1)	1,493	384
Baker Hughes	264	152
Black & Decker	214	96
Boise Cascade	218	113
International Paper	1,040	409
Lucent Technologies	6,166	1,265
NVidia	136	82
Unisys	-19	-528
Viacom	331	55

Figures are cumulative for 1996 through 2000. (1)Figures do not include Time Warner. Sources: The Analyst's Accounting Observer; company filings.

Source: http://www.forbes.com/forbes/2002/0304/106.html

Julia Childs, CFO- "Cookin' the Books"

Our point in detailing the perceived accounting anomalies and outright deception is that reported earnings might be overstated. As the market is currently priced for perfection relative to earnings as reported, with the S&P 500 trading at 29 times, there is no margin of safety. None of the issues discussed above are new. All professional investors have known for years the games that corporations play. The difference now is due to Enron and the Arthur Andersen problems, each of these issues is slowly finding its way to investor consciences.

You may be thinking, "So the market may be overvalued, and corporate financial illusions are being revealed, but it doesn't really matter because the market trades on incremental information, and the economic news is all good."

We would disagree.

> "Things are bad now, but we see a recovery in 6 months. As the stock market always has bottomed 6-9 months prior to an economic recovery, you must invest now."
>
> -Typical Wall Street Analyst Opinion

Economic Recovery

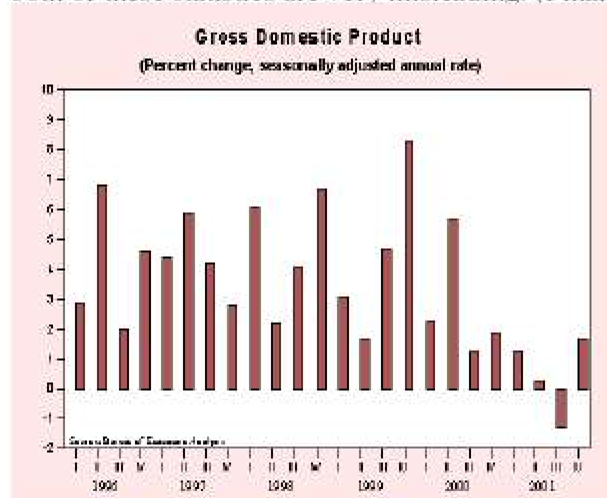
Every day, new economic data is released indicating the US economy is emerging from recession and moving into a new growth phase. With new growth in the economy, many investors believe the market will also be revived. First of all, the market is currently priced for one of the largest economic recoveries ever. Therefore, simply recovering from recession would not in itself justify higher equity prices. Even with a historic economic recovery for both GDP and corporate profitability, the market would still be valued at historically high levels. We are not necessarily betting against a recovery, so much as we are betting that the recovery will not be well in excess of the largest recovery in history (as is already priced into the market). Thus…**if** the robust recovery doesn't fully materialize as expected, the market will likely continue its downward trend.

We are skeptical about both the existence and strength of a real recovery for four basic reasons. First, GDP growth in the 4th quarter of 2001 versus the artificially low 3rd quarter was easy. Second, many of the "improvements" are solely due to "seasonal adjustments" from warm weather. Third, the economy is replacing depleted inventory. This is what we refer to as the "inventory fill." And lastly, if we are growing, where are the profits? (In addition, haven't were heard this "recovery" story before? Aren't we

always six months away from the actual evidence, but currently seeing "signs" of a recovery?)

GDP Growth in 4th quarter of 2001 vs. Q3 2001

At end of February, two economic statistics were released that set the market ablaze. Fourth quarter 2001 GDP was revised upward from 0.2% growth to 1.4%, and the National Association of Realtor released a report that said existing home sale grew 16.2% between December 2001 and January 2002. Upon release of those statistics, the market shot upward, as investors felt the economy was back on track. The only problem is that both of these statistics are very misleading. (Final Q4 GDP was released in March,



Source: http://www.whitehouse.gov/fsbr/output.html

On the surface 1.7% GDP growth sounds great. However, review of the underlying details question the validity and relevance of the final reported figure. First, the US stopped functioning for a few weeks in the 3rd quarter, due to the September 11th events, with much of the economic activity that usually should have occurred in the 3rd quarter being pushed to the 4th. Naturally, the 4th quarter would appear to be growing, simply due to the rise from a lower base. Secondly, a detailed review of GDP components does not foster a sense that the world is profitably growing.

