



Eye of newt and toe of frog,
Wool of bat and tongue of dog.

Recipe for a witches' brew from *Macbeth* by William Shakespeare

The investment world has become a real witches' brew the last three months. Stocks are back where they were at the beginning of the year even though the economy continues to improve. (We just returned from ten days in Mexico. The market hardly moved during our absence.) Reported earnings gains from most companies are met with a price drop because of fears the pace of the earnings gains cannot be sustained. Interest rates continue to fall which is more an indicator of recession than of an economic expansion. News that Medicare could go broke in 2019 was greeted with a yawn. It was not news to anyone. If you pay out more than you take in, you go broke. Simple.

Microsoft was attacked, again, by the socialist regulators of the European Union. These people cannot stand success. Microsoft reportedly has 30 percent of its business in Europe. One of these days I want to see a major company refuse to do business in an area that is unfriendly to business. Costco, for example, could pull out of California because of their terrible workman's compensation rules. Pfizer could refuse to sell drugs to Canada unless Canada takes strong measures to stop reimportation of patented drugs into the USA. To me, these issues aren't a question of fairness. They are issues of ownership. Companies need to respond to unreasonable demands and circumstances aggressively or they will continue to be treated as doormats. Being big is not necessarily bad although big provides an easier target.

Putnam Investments is back in the news because of two portfolio managers who made a few hundred thousand dollars for themselves by market-timing their own funds in 2000. Turns out these two were paid \$14.3 million and \$8.7 million in 2000. How greedy can you get? Greedy enough to get fired, I guess. Billionaire investor Warren Buffet devotes many paragraphs to corporate governance in his latest letter to Berkshire Hathaway's shareholders. His actions and statements have been known to move the market. In this letter he is especially critical of the directors of other companies and mutual funds who are more interested in job security and personal pay than representing the shareholders. He uses words like "looted" and "miscreant" and "payoff" and "blatant wrongdoing." These lightning rod words play well in the media which never misses an opportunity to bash business and the folks who run it. Have you ever seen a movie or a TV show where business executives are portrayed as real people doing a good job for the employees or shareholders? No, they are all devious crooks who cut corners, pollute for a buck, and mistreat the "help." Remember the movie *Erin Brockovich*? I was surprised Mr. Buffet's words didn't have a greater impact on the market.

Mr. Buffet likes to point out that members of Berkshire Hathaway's Board of Directors own substantial amounts of company stock. His position is that the directors win if the shareholder wins and vice versa. He then writes this remarkable sentence. "(This structure does not guarantee perfect behavior, however: I've sat on boards of companies in which Berkshire had huge stakes and remained silent as questionable proposals were rubber-stamped.)" When the "questionable proposal" came to a vote, he sat on his hands? I find it impossible to believe that a holder of a "huge stake" is really a corporate eunuch who would not vote in the interests of his "huge stake." It would appear that Mr. Buffet recognizes that he is stuck with the "huge stake." He can't change minds, and he can't sell, so he has to go along with the bad corporate governance that he criticizes so vigorously. It appears that a director's independence is situational.

The most important section of the Berkshire letter details the unpleasantness at Gen Re Securities. When Berkshire acquired General Reinsurance in late 1998, the company came with a financial derivatives portfolio having an unknown risk exposure. Berkshire decided to liquidate the portfolio. They started with 23,218 contracts with 884 counter parties. (A counter party is the outfit on the other side of the trade.) After four years trying, they still hold 7,580 contracts with 453 counter parties. The dollar risk may have been reduced but the financial risk is more concentrated. Gen Re is a financial garage sale. The good stuff goes early. By early afternoon, only the dregs are left - the financial broken toys, worn clothes, chipped dishes, rusty pots and pans, the contracts he can't get rid of at any price.

While Mr. Buffet rails against the derivatives in the Gen Re portfolio, he later confesses that he has "invested" a modest \$12 billion in foreign exchange contracts, betting against the dollar in five different currencies. A foreign exchange contract is a derivative and a derivative is like loaning money to a close relative. Certainly the obligation to repay exists, but what if they don't pay, or can't pay, when the note is due? There is always court but that gets ugly and expensive.

