

INSIGHT & OUTLOOK

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Janus The Two-Faced God

The month of January is named after the Roman god Janus. Janus was the god of gates and doors (*janua* is the Etruscan word for door). Sculptors often depicted him with two faces - one facing forward and the other facing backward. Because a person must cross through a doorway to enter a new room, the Romans also honored Janus as the god of new beginnings. So it was natural for them to name the first month of their year after Janus. January traditionally is a time when people look backward to reflect on the year just past and forward to the year just beginning.

2004-The Year Past

After peaking in the First Quarter of 2004, most stock market averages drifted erratically lower in the months prior to Election Day. The S&P 500, Dow Jones Industrial Average, and the NASDAQ 100 all showed a pattern of lower lows and lower highs which prompted us to take defensive measures in clients' portfolios. Up until November 2 the year was shaping up to be a disappointing one for investors, as the following table demonstrates:

	<u>Stock Indices Price Returns</u>		
	<u>12/31/03 to 11/02/04</u>	<u>11/2/04 to 12/31/04</u>	<u>Full Year 2004</u>
Dow Jones Industrials	-4.0%	7.5%	3.5%
S&P 500	1.7%	7.2%	9.0%
NASDAQ 100	1.8%	8.5%	10.4%

The unexpectedly strong Republican gains in the Senate and House (plus some relief that the country would not face a repeat of the 2000 post-election turmoil) ignited a vigorous rally which carried through year end. As the numbers in the table above show, the final two months "made" the year.

Our defensive investment posture partially offset participation in the year end rally, but investment success is a long term game. Managing downside risks, based on the probabilities as we see them at the time, is an important part of what we do for clients.

The other big story in 2004 was the decline in the exchange value of the dollar. Similar to the equity markets, the real action took place mostly in the Fourth Quarter. The dollar fell nearly 12% versus the Euro providing attractive capital gains to holders of Euro-denominated securities. So international bonds were again a big winner in 2004. Mainstream media and even some politicians finally awoke to the fact the dollar was in serious decline.

2005-The Year Ahead

We will resist the temptation to forecast the outlook for 2005 and leave that entertainment to the Wall Street strategists and the CNBC crowd. Everybody's crystal ball is clouded whether they admit it or not. As John Kenneth Galbraith put it, "One of the greatest pieces of economic wisdom is to know what you do not know."

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"When I was younger I could remember anything, whether it happened or not."

Mark Twain (1835 - 1910)

Janus The Two Faced God (continued)

We have often stated in client meetings that investing is a matter of assessing probabilities and payoffs and aligning investments accordingly. For example, financial history reveals that buying “value” stocks has a very good chance of outperforming the stock market averages. Not every quarter or even every year, but over time value investing works. A relatively recent study* covering the years from 1952 to 1996 showed that low price-to-earnings stocks outperformed in 32 of 45 years with an average advantage of about 3% annually. Even throwing in the manic years of 1997-1999 when growth stocks excelled, value stocks were 32 for 48 or winners two-thirds of the time. We like those probabilities even though we don’t know in advance which years will be the winners.

Similarly, we do not know with a high degree of certainty where interest rates are headed in 2005. But we do know that the incremental yield (“spread” in bond talk) for taking on additional credit risk is very narrow by historical standards. We will play the odds and stick with higher credit quality bonds and bond funds. With domestic interest rates near multi-generational lows, we will not be aggressive buyers of longer term bonds.

“I like the dreams of the future better
than the history of the past.”

Patrick Henry

We also do not know where the major stock market indices will be one month or one year from now. We do know that by most valuation measures stocks are not cheap as we enter 2005. We know the Federal Reserve is raising short term interest rates and that often creates a more tentative environment for equities. We plan to continue closely monitoring the macroeconomic situation, remembering that it is “A market of stocks”, not “A stock market” which we must be focused on. Some companies, industries, and sectors will perform well regardless of the overall market. Others will not. Our job is to discern the differences for our clients.

A final observation about Janus. Of the many temples dedicated to that god, the Ianus Geminus on the Roman Forum had a special symbolic function. Whenever Rome was at war, the priests of Janus kept the temple’s east and west bronze doors open. They closed the doors only on the rare occasions when Rome was at peace. In the modern day war for investment survival, rest assured that symbolically the doors at Patton Albertson & Miller are always open.

Bill Miller

“How We Invest”

In the 1930’s the great golfer Bobby Jones made a series of films called “How I Play Golf.” Today these films are considered masterpieces of cinematography that were far ahead of their time and they are acclaimed for their simple, straightforward and effective teaching of the game of golf.

We are often asked about our investment philosophy or, put another way, “How Do You Guys Invest?” Many times this question is rooted in a misunderstanding or frustration that we are being too conservative or too aggressive in our portfolio management. But it is a very fair question and one that should be answered as simply and as straightforwardly as possible. Clients should fully understand our investment philosophy and they should make sure it is consistent with their own expectations. So, exactly what is the investment philosophy of Patton Albertson & Miller? How do we invest? The answer may not be as appealing as Bobby Jones’ films were in the 1930’s but we hope it will at least be instructive.