The final 4th quarter GDP release by the US Bureau of Economic Analysis has a section, which details the actual contribution each sub-sector had on GDP growth. We found two figures particularly interesting: Durable Goods Purchases, and Imported Goods, with which the weighted impact on GDP was 2.84% and 1.0%, respectively.

Durable goods production was bolstered by a 13.8% increase in "automotive vehicles, engines, and parts". Which simply goes to show that if you give away cars through zero percent financing incentives, people will actually buy them. Was this "growth" good for the auto industry? In the 4th quarter of 2001: Ford lost \$5.1 billion, DaimlerChrysler lost \$34 million, and General Motor managed to make \$66 million (down from \$393 million in Q4 2000). Sure, sales grew, but so did losses because each auto sale cost the manufacturer money.

Imports also increased reported GDP by 1.0%. How do imports increase a "domestic product" figure? The government tracks the economic activity in the U.S., and in most quarters, imports usually increase. GDP is reduced by the increase in imports to account for just the "domestic" activity. In the 4th quarter of 2001, imports fell 7.5%, whereby the effect was to increase GDP by 1.0%. In other words, the weaker imports are, the greater GDP looks. Follow the logic if you can: Demand is weak, so we import less. This increases reported GDP, which many investors interpret to mean the economy is improving, and thus the assumption that demand must be improving.

In summary, ex-auto sales and import adjustments, fourth quarter 2001 GDP actually fell. Perhaps we are nitpicking the numbers along with everyone else, but we view these as the "reality adjusted" numbers. Had the automobile manufacturers not "agreed" to lose billions of dollars, the economy would not have shown growth in the fourth quarter, which should have been a lay-up versus the third quarter. They "took one for the team."

Source: US Bureau of Economic Statistics Q4 GDP- Final
http://www.bea.gov/bea/newsrel/gdp401f.htm

In the last 45 years, only the 1990 recession did not do a "double dip." The normal recessionary path is to fall a few quarters, under heavy inventory liquidation, pick up for a quarter or two (the inventory fill), then relapse. Take the 1969-70 recessions. Two quarters of mild economic decline were largely made up for by two quarters of advance, only to relapse violently in late 1970.

The latest market run-up, starting Feb. 22, does not break the bear market pattern. Since the down market started in March 2000, there have been eight other upward moves of 7.5% or more lasting 11 trading days or more. This is number nine. The market is no higher than in December or January. But sentiment sure is higher. A declining market with ever increasing optimism is almost always a recipe for further declines.

Source: http://www.forbes.com/forbes/2002/0401/116.html

Capacity Utilization

Two of the major forces that drive economic growth are consumer spending and corporate investment. The consumer spending side of the equation has not dipped due to low interest rates, which have bolstered the housing and automobile markets. Corporate investment however has fallen dramatically due to excessive industrial capacity. US industrial capacity utilization has now fallen below 75%, the lowest level since the 1982 recession. (See attached file "Capacity Utilization"). If the consumer has never stopped spending, and is unlikely to increase spending due to increasing unemployment, increasing mortgage rates, increasing energy costs, curtailment of zero percent auto financing, and no pent up demand seen in all other recessions, will companies return to capital spending? As one in four US factories are effectively closed (implied by 75% capacity utilization), is it likely they will start spending money building new ones?

Source:

http://www.federalreserve.gov/pubs/bulletin/2002/0302_2nd.pdf

Smooth As A Market's Bottom

Ask yourself: Have you ever heard the abovementioned quote, that "the market bottoms 6 to 9 months before the economy recovers?" We have heard this so many times recently, that it almost seems true, doesn't it? The only problem is that it is contrary to a simple review of the facts.

The table below shows the date when prior recessions have ended, and the corresponding lead-time of the stocks (S&P 500) reaching their lowest levels:

Rising Markets Predate Recoveries

Recession End Date	**Lead Time of Stock Prices (Months)**
October 1949	4
May 1954	8
April 1958	4
February 1961	4
November 1970	4
March 1975	3
July 1980	3
November 1982	4
March 1991	5

Source: Anirvan Banerji, Director of Research for Economic Cycle Research Institute. www.Realmoney.com

The market does bottom prior to economic recoveries, but not as quickly as the talking heads would like you to believe. 6 to 9 months? Please look at the data again. Perhaps the market "gurus" have not actually looked up this information. With the average lead-time around 4 months, and only one period ever falling within the highly touted "6 to 9 month" period, we would agree their babbling definitely smells like a "bottom".

