



We're poor little lambs who have lost our way  
Baa, baa, baa  
We're little black sheep who have gone astray  
Baa, baa, baa

Chorus from the *Wiffenpoof Song*

This year turned out to be a pretty good one for market participants. The market forecast was for a strong first half of the year continuing the strong 2003 trend, followed by a sluggish second half. It didn't happen that way. The Dow started at 10,435 and then went down all year through most of October, bottoming around 9,750. Just before the election, the market took off and we are up 1,000 points in nine weeks, a 10% move which surprised just about everyone. For the year, however, we are up only 4% on the Dow, 8% for Nasdaq and 9% for the S&P 500. The sluggish first half and a strong second half was the absolute opposite of the forecast. As the old saying goes, "Forecast frequently." I'll be watching the year-end commentary for the corollary. "If your forecast is right, never let your audience forget it." Few got it right in 2004.

Today, as I was writing this, another forecaster said it was time for investors to take their money out of the smaller growth stocks and move it to "large high-quality growth" stocks. This is tough to argue with. The only difficulty is that I don't know what a "large high-quality growth" stock is. Let's break that down into its component parts. "Large" means big, as in market capitalization or revenue. "High quality" and "growth" are the problem. Shown in the table is a stock portfolio I created, made up of large companies from several industry sectors. I don't think anyone would quarrel with the fact that they are high quality.

	Price 12/31/1999	Price 12/29/2004	% Change
Wal-Mart (Retail)	69.12	53.44	-22.7
Coca-Cola (Food)	58.25	41.56	-28.7
Intel (Technology)	41.08	23.25	-43.4
General Electric (Industrial)	51.58	36.56	-29.1
Merck (Pharmaceutical)	67.10	32.24	-52.0
American Int'l Group (Insurance)	72.17	65.80	-8.8

Assume you put \$2,000 into each of these at the end of 1999. Unfortunately, as the table shows, you paid too much for "growth" and didn't get any. In fact, your \$12,000 is now worth \$8,300, a loss of almost 31% while the stock market return is essentially zero over the last five years. As companies, they are OK. As stocks, they have lost their way, baa, baa, baa. And these are the largest holdings of index funds!

In the first quarter of 2005 we will celebrate the fifth anniversary of the start of the Nasdaq market crash. I made the best market call of my career in my April 1, 2000 letter. On March 29, 2000, Cisco Systems became the most valuable company in the world with a market value of \$520 billion, exceeding that of Microsoft and General Electric. Cisco was the growth darling of the technology bubble. My comment:

When I buy a stock I like to think that I am buying the whole company, not just a few hundred shares. Buy ALL of Cisco or, for the same money, I could buy ALL of Ford Motor Company, Johnson & Johnson, Hershey Foods, Southwest Airlines, Dow Chemical, Weyerhaeuser, Boeing, Federated Department Stores (Macy's), Campbell Soup, Walgreen, Clorox, Gillette, Chevron, Northern Trust Company, Merrill Lynch, GTE and I'd still have \$10.6 billion left over to spend foolishly.

Cisco crashed along with the rest of the technology stocks. Today, almost five years later, Cisco's market capitalization is 75% below March 29, 1999 for a loss of \$390 billion. The stocks I named on my list are now worth \$715 billion, a gain of almost \$200 billion. That doesn't include dividends on the \$715 billion either which, at about 2%, adds another \$10 to \$15 billion a year for each of the five years. Cisco has never paid a dividend. I think most investors, if asked, would consider Cisco a "large high-quality growth" stock. For most Cisco owners, though, a "profit" is still a bearded, religious guy.

The table above is a wonderful illustration of the difference between "growth" investing and "value" investing. In study after study, academic work has shown that value beats growth consistently. Not every year but certainly often enough to make a significant difference in returns. Growth investors have a habit of getting caught in the frenzy of the chase, lose their bearings, and end up lost in the woods. I still get asked what I think about Cisco. To me, Cisco is the Maltese Falcon of stocks, "the stuff that dreams are made of." I suppose the questioner believes that it has fallen so far that it can only go up from here. Perhaps, but I'd rather spend my time looking for tomorrow's growers instead of waiting for the second coming of yesterday's. How much time and effort have been wasted analyzing Eastman Kodak? It is still in business but no longer a leader. The stocks in the table are still leaders, certainly, but all have their share of cooties. Wal-Mart is too big and the grocery business is a lousy business. Coke and Intel are too big and have saturated the market. GE is reinventing itself and has some hope. Merck has few new products and may be killed with litigation over Vioxx. AIG has no management succession plan. Yes, it is true that smaller companies have more risk than larger ones just as it is true that a rowboat sinks faster than an aircraft carrier, but they both can sink.

For 2005, I'm sticking with natural gas stocks. Gas is not a growth business but it is a commodity that is in short supply and getting shorter. Ignore the periodic shocks that occur when oil traders react to this week's inventory report and you will do fine. Energy is a long-term problem for the USA and it still gets cold in the winter. Most of the oil we use is owned by people who don't like us. I'm not ruling out a nasty drop in our oil supply in the next year or two due to a coup in the Middle East, setbacks in the Iraq war, a revolution in Russia, or a shooting conflict between China and Taiwan. Sure, prices are high now but even if none of my gloomy guesses happen, prices are likely to stay high because of the expense and difficulty of finding new supplies. This country needs to face reality. We will never be energy self-sufficient no matter how many holes we drill in Alaska, or off the coast of Florida and California.

I still like the smaller defense stocks. The politicians may bluster but they are unlikely to cut expenditures for homeland defense, or port and airport security. I also like the smaller healthcare issues that are not directly involved in pushing pills. Joint replacement, dental and medical diagnostic companies stay below the FDA's radar screen. Even if the giant companies' stocks prosper in 2005, the underlying companies still can't grow as fast as the smaller and middle-sized companies owned in client accounts. The big ones, like Merck and Fannie Mae, have lost their way but that won't stop some observers on the year-end forecasting shows from bleating "bigger is better." Blah, blah, blah.

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Gulp! Amgen is one of my favorites in healthcare and it was just named "Company of the Year" by *Forbes* magazine. In the past, such recognition has been the kiss of death for a stock. "Maybe it will be different this time," he says with pained look on his face. Harley-Davidson was the last honoree I commented on three years ago. After three years, the stock is up \$7.00 and most of that came since the last week in October. Ouch! Anyway, have a safe and Happy New Year.

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