Mr. Buffet is correct that the list of companies owned by Berkshire is also a witches' brew, from utilities to insurance, banks, steel, manufactured housing, furniture, underwear, candy, and more. The only common thread I can find is that

they were viewed as good businesses and were cheap when available. I am baffled how investors are supposed to analyze Berkshire as an investment other than as a “trust Buffet” stock. Evidently, despite warnings, investors really do believe past performance is a guarantee of future results. I see Berkshire as a speculation.

Freddie Mac, mentioned in Mr. Buffet's annual report, sent its 2002 (!) annual report this month. It arrived March 12, 2004, a year late because of an “especially difficult 2003.” Freddie is the government-sponsored issuer of mortgage-related securities that has been in the news because of its questionable accounting, truly a company that deserves our scorn. The report restates Freddie's results for 2000, 2001, and 2002, although in a positive direction. It is 225 pages long and weighs one pound, three ounces. Consider this on their page 2.

[Management] began a comprehensive remediation program, under the oversight of our Board of Directors, to address each of the principal factors that contributed to the need for the restatement. This program includes initiatives relating to corporate culture, governance, accounting staffing and expertise, accounting policies, processes and controls as well as financial reporting and disclosure . . .

What exactly did they do right? The proxy, a document separate from the annual report, is seventy pages long and discloses that the senior executives each made more than \$1 million in salary with expected bonuses in the millions when the 2003 earnings are released. Wow! Imagine how much they would get if they did a really good job? I'm not going to read any farther than I have. Freddie may turn out to be a great investment. We won't own it, though.

The explosions in Madrid were a shock but not unexpected. While this attack may be Islamist in origin, Spain has had a problem with Basque terrorists for a long time with over 800 killed before now. You go to these countries knowing there is always a risk. We were in Madrid six months ago, arriving in the city through the Atocha rail station which was one of several bombed. From Atocha, it is one long block to the Prado Museum and the Ritz Hotel. If Atocha were in New York City, it would be on Fifth Avenue at Central Park. Only a few days after the blasts, the Socialist Party won an upset victory over the ruling party. This appears to be a reaction to terror rather than a reasoned vote. I just finished reading the popular thriller Angels & Demons by Dan Brown. This quote is on page 174.

Death is only a *byproduct* of terrorism . . . The goal of terrorism is to create terror and fear. Fear undermines faith in the establishment. It weakens the enemy from within . . . causing unrest in the masses. . . Terrorism is not an expression of rage. Terrorism is a political weapon. Remove a government's facade of infallibility, and you remove its people's faith.

Sounds like Spain to me. The terror network succeeded in removing the Spanish government's “facade of infallibility.” With this success it would not be unreasonable to expect that the USA may face an attack just before our election in an attempt to influence our election results also. The markets will react negatively. How negative depends on the severity.

No one should expect politicians to be intellectually honest during an election year. Facts take too long to present accurately so it is easier to make stuff up. Particularly galling is issue of jobs “lost” the last few years under the Bush administration. I checked the Bureau of Labor Statistics for the actual numbers. Between July 1999 (Clinton) and July 2000, 2.4 million private sector “jobs” were created which coincides exactly with the internet bubble. Between July 2000 and July 2002, 2.4 million “jobs” disappeared. This fact made me question what a job was. If 2.4 million people consumed the funds of venture capitalists, “employed” in occupations that produced nothing, I find it hard to believe the jobs were “lost” because real jobs never existed. Is it really a job if you sell kitty litter on the internet?

The exporting of manufacturing jobs is also newsworthy. I've worked in manufacturing, both in production on the line and as a foreman. Many of these jobs are terrible. Put ten bolts in ten holes every forty-five seconds, eight hours a day, day after day until you retire. The problem is that these jobs pay well. What we really want are high paying jobs without any required mental or physical activity. More internet non-jobs? Folks concerned about exporting jobs need to read the “Made in . . .” labels on the goods they buy. We can either buy pajamas made by low-paid workers in Honduras at the local Wal-Mart or Target, or we can pay much more for American-made pajamas. (Are PJs still made in the USA?) We can either save money or save jobs. We can't do both. Warren G. Bennis had it right when he wrote, “The factory of the future will have only two employees, a man and a dog. The man will be there to feed the dog. The dog will be there to keep the man from touching the equipment.”

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