Peter and the Wolf

The common belief that "the market always bottoms before for the economy" is the very basis for the Wall Street/ market guru community investment thesis: "It is so bad right now, it can't get any worse". They may be correct. However they have been saying the same thing for the past 18 months. Unfortunately, the same exact quote is repeated every time the recovery fails to materialize. A broken clock is right twice a day, so they to will be "correct" at some point.

The promise of economic recovery pushes the market upward, but then collapses to a new low when the "recovery" is postponed yet again. This pattern is clearly visible in the chart of the S&P 500 below. Currently we are on the upper edge of this overall trend. We are fully aware that some day this trend will end, with a clear break to the upside. To date, it has not happened.

We believe all markets follow an emotional cycle, moving between fear and euphoria, and back again. The attached file "Cycle of market emotions" has an interesting chart of changing investor emotions through an investment cycle. The media/analyst/ guru communities (including Don Hays who wrote the attached article) believe we are currently at "hope". We contend the market has simply moved to "denial". Time will tell who is right.

The cycle of
market emotions

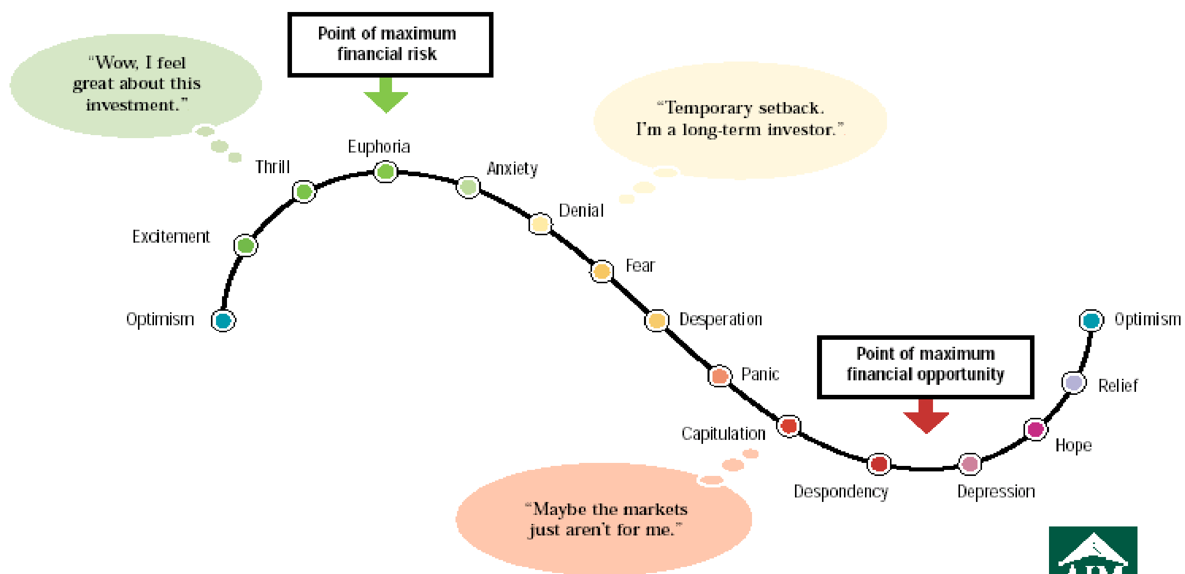


Chart source: Westcore Funds / Denver Investment Advisers LLC, 1998

"Seasonally Adjusted" it is now summer

The stock market jumped over 7% in a few short weeks at the end of February and early March, on the heels of the revised Q4 2001 GDP discussed above, and the release of the National Associations of Realtors (NAR) existing home sales data for January. The NAR issued the press release below, which was subsequently used in hundreds of news stories across the country that the economy was recovering.

"WASHINGTON (Feb. 25, 2002) – Existing single-family home sales surged in January and reached an unprecedented monthly high, according to the National Association of Realtors. This is the first time sales have reached the six million mark and is also the largest monthly increase on record.

Existing-home **sales jumped 16.2 percent** to a seasonally adjusted **annual rate of 6.04 million units in January** from a pace of 5.20 million units in December..."
See link for full text:
http://www.realtor.org/publicaffairsweb.nsf/Pages/JanEHSNewsRel?OpenDocument

On the surface this looks like a fantastic report. The headlines across the country screamed **"existing home sales jump 16.2% to 6 million houses".**

This would in fact be great news **if it were actually true**. A closer inspection of the actual data indicates existing home sales actually fell 16.8% between December and January, from 404,000 home sales to 336,000 home sales, respectively.

