> *"Investors may be quite willing to take the risk of being wrong in the company of others, while being much more reluctant to take the risk of being right alone."*
>
> *John Maynard Keynes*

We started Patient Capital Management one year ago. Tongue firmly in cheek we chose April 1 or April Fool's Day as our start date. As many will recall markets were quite different then. While equities had declined slightly from their peaks; valuations were extraordinary by historical standards. The few remaining true value managers were viewed as dinosaurs that did not understand the new paradigm. Clients were abandoning value managers faster than momentum managers could shout Yahoo! Indeed it seemed quite foolish to stand apart from the crowd and start a pure value investment firm on April 1, 2000. No one is laughing anymore!

The Nasdaq is down sixty percent and other major indices have declined by approximately twenty per cent. Stocks that once traded in the hundreds of dollars are now quoted in pennies. Over five trillion dollars of wealth has been lost. The economic climate has changed dramatically; downward earnings revisions are common and layoff announcements are increasingly familiar. Greed has turned to fear on the way we believe to total capitulation.

Perhaps we weren't so foolish after all!

At PCM we are quite pleased with the past year. We stood by our convictions and showed that we were not afraid "to be right alone." We are pleased to report to you, our clients that we did what we said we would do. We preserved your capital in the face of steep market declines and adamantly refused to compromise on our philosophy based on purchasing securities at a substantial discount to their absolute value. Our one year (March 31, 2000 to March 31, 2001) performance[1] is as follows:

	Taxable Portfolio	Non-Taxable Portfolio
PCM		
Total Portfolio	6.50%	13.12%
Equity Portion	19.09%	59.25%

TSE 300	(18.61%)
Nasdaq	(59.76%)
Dow Jones	(9.55%)
S & P 500	(21.68%)

In addition to a successful year of performance our business grew. From a standing start (including commitments not yet received) we are now at approximately forty five million dollars of assets under administration. More importantly, we've been very fortunate to work with a wonderful group of clients

[1] Past performance is not indicative of future performance.

and have had the opportunity to work with some impressive individuals. Regardless of our future growth the opportunity to work with our clients, partners and associates has made this endeavor most satisfying.

Many market pundits and investors are claiming that markets are close to bottoms because of the large percentage declines in equity prices. This type of analysis is ill founded. The key issue is valuation; not the percentage decline in price! A moderately growing company trading at 100 times earnings may fall sixty per cent to forty times earnings and still be very expensive!

We are still very concerned about the level of equity valuations. An analysis of the "markets" historical record would indicate that now is not the time to invest in North American equity indexes. Fundamental valuations indicate that equity indexes are extremely overvalued as the following statistics show:

	Current	***80 Year Average***
Dow Jones P/E Ratio	***23.0x***	***14.0x***
Dow Jones Dividend Yield	***1.74%***	***4.4%***

Based on current earnings and dividends the Dow Jones Industrial Average would have to fall to approximately 6000 to get to a P/E ratio of 14 and to approximately 3900 to return a dividend yield of 4.4%. These represent declines of 40% and 60% respectively.

Currently earnings on the Dow Jones are approximately $429.00. In order to return to the average P/E of 14, earnings would have to be $705.00. Earnings have grown at an average annual rate of 5.3%. Assuming that the current earnings are not close to "peak earnings" (highly unlikely) it would take approximately 10 years for earnings to grow to the point where the current market level equates to the long term average P/E of 14.

Using the same analysis for dividends indicates that it would take approximately 20 years for dividends growing at the long term rate of 4.7% to justify current market valuations.

Those who argue that interest rates are substantially lower today than they were in the past are simply misinformed. The long term Moody's Aaa bond rate is 7%. Today's Moody's 30 year Aaa bond rate is in line with this historical average.

During the past 80 years there have been two periods that "equity manias" appeared. Just like today's environment, the 1929 and 1968 markets reached new highs, investing was widely covered by the media and public participation was at a feverish pitch. The table below shows how long it can take investors just

to break even from these market tops. If inflation were taken into account the number of years required to break even would be even more staggering!

	DJ Average Level	*Break-even Year*	*# of Years*
1929 Average	*311.2*	*1954*	*25*
1929 High	*381.1*	*1954*	*25*
1929 Low	*198.7*	*1947*	*18*
1968 Average	*985.2*	*1982*	*14*
1968 High	*906.0*	*1983*	*15*
1968 Low	*825.1*	*1983*	*15*

A more recent example of an "equity mania" occurred in Japan during the late 1980's culminating in a peak of approximately 40,000 on the Nikkei Dow. Today, 12 years later the index hovers at approximately 13,000. Assuming an annual return of 10%, it would take roughly another twelve years to get back to 40,000. Again, it will likely take 20 to 25 years for the market to recover to its previous highs.

At PCM we are not market timers. However, when overall market valuations are trading substantially above historic norms as they now are, it is very difficult to find investment candidates that meet our criteria. A rising tide raises all boats.

As a result, we are having tremendous difficulty finding investment opportunities that meet our strict criteria for quality and value.

We are also quite concerned at what we are discovering when we analyze the financial statements of many companies. Our analysis has uncovered one or more of the following on a frequent basis:

- ***"non-recurring" charges that continue to recur***
- ***earnings increases arising from unsustainable non-operating items such as pension plan gains and investment gains***
- ***dramatic increases in deferred charges***
- ***increasing debt levels; often as a result of funds used to repurchase very high priced stock***
- ***the use of risky financial instruments to offset the cost of share repurchases***
- ***a large percentage of reported operating cash flow from tax credits received by the corporation on the exercise of employee stock options***
- ***acquisitions consummated at extraordinary valuations***

Most disconcerting is the fact that many management teams felt the need to meet "street estimates" or "whisper numbers" at virtually any cost. Failure to meet expectations by even a penny led to punishing declines in their company's share price and the value of their options. We are now

starting to hear of management decisions that were essentially driven by the need to meet short term quarterly expectations. We are certain that more harrowing tales will emerge as the inevitable consequences of robbing Peter to pay Paul come to pass.

We at PCM continue to search for opportunities that meet our criteria. You can rest assured that we will only commit your capital and ours when we are confidant that the potential for the permanent loss of capital is negligible and the potential long-term returns are above average. Our only goal is to be right; even if it means being alone.