FALL, 2001

The RORER REVIEW

A quarterly commentary on the markets and the economy from Rorer Asset Management, LLC

TOMORROW IS STILL A BRIGHTER DAY

We, at Rorer Asset Management, are deeply saddened by the horrific events of September 11th, 2001 and express our sympathy to those who suffered the loss of family and friends in New York, Washington, and Pennsylvania on that fateful day. When considered against the tremendous loss of life that occurred in this national tragedy, any discussion of how the economy and the markets might fare in the months ahead seems misplaced and unimportant. Nonetheless, the reality is that there has been economic fallout, and as America goes about rebuilding her partially shattered infrastructure and psyche, it is worthwhile to consider what lies ahead for the economy and the markets.

Amidst so much chaos, several things are clear:

- The economy has entered a recession;
- Unemployment, currently at a 4 year high, will continue to climb;
- Consumer confidence, already at a 5 year low, is still deteriorating;
- The "peace dividend" is history and the budget will move into deficit territory in 2002.

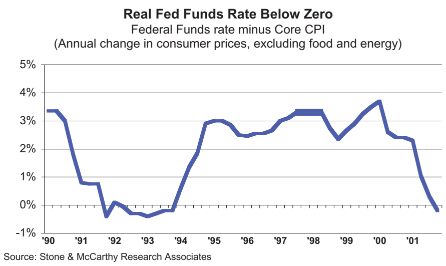
It all sounds pretty gloomy. Reflecting the malaise, equity markets around the globe, already in bear market territory, fell sharply in the days following the attacks. Some investors reacted precipitously, not unlike our friend Bob whom we wrote about in last winter's ***Rorer Review*** ("Bob's Lament"), and "sold everything" at the first opportunity to wait for better days ahead. Bob was reacting to the crash of 1987, just as investors who sold out several weeks ago were reacting to their perceptions of the changed economic landscape as a result of the terrorist atrocities of September 11th. It might be different this time, but history suggests that investors who make an emotional decision to sell in the wake of a crisis are unlikely to be making a wise long-term move. Indeed, if one looks back to other crises with perceived economic impact, it was far better, on balance, to be a purchaser of equities than a seller. Several examples come readily to mind: The Gulf War, the resignation of President Nixon, and the aforementioned crash of 1987. Nonetheless, we at Rorer Asset Management understand how easy it is to get caught up in the prevailing sentiment of the day and to dwell on the negative at an emotional time like the present. It is precisely at times like these that we recognize how important it is to have a disciplined approach to investing and to rigorously apply those disciplines to all of our investment decisions.

10 LARGEST HOLDINGS AS OF SEPTEMBER 30, 2001

American Int'l Group
Allstate
Bristol–Myers Squibb
Fannie Mae
General Dynamics
HCA – The Healthcare Co.
Marsh & McLennan
MBNA Corp.
Merck & Co.
Pepsico

Notwithstanding the message of the bullet points above, we are optimistic about a strong economic recovery in 2002 and believe that this will start to be reflected in equity valuations in the not too distant future. We base our optimism for the economy on five distinct points which we believe point to tomorrow being a brighter day. Long-time readers of these pages recognize that we have used this phrase in our title before to state our positive outlook for the economy in 2002. The events of September 11th have not dimmed that optimism, though we believe that the recovery might commence later than it would have in the absence of the attacks.

The first part of our brighter day thesis relates to interest rates. It was in January of this year when the Fed started lowering interest rates. They have lowered the Federal Funds rate from 6.5% in January to 2.5% in October, an astounding 400 basis point drop over a 9 month period. In fact, this is the lowest Fed Funds rate since 1962, a rate that has pushed the ***Real Fed Funds Rate*** to below zero. The Real Fed Funds Rate is the Federal Funds rate minus the core inflation rate, which currently stands at 2.7%. Now this is key: the last time the Real Fed Funds Rate was in such a favorable position was in the 1992 to 1993 period (see chart) when the economy was in the early stages of a period of record prosperity in the United States. We believe that, once the consumer regains confidence, these extremely favorable interest rates will prove to be an important part of the mosaic currently being formed which will lift the economy into a sustained and formidable recovery.



The second favorable portent for an improving economy relates to the price of oil. At this time last year, the price of crude oil had been rising steadily for several years from its trough of $11 a barrel in late 1998. Although this price increase occurred during a time of economic expansion, it began to have an adverse effect on the growth of the economy, particularly as it rose above $30 a barrel in the fall of 2000. The rising cost of gasoline, heating oil, and jet fuel served as a tax upon consumers and businesses alike. In the height of the crisis, some dealers were accused of price gouging and Congress called for hearings. What a difference a year makes! Today, the price of crude has fallen more than 30% from its peak price last November. In that oil prices tend to lead economic activity by about 12 months, we expect that this important reversal will act as a vital catalyst in stimulating economic growth as we move into the early part of 2002.

The third stimulant for the economy is the inventory cycle. Throughout the last decade, a three-year cycle has developed with rising, and then falling, inventories. In the recent economic slowdown, companies have been cutting costs any way they could, including reducing capital expenditures, employment, and inventory levels. In the second quarter of 2000, inventory levels were growing at $79 billion per quarter. A year later, in the second quarter of 2001, inventories were being *liquidated* at a $39 billion annualized rate. It's interesting to note that inventory activity troughed in late 1995, late 1998, and signs point to the same phenomenon occurring again in late 2001. Next year, we expect that companies will literally be forced to rebuild inventories after having worked them down to extremely low levels. This activity will reverberate throughout the economic spectrum just as the economy is starting its economic rebound.

The fourth leg of the brighter day thesis comes from increased government spending, a very important part of our national economy. In the latter part of August, there was discussion at the highest levels of government about how to protect the budget surplus from further erosion due to the deleterious effects of the slowing economy. One idea that received prominent attention on Capitol Hill was to reduce federal expenditures. Economists from the popular Keynesian school of thought virtually choked on that idea, arguing that government should *increase* expenditures in a slowing economy in order to provide economic stimulus to the suffering patient. Well, the events of September 11th have silenced whatever debate may have existed before. The national emergency will require huge amounts of government spending, be it on the military, security at airports, infrastructure, water projects, unemployment benefits, and so on. The costs will be mammoth, perhaps well over the $100 billion currently estimated. One thing is certain, however: these funds will find their way into every nook and cranny of a moribund economy, thereby providing a much needed stimulus at exactly the right time.

We won't dwell on the last piece of the mosaic, which, like the previous item, is a part of fiscal policy. Suffice it to say that the tax cut already enacted has had a stimulating effect on the economy and we believe that there are likely to be more tax reductions to come as Congress struggles with how to get the economy moving again. Our expectation is that this additional fiscal stimulus package, perhaps in the $50 billion to $75 billion range, will be put in place before the end of this year.

These are interesting and trying times for investors. At Rorer Asset Management, we have always relied on strict investment disciplines to guide us through difficult times in the markets. Our Relative Value approach to investing identifies high quality companies that are trading at a discount to historic norms. It is precisely in times like the present, when uncertainties abound, that we are usually presented with our most compelling opportunities. We know that, no matter how severe the current recession, it will end just as have all its predecessors. We can't predict what will happen tomorrow or next month, but we can tell you that we believe in the long-term fundamental strength of our economy and the great companies which comprise corporate America.

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Rorer Asset Management, LLC
Investment Counsel

One Liberty Place • Suite 5100
Philadelphia PA 19103-7301

215-568-2126