Actual data:http://www.realtor.org/Research.nsf/files/Rel0201k.pdf/$FILE/Rel0201k.pdf

The difference between existing home sales actually falling 16.8% and reported as a 16.2% increase is solely due to "seasonal adjustments". Seasonal adjustments are a statistical necessity to smooth economic data that are greatly affected by seasonal factors. Significantly more houses are sold in the summer than winter. Therefore, to compare housing sales between the two, they must be seasonally adjusted. However, seasonal adjustments are simply a "best guess" based upon historical patterns. Anomalous events would not be taken into consideration. We feel housing data, and many other economic statistics have been greatly overstated due to the anomalously warm winter in the Northeast, and 40 year lows in short term interest rates. (Folks are not buying many homes if it is 20 degrees below zero in New England)

Just how warm as it being in the most seasonally effected areas of the U.S.?
The US weather services reported New York had the least precipitation in 107 years, and the Northeast had the warmest winter in 122 years.

Source:
http://www.weather.com/newscenter/topstories/homeandgarden/home/020301xhomxwarmestwinter.html?from=newschindex

As all seasonal adjustments must even out during the entire year, spring and summer economic data will have a significant "seasonal" headwind to overcome.

Wall Street Analysts use ***statistics*** like a drunkard uses a lamppost.
Not for illumination, but simply for support.

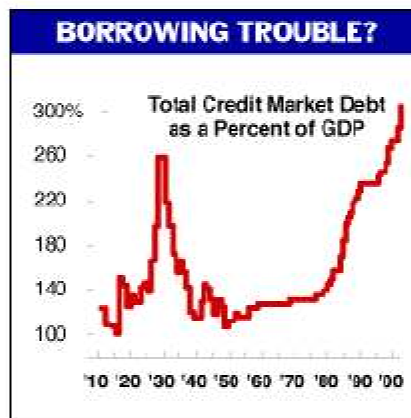
No doubt, the economy will recover someday. We simply feel the data released to date is inconclusive of such a recovery.

Other Uncertainties

Ineffective Monetary Policy: The Lowering of Interest Rates- Remember all the hype a year ago when the Federal Reserve began lowering interest rates. Analysts and financial publications issued all kinds of reports showing the market had historically increased X% one year after the Federal Reserve cut interest rates for the second time (then 3rd, 4th, 5th, and so on). This analysis was based upon fairly firm footing. The market had historically increased in 19 of the 20 prior instances when the Fed cut rates consecutively. We felt this analysis was flawed as our current economic problems are due to excessive supply, not low demand. Lower interest rates have no effect on reducing supply. One year later, the S&P 500 is more than 10% lower than when the Fed began cutting rates. The only other time (the 1 in 20) the market was lower one year later, directly preceded the depression. You don't hear CNBC or anyone else discussing that, now do you?

Middle East heating up- the millennium of turmoil in the Middle East appears to be escalating. This should not have global economic effects unless the oil supply is interrupted or major powers are dragged into the conflict. Oil prices have jumped 45% since January, from $18.50 to over $27 now. Remember all the talk of the stimualeous effects of low oil prices?

Debt- Total US debt is currently at historic highs relative to GDP. While debt is not necessarily bad, debt is risky. It is very unusual for companies or individuals to file bankruptcy without any debt. It is hard to be forced out of business if you don't owe anyone any money. The line between appropriate corporate leverage and excessive debt is fine indeed. One moment the world is happy to provide you capital. The next, for reasons completely outside of your control, creditors may not be willing to provide access to money at reasonable rates. High leverage is inherently more risky. It's like the difference between driving a car at 25 mph and 125 mph. You may **not** be in an accident either way, but if you are, in one case ***you*** call your insurance company, in the other case ***someone else*** calls the morgue.



Source: Barron's April 1, 2001- Requires paid registration
http://online.wsj.com/barrons/article/0,4298,SB1017354473475816680,00.html?mod=this%5Fweeks%5Fbarrons%5Fcolumns%5Fhs

Enron/ Arthur Andersen- The major market related impact we see due to the Enron/ Arthur Andersen mess is a tightening of accounting standards. Both the FASB and congress will likely create new rules aimed to increase the quality and transparency of corporate financial statements. As we discussed above, many investor may be surprised with what they see. Even if new politically driven initiatives are not created, the rest of the Big 4 accounting firms have been put on notice that aggressive accounting will no longer be accepted. In the early 90's there were six large accounting firms known as the "Big 6". The slow elimination of the 6 firms has felt analogous to the 6 rounds of a gun. Every few years, another bullet is placed in the chamber for a game of Russian roulette. The remaining 4 players may wish this game to end, which means tight, conservative, transparent financial statements, and consequently lower reported earnings.

