

The RORER REVIEW

WINTER, 2003

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

THINGS AREN'T ALWAYS WHAT THEY SEEM

The present great struggle has taught us increasingly that freedom of person and security of property anywhere in the world depend on the security of the rights and obligations of liberty and justice in the world. This is a new kind of war. It is different from all other wars of the past, not only in its methods and weapons but also in its geography. It is warfare in terms of every continent, every island, every sea, every air lane in the world... We must all understand and face the hard fact that our job is to fight at distances which extend all the way around the globe. We fight at these vast distances because that is where our enemies are...

We bid farewell to 2002 with little sadness. For the third year running, equity investors have endured increasingly negative returns. Notwithstanding record low interest rates, the economy seems to be struggling: there is no firm evidence of a turn in the inventory cycle, capital goods orders are disappointing, earnings expectations for Corporate America, while rising from their depressed levels, are nevertheless disappointing, unemployment is rising and many pundits are predicting a return to recession and possibly deflation. The specter of war hangs heavy on the American psyche.

Although the markets have recovered somewhat from their lows of last fall, many investors remain deflated and pessimistic about the immediate future.

When the President of the United States delivered the speech above to a shocked and traumatized nation, the country was reeling from an unprovoked attack wherein 2340 of her citizens had died and untold property damage had occurred. The nation's sense of security and innocence had been shattered in an instant of horrific terror and her citizens were forced to face the reality of prolonged warfare waged in faraway places and at great expense. The populace was depressed and withdrawn; the investment markets were in the ashcan.

Occasionally, it is good to recall that things aren't always what they seem. In fact, the human mind, flawed as it is, possesses an uncanny ability to misjudge events at critical inflection points, particularly when swayed by the

hyper emotion of groupthink and crowd psychology. This phenomenon manifests itself most often in financial markets, but exists in all other aspects of human endeavor as well. In this issue of *The Rorer Review*, we take a look at two periods in American history when the financial system of the United States seemed in jeopardy. In one instance, the continued existence of the Republic itself seemed at risk, giving rise to global speculation about the future viability of democracy and capitalism. In the other, bedlam reigned in the financial markets as recession racked the economy while inflation ran rampant and interest rates soared to unprecedented heights. Against this backdrop, we survey the current scene and contrast it to the earlier eras.

The address excerpted above was delivered by President Franklin D. Roosevelt in one of his "fireside chats" on February 23, 1942. The mood in America in the early days of 1942 was somber. The Nazis had conquered most of Western Europe and the Japanese attack on Pearl Harbor had stunned the country into joining a war that many Americans had hoped to avoid. An air of grim hopelessness hung over the nation. Many felt that the next target of attack would be the West Coast. Radio stations went silent for fear that their broadcasts would serve as beacons to incoming enemy aircraft. Even the Rose Bowl game was moved from Pasadena to North Carolina. Fear spread to the East Coast as well: early in 1942, German U-boats began

LARGE CAP RELATIVE VALUE EQUITY 10 LARGEST HOLDINGS AS OF DECEMBER 31, 2002*

**Bank of America
ConocoPhillips
HCA - The Healthcare Co.
Hewlett-Packard
Johnson & Johnson
Marsh & McLennan
MBNA Corp.
Microsoft Corp.
PepsiCo, Inc.
Viacom, Inc. - Class B**

sinking American ships while teams of enemy saboteurs concurrently came ashore in Florida and New York.

With the luxury of hindsight, we know that the nation survived the tests of World War II. Yet, at the time, the outcome seemed far from certain. Against this background, it is useful to point out that it required an enormous amount of courage to invest in the future of America, her industries and her markets at the start of 1942. In a situation somewhat analogous to the current day, investors had endured three years of increasingly negative returns in the 1939 to 1941 period. Yet for those prescient enough to purchase equities then, the returns were excellent. By the end of 1945, the S&P 500 Index had advanced nearly 100% from the end of 1941.

Are there any possible lessons for today's investors in the retelling of this story? Perhaps paraphrasing a second Presidential speech will provide some illumination.

I want to speak to you very bluntly. I've got bad news and I don't expect much, if any applause. I must say to you that the State of the Union is not good. Millions of Americans are out of work. Recession and inflation are eroding the money of millions more. Prices are too high, and sales are too slow. Our plant capacity and productivity are not increasing fast enough...(Moreover)...the economic distress is global. We will not solve it at home unless we help to remedy the profound economic dislocation abroad. World trade and monetary structure provide markets, energy, food, and vital raw materials—for all nations. This international system is now in jeopardy...

So spoke President Ford on the occasion of the State of the Union Address delivered to a subdued nation on January 15, 1975. America had been going through a tough time. The

government was in disarray: President Nixon had been forced to resign in disgrace five months earlier. Oil prices had quadrupled in the last year. Inflation, as measured by the CPI, was +11.8%. Unemployment stood at 8.1%. The economy was in recession, and yet interest rates were in the stratosphere. The prime rate was 10%. The stock market, as measured by the Dow Jones Industrial Average, had endured a two-year bear market, closing that day at 655, well below its peak of 1067 two years earlier. The gloom on Wall Street was as thick as pea soup.

As we close the books on 2002, the investor psyche seems as damaged today as it was in late 1974 or perhaps late 1941. Not unlike the earlier period, the prospect of a fearsome war looms. And not unlike the latter period, the economy feels fragile and a vicious bear market has devastated investors' appetite for risk.

Nonetheless, we are optimistic about the future and submit that fundamentals are far stronger today than in either of the preceding comparisons.

Today our military is by far the most technologically advanced and the strongest fighting force in the world. Our expectation is that any upcoming conflict in the Middle East, if it occurs at all, will be met with overwhelming, and swift, success. The ongoing war on terror will persist, though we do not expect that effort to have a meaningful long run impact on our financial welfare.

The contrasts in the economy of today relative to early 1975 are dramatic. Unlike then, we are already in an economic recovery. GDP and corporate earnings are on the rise, though perhaps not as robustly as has been the average after an economic downturn. We believe that the reason the recovery hasn't been stronger relates to the continuous shocks the

economy has had to endure over the past year. These include accounting scandals, major bankruptcies, terrorism, a dearth of credibility on Wall Street, rising oil prices and the ongoing threat of war. We acknowledge that it's not a very appetizing lineup, but note that some of these problems are already on the wane and believe that the rest will fall away in time. As that unfolds, we believe that the economy and corporate profits will continue to strengthen.

In contrast to the record high interest rates of 1975, our interest rates are at 40-year lows. In contrast to 1975, when inflation was almost 12%, it is tame today and we expect it to remain that way for the next several years as productivity continues to grow. In contrast to 1975, when unemployment was north of 8%, today it is 6%, though we expect it to increase slightly in the early part of 2003.

The counterintuitive nature of successful investing relates to overcoming emotion. These Presidential addresses were delivered in troubled and frightening circumstances. Today, our nation and our economy are the strongest in the world, far more so than in the earlier eras. As noted earlier, those investors who held equities through the devastation of World War II prospered. And consider this: out of the gloom and misery of the President of the United States intoning on national television that "the State of the Union is not good" a new bull market was born. One year after those despairing words were spoken, the Dow Jones Industrial Average had advanced +42%.

Indeed, things aren't always what they seem.

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* The views expressed represent the opinions of Rorer and are not intended as a forecast or guarantee of future results. The Ten Largest Holdings are not investment recommendations and may no longer be held in an account's portfolio.

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