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“How We Invest” (continued)

The answer to this question should begin by defining the two primary participants in the stock market – investors and speculators. Neither is inherently good or bad, they simply have very different appetites for risk and very different approaches to investing. Benjamin Graham, author of *The Intelligent Investor* which is considered by many (including Warren Buffett) as the Bible of securities analysis, differentiated the two this way:

“An investment operation is one which, upon thorough analysis promises safety of principal and an adequate return. Operations not meeting these requirements are speculative.”

Pat Dorsey, Director of Stock Analysis for Morningstar, puts it this way in his book *The Five Rules for Successful Stock Investing*:

“This is the difference between investors and speculators. Investors purchase an asset for less than their estimate of its value and receive a return more or less in line with the financial performance of that asset. Speculators, by contrast, purchase an asset not because they believe it’s actually worth more, but because they think another investor will pay more for it at some point. The return that investors receive on assets depends largely on the accuracy of their analysis, whereas a speculator’s return depends on the gullibility of others.”

Simply put the investment philosophy of Patton Albertson & Miller is to be investors and not speculators. The ramification of that philosophy is that we tend to be quite deliberate in our actions (that’s the “thorough analysis” part of Graham’s definition above) with a bias toward protecting principal (the “safety of principal” in Graham’s definition). Clients who fall into the investor category tend to appreciate that approach whereas those who are more of the speculator variety are frustrated by it.

The second thing you should know about our investment philosophy is we are “value investors.” This means we try to determine what a stock is worth (its “value”) before we buy it. Our investment philosophy is underpinned with the belief that a stock is worth the present value of its future free cash flow (cash from operations minus capital expenditures). Our analysis focuses on reasonable projections of a company’s future cash flow and then a calculation of the present value of that cash flow stream to arrive at a total value for the company. This is the same approach Warren Buffett or any other informed business person would use when buying a company. Once we have an estimate of the total value of the company then we simply divide that value by the total number of shares outstanding and the result is a value per share. We call this number the “intrinsic value” others call it the company’s fair value.

The second tenet of value investing is buying at the right price (this relates to the third part of Graham’s definition above, “adequate return”). Our analysis to this point has given us an estimate of the stock’s value but it is only an estimate and we could be wrong. We only buy stocks that are trading at a discount to “intrinsic value.” This accomplishes two things: First it provides margin for return, and secondly, it provides margin for safety.

Common sense tells us that if you buy something at its full value then it is unreasonable to expect a profit when you go to resell it. Successful businesses are those that are able to buy or produce their product at one price and sell it to their customers at a higher price. Stock investing is no different. Great companies are not always good investments if they present no opportunity for profit. If a stock is bought at its discounted intrinsic value, then the investor should expect to earn the “discount rate” on that investment overtime if the underlying projections pan out. The beauty of buying at less than intrinsic value is the investor earns an even higher return than the discount rate and, secondly, even if the projections of future free cash flow are wrong (within reason) the investor may still make an acceptable, although lower, return because the stock was purchased at a bargain.

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“How We Invest” (Continued)

Buying stocks at a discount also provides a margin of safety in case our analysis is wrong or if the market moves against us. This helps protect portfolios against significant principal loss which can be much more damaging to the long run achievement of clients' goals than occasional periods of “under” performance. We would much rather earn a more modest return and avoid a 30% decline in market value (like what happened in the 2000 bear market) than chase returns and attempt to “beat the market” by taking inordinate risks. At the end of the day we believe our approach will result in larger portfolios for our clients and that is the ultimate measure of our success.

It takes thick skin to be value investors because you always seem to be running counter to the conventional wisdom – it is “the road less traveled.” Speculators will find that road boring, unsatisfying and frustrating. Investors will find it comforting. Jason Zweig in his commentary on *The Intelligent Investor* provided some insight as to why value investing takes courage and goes against the conventional wisdom:

“The intelligent investor realizes that stocks become more risky, not less, as their prices rise – and less risky, not more, as their prices fall. The intelligent investor dreads a bull market, since it makes stocks more costly to buy. And conversely, you should welcome a bear market, since it puts stocks back on sale.”

There are many more aspects to our investment methodology than we can cover in these few words but what we have outlined above is our general approach to stock investing. The three pillars of our investment philosophy are thorough analysis, protection of principal and realistic expectations of investment returns commensurate with our conservative value approach. It is not a get rich quick philosophy, but rather a long journey that requires patience, personal discipline and the ability to harness your own emotions. That is our road less traveled and we invite investors to travel with us.

Jimmy Patton

“The only time to buy these is on a day with no 'y' in it.”

Warren Buffett

US financier & investment businessman (1930 -)