Many pundits have expressed this same opinion as to why the investment world is getting better. We agree it is a step in the right direction, but that does not mean it will be a painless process. When we were kids, it would be a step in the right direction to tell your parents the truth when you cheated on a school exam. However, from that moment forward, was your life immediately better? Or did you first pay a price in the name of punishment?

War on terrorism- While additional terrorist attacks are possible within the US, we do not believe these would have a long-term effect on the markets. Short term, the market certainly may fall.

Rising Interest rates- We would agree with the following statement: "The Federal Reserve lowering interest rates helps stimulate the economy, and increases the implied value of corporate profits as an alternative to lower yielding fixed income investments." Therefore, all else being equal, the stock market *should* rise. However, many other variables are at work. What we find humorous, is the media's current unified chorus that rising interest rates are now good, because it "proves" the economy is recovering. Rising interest rates are either good or bad. The market can't simply benefit when the Fed is lowering interest rates, and also benefit when those same rates begin to rise. Yet we see the exact opposite premises being used to once again justify higher equity prices. If you would like the stock market to go up, history shows rising interest rates to be bad for stocks. We feel the current market is analogous to a chess stalemate. If the economy does improve, rising interest rates will offset its beneficial effects, and vice versa.

> "A man sees what he wants to see and disregards the rest."
> -Lyric from Simon & Garfunkel song

"Two Outs, So What"

The marker already knows everything we have discussed above; therefore it is irrelevant because this information is already discounted in the current stock prices. This is a favorite Bull argument, which may be true. However, this argument taken to its logical extreme could also imply the market will not rise in the future, because all the good things to come have also been discounted. As the market will fluctuate, someone is wrong.

Conclusion

Everyone has 20/20 vision with the benefit of hindsight. Decision making in the here and now becomes much more difficult. While we cannot determine with any degree of certainty which issues will ultimately be relevant to investors, we feel confident that we can identify the major risks that have the potential to matter. The caveat, again, is that we do not know whether any of the abovementioned topics will ultimately come to the forefront of investor concerns. In 1994, Forbes wrote an article questioning the accounting practices of Jeffrey Skilling, CFO of Enron, deeming such practices to be "extremely aggressive." It took six years for people to "care," and the stock increased more than five fold from that point, before ultimately becoming worthless. The issues at Enron did in fact matter, eventually.

We deem our job as to identify the risks inherent in portfolios, and weigh those risks against the potential for gain. As we have described, we currently feel the risks significantly outweigh the potential gains of the broader markets. This is not to say that opportunities cannot and will not arise. It is our opinion, however, that the excessive optimism in the face of such risks poses a potentially unpleasant situation. We may not always feel that these concerns, whether they come to light or not, will pose such dangers. But currently, with stock valuations at historic highs, interest rates at historic lows, the US economy fighting to emerge out of recession, and our military fighting to eradicate terrorism, the uncertainties lie in favor of caution. Regardless of where equity prices go today, tomorrow, or next month, we feel strongly that continued caution right now, is clearly prudent.

Rest assured, however, that we do not view this as religion. We can, and will, change our minds at some point.

We hope this letter allowed you to clearly understand our thoughts on the current volatile marketplace. We would enjoy hearing your thoughts on any of the subjects discussed, or conclusions reached. One of the joys of our job is talking to a diverse, intelligent client base. We learn (steal ideas) more from you than we would like to admit.

Please contact us with any questions or concerns with any of the issues raised in this letter, or how they may impact your particular situation.

Sincerely,

Shane Hoover
Hoover Capital, L.L.C.
shanehoover@hoovercapital.net

"Anyone who isn't confused really doesn't understand the situation"
Edward R. Murrow

Recommended Further Reading

Irrational Exuberance- Robert Shiller Chapter 1 discusses the current market overvaluation.
http://www.amazon.com/exec/obidos/ASIN/0767907183/qid=1017979871/sr=8-1/ref=sr_8_67_1/104-6256871-3002320
Lexus and the Olive Tree- Thomas L. Friedman Optimistic vision of economic globalization.
http://www.amazon.com/exec/obidos/ASIN/0385499345/qid=1017979913/sr=2-1/ref=sr_2_1/104-6256871-3002320
Devil Take the Hindmost, The history of financial speculation- the chapter discussing the advent of the train industry in 1860's England, is particularly interesting. The parallels to our Internet revolution are eerie.
http://www.amazon.com/exec/obidos/ASIN/0452281806/qid=1017979949/sr=2-1/ref=sr_2_1/104-6256871-3002320
Buffettology- Mary Buffett "The previously unexplained techniques that have made Warren Buffett the World's Most Famous Investor
http://www.amazon.com/exec/obidos/ASIN/068484821X/qid=1017980000/sr=2-1/ref=sr_2_1/104-6256871-3002320
Ken Fishers' Forbes articles beginning with 3/19/01 through April 2002. We agree with his insights into investor psychology.
Link:
http://www.forbes.com/columnists/col_archive.jhtml?aname=Kenneth+L.+Fisher&author=kenneth+and+fisher

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Note:
While facts presented were obtained from sources deemed to be reliable, we make no warranty that this information is accurate or complete. Opinions expresses are not necessarily those of RBC Dain Rauscher Inc. This letter is not intended to discuss all material facts. Opinions express herein are subject to change without notice. This letter is not intended as a recommendation to buy or sell any security.

GENERAL ELECTRIC NYSE-GE

RECENT PRICE 38.55 | P/E RATIO 26.2 (Trailing: 27.7 Median: 19.0) | RELATIVE P/E RATIO 1.34 | DIV'D YLD 1.9% | VALUE LINE

TIMELINESS 3 Lowered 10/20/00
SAFETY 1 New 7/27/90
TECHNICAL 3 Raised 7/20/01
BETA 1.30 (1.00 = Market)

High:	6.3	6.5	7.3	8.9	9.1	12.2	17.7	25.5	34.6	53.2	60.5	53.6
Low:	4.2	4.4	6.1	6.7	7.5	8.3	11.6	16.0	23.0	31.4	41.6	28.5

Target Price Range 2004 2005 2006

LEGENDS
— 25.0 x "Cash Flow" p sh
.... Relative Price Strength
2-for-1 split 5/94
2-for-1 split 5/97
3-for-1 split 5/00
Options: Yes
Shaded area indicates recession

2-for-1
2-for-1
3-for-1

100 80 64 48 40 32 24 20 16 12 8 6

Percent shares traded 6.0 4.0 2.0

2004-06 PROJECTIONS

	Price	Gain	Ann'l Total Return
High	75	(+95%)	19%
Low	60	(+55%)	13%

Insider Decisions

	F	M	A	M	J	J	A	S	O
to Buy	0	1	0	0	0	0	1	1	0
Options	1	1	2	1	1	0	0	0	1
to Sell	1	1	3	1	0	0	1	0	1

Institutional Decisions

	1Q2001	2Q2001	3Q2001
to Buy	580	533	647
to Sell	724	754	654
Hld's(000)	5106005505784549866 19		

% TOT. RETURN 12/01

	THIS STOCK	VL ARITH. INDEX
1 yr.	-15.1	10.9
3 yr.	23.5	31.9
5 yr.	163.7	79.3

To prevent the distortion of GE's industrial operations, our presentation excludes all of GE Capital's results except net earnings, which are reflected in the Net Profit line, which is after taxes, eliminations and interest and financial charges. For additional clarity, we are capsulizing GE Capital's fiscal results. (All figures in billions). Revenues: 2000, $66.18; 1999, $55.75; 1998, $48.70; 1997, $39.93; 1996, $32.71. Net Earnings: 2000, $5.19; 1999, $4.44; 1998, $3.80; 1997, $3.26; 1996, $2.82.

1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	© VALUE LINE PUB., INC.	04-06
4.16	3.70	3.69	3.87	4.30	4.67	5.00	5.25	5.65	6.42	6.85	7.30	Sales per sh A	9.55
.58	.56	.66	.73	.82	.90	1.00	1.18	1.32	1.51	1.70	1.90	"Cash Flow" per sh	2.55
.43	.42	.51	.58	.65	.73	.83	.93	1.07	1.27	1.41	1.55	Earnings per sh B	2.20
.17	.19	.22	.25	.28	.32	.36	.42	.49	.57	.64	.72	Div'ds Decl'd per sh C ■	1.08
.22	.14	.16	.17	.18	.24	.22	.21	.21	.26	.25	.30	Cap'l Spending per sh	.40
2.09	2.29	2.52	2.58	2.96	3.15	3.52	3.96	4.32	5.08	5.55	6.35	Book Value per sh D	9.45
10369	10265	10244	10236	9999.1	9867.3	9793.8	9813.9	9854.5	9932.0	9900.0	9800.0	Common Shs Outst'g E	9400.0
13.7	15.5	15.5	14.3	15.1	19.4	25.1	30.3	35.9	40.1	30.7		Avg Ann'l P/E Ratio	30.0
.88	.94	.92	.94	1.01	1.22	1.45	1.58	2.05	2.66	1.61		Relative P/E Ratio	2.00
3.0%	3.0%	2.8%	3.0%	2.9%	2.2%	1.7%	1.5%	1.3%	1.1%	1.5%		Avg Ann'l Div'd Yield	1.5%
43089	37943	37822	39630	43013	46119	48952	51546	55645	63807	68000	71500	Sales ($mill) A	90000
15.0%	15.0%	16.9%	17.4%	18.0%	18.3%	19.0%	21.2%	21.4%	21.8%	21.5%	22.0%	Operating Margin	22.5%
1607.0	1483.0	1631.0	1545.0	1581.0	1635.0	1622.0	2292.0	2319.0	2248.0	2450	2650	Depreciation ($mill) F	3300
4435.0	4305.0	5102.0	5915.0	6573.0	7280.0	8203.0	9296.0	10717	12735	14135	15500	Net Profit ($mill)	20800
26.7%	25.0%	24.4%	24.1%	23.9%	24.0%	24.0%	23.3%	23.0%	23.0%	23.0%	23.0%	Income Tax Rate	23.0%
10.3%	11.3%	13.5%	14.9%	15.3%	15.8%	16.8%	18.0%	19.3%	20.0%	20.8%	21.7%	Net Profit Margin	23.1%
d79.0	d822.0	d419.0	544.0	204.0	d2147	d4881	d6708	d4436	d4080	d5085	d4190	Working Cap'l ($mill)	d1650
4333.0	3420.0	2413.0	2699.0	2277.0	1710.0	729.0	681.0	722.0	841.0	800	600	Long-Term Debt ($mill) A	600
21683	23459	25824	26387	29609	31125	34438	38880	42557	50492	54790	62235	Shr. Equity ($mill) D	88925
18.1%	17.0%	18.6%	20.9%	21.6%	22.9%	24.2%	23.5%	24.8%	24.9%	26.0%	25.5%	Return on Total Cap'l	24.0%
20.5%	18.4%	19.8%	22.4%	22.2%	23.4%	23.8%	23.9%	25.2%	25.2%	26.0%	25.0%	Return on Shr. Equity	23.5%
12.1%	10.1%	11.4%	13.1%	12.8%	13.6%	13.9%	13.8%	14.4%	14.5%	14.0%	13.5%	Retained to Com Eq	12.0%
41%	45%	42%	42%	42%	42%	42%	42%	43%	42%	45%	46%	All Div'ds to Net Prof	49%

CAPITAL STRUCTURE as of 9/30/01

Total Debt $1740 mill.A Due in 5 Yrs $1278 mill.
LT Debt $808.0 mill.A LT Interest $48.0 mill.
(Total interest coverage: 21.4x) (1% of Cap'l)

Leases, Uncapitalized None
Pension Liability None
Pfd Stock None

Common Stock 9,927,381,000 shs (99% of Cap'l) as of 9/30/01

MARKET CAP: $383 billion (Large Cap)

CURRENT POSITION A ($MILL.)	1999	2000	9/30/01
Cash Assets	3273	8219	11095
Receivables	8743	9727	10155
Inventory (LIFO)	5798	7146	8148
Current Assets	17814	25092	29398
Accts Payable	4845	6153	6303
Debt Due	2245	940	932
Other	15160	22079	27123
Current Liab.	22250	29172	34358

ANNUAL RATES of change (per sh)	Past 10 Yrs.	Past 5 Yrs.	Est'd '98-'00 to '04-'06
Sales	4.0%	8.0%	8.5%
"Cash Flow"	11.5%	15.5%	10.0%
Earnings	12.0%	13.5%	13.5%
Dividends	13.5%	14.5%	14.0%
Book Value	9.0%	10.5%	14.5%

Calendar	QUARTERLY SALES ($ mill.) A Mar.31	Jun.30	Sep.30	Dec.31	Full Year
1998	11408	13217	12075	14846	51546
1999	11796	13966	13228	16655	55645
2000	14370	16414	15578	17445	63807
2001	16436	17588	16170	17806	68000
2002	16100	17850	17600	19950	71500

Calendar	EARNINGS PER SHARE B Mar.31	Jun.30	Sep.30	Dec.31	Full Year
1998	.19	.25	.23	.26	.93
1999	.22	.28	.27	.30	1.07
2000	.27	.34	.32	.34	1.27
2001	.30	.39	.33	.39	1.41
2002	.33	.42	.37	.43	1.55

Calendar	QUARTERLY DIVIDENDS PAID C ■ Mar.31	Jun.30	Sep.30	Dec.31	Full Year
1998	.105	.105	.105	.105	.42
1999	.123	.123	.123	.123	.49
2000	.138	.138	.138	.138	.55
2001	.16	.16	.16	.16	.64
2002					

BUSINESS: General Electric Co. is one of the largest & most diversified industrial cos. in the world. Indus. segments incl. Aircraft Engines (17% of '00 revs.; 18% of oper. pfts.); Appliances (9%, 1%); Broadcasting (11%, 13%); Indus. Pdts. & Systems (19%, 16%); incl. lighting, locomotives, motors, indus. systems; Materials (12%, 14%); mainly plastic; Power Generation (23%, 21%) turbine-generators; Technical Pdts. & Svcs. (12%, 13%), medical systems, computer svcs. Also has GE Capital (provided $5.2 bill. in other inc.) Fgn.: 50% of sls.; R&D, 3.2%. Has abt. 293,000 empls., 534,000 stkhldrs. Off./dir. own less than 1% of stk. (3/01 Proxy). Chairman & CEO: Jeffrey Immelt. Inc.: NY. Add.: 3135 Easton Turnpike, Fairfield, CT 06431. Tel.: 203-373-2211. Internet: www.ge.com.

General Electric is predicting strong growth in 2002 and 2003. While the company's short-cycle businesses continue to slow in Europe and Asia, they have stabilized in the U.S. For this year and next, GE believes it can achieve double digit earnings growth, even amidst prolonged economic adversity. In 2002, the company is assuming 20% overall growth in its long-cycle businesses, which include Power Systems and Medical Systems, and 15% growth in GE Capital. These segments should pick up the slack for GE's Aircraft Engines division and short-cycle businesses, which are expected to deliver flat results. Power Systems will likely hit a wall in 2003, based on a projected slow-down in the global power market, but the scope of GE's other divisions should allow the company to effectively manage this setback. All in all, we are calling for earnings per share of $1.55 in 2002, and assuming low double-digit growth thereafter. Note that our targets could prove conservative if a meaningful economic recovery occurs this year.

Cost-control measures should provide additional leverage. Management intends to produce $3 billion-$5 billion in cost and growth benefits over the next two years through various initiatives, including business restructuring at GE Capital and additional workforce reductions.

Part of the growth plan is to remain acquisitive. With more than $10 billion in cash, GE is targeting several buyouts that could potentially add $100 billion in industrial revenues. Recent deals include GE Capital's intent to purchase real estate firm Security Capital Group for $4 billion, NBC's offer to buy a San Francisco station for $230 million, and GE Industrial Systems' plan to acquire electronic security company Interlogix, for $777 million in cash and stock.

High-quality, neutrally-ranked GE shares offer above-average 3- to 5-year appreciation potential, given their current price. Moreover, their high safety and stability ranks make them a worthwhile long-term holding on a risk-adjusted basis. That's primarily because consistent earnings growth is practically assured, thanks to the breadth and efficient management of GE's businesses.

Edward Plank *January 18, 2002*

(A) Revs. and balance-sheet data excl. fin. serv. sub.; revs. also excl. other inc. (B) Based on avg. shs. Excl. nonrecur. losses: '91, 52¢; '93, 26¢; '00, 24¢. Excl. gains/(loss) from disc. oper.: '92, 13¢; '93, 22¢; '94, (35¢). Next egs. rpt. due mid-April. (C) Next div'd mtg. mid-February. Goes ex late January. Approx. div'd. pymt. dates: 25th of Jan., April, July, Oct. ■ Div'd reinvest. plan. avail. (D) Incl. intang.: in '00: $12,424 mill., $1.25/sh. (E) In mill., adj. for stk. splits. (F) Mostly on an accelerated basis.

Company's Financial Strength	A++
Stock's Price Stability	85
Price Growth Persistence	100
Earnings Predictability	100

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