"For prudent investors, the price of the marketplace has to be eternal vigilance."

The Economist, November 30, 2002

Over the past two years my partner, Gary Sharpe has introduced me to Ravi Zacharias. Ravi is a Christian apologist who travels the world debating atheist scholars on the existence of God and the fundamental beliefs of the Christian faith. Listening to Ravi speak is awe-inspiring. The logic and conviction with which he spells out his arguments is breathtaking. His ability to put forth his point of view in an intellectually consistent manner and reveal the errors of logic in others' statements is a marvel to behold.

Ravi has provided me with a new standard of intellectual consistency against which to judge investment analysis and arguments Unfortunately, most of what passes for logical thought and analysis in the investment business falls short under any rigorous scrutiny. Even more disturbing is the fact that as long as share prices are rising, a blind eye is turned to all but the most serious of intellectual failings. We strongly believe that matters of investment principle and logic should be independent of stock price movements.

Market valuation is a topic riddled with inconsistency. Many argue that equities are attractive because P/E ratios are close to historical norms. Depending on the particular commentator different earnings numbers for the S & P 500 are provided to support the bullish case. Table 1 illustrates the different earnings estimates that are being used to calculate market P/E's.

Table 1[1]

S & P 500 Earnings and P/E Ratios

	Earnings	P/E	Comment
12 Months Trailing Reported Earnings	**$26.50**	**30.00X**	**most consistent and longest historical data**
S & P Core Earnings	**$18.50**	**50.60x**	**not enough historical data**
12 Months Estimated Earnings by Strategists	**$38.60**	**24.26x**	**consistently optimistic**
12 Months Estimated Earnings by Analysts	**$37.40**	**25.04x**	**consistently optimistic**
12 Months Estimated Operating Earnings			
By Strategists	**$52.50**	**17.83x**	**confused with**
By Analysts	**$55.10**	**16.99x**	**reported earnings**

As the table above illustrates, there are many different earnings that one can use to calculate the P/E multiple for the S & P 500. We have no objection to any one of these numbers being used to calculate the market's P/E ratio as long as it is applied properly and presented with the appropriate caveats. Unfortunately, this is not the case. Most analysts choose a number and throw it around recklessly and use it to support a bullish case. For example, many prognosticators use forward earnings estimates. However, they rarely disclose that these estimates are consistently far too optimistic.

The worst offenders are those that use operating earnings to calculate the market multiple. Operating earnings exclude many items that are deducted from reported earnings; as a result they are higher. When these operating earnings are used to calculate the P/E multiple it is conveniently low. Those who use this number and then compare the resulting

[1] It's All in the Earnings, Samuel Lee, CFA Nesbitt Burns
Based on S & P 500 closing price as of November 29, 2002

P/E ratio favorably to long-term historical averages based on the more conservative GAAP number are at best engaging poor logical thinking.

If one wants to use operating earnings to determine a fair value for the markets, then they must go back many years and calculate the operating earnings and derive the appropriate historical P/E multiple using the new denominator.

In our view the reported earnings number is the best measure of overall market valuation. Reported earnings are audited, reported to regulators and are used to evaluate individual companies. Furthermore, they have been calculated for more than fifty years on a consistent basis and thus provide a true historical perspective over many market cycles. On this basis the S & P 500 is trading at twice the value of its' historical long-term average P/E of 15x.

Ever since the market bubble burst accountants and analysts have been blamed for the huge losses that have been incurred. In our view, investors (particularly institutional investors and mutual fund managers) have nobody to blame but themselves. It is their fiduciary duty to carry out the proper analysis and due diligence before making an investment decision on behalf of the clients who have entrusted their capital to them. To now blame the accounting establishment and brokerage analysts for the losses experienced over the past two and one half years is extremely inappropriate.

Accounting has been the language of business for centuries and the accounting profession has facilitated the growth of modern economies by introducing a method of agreed upon standards that allow transactions and investments to be evaluated and made. It has been my experience that in the absence of outright fraud (which thankfully is rare) all the information required for a proper analysis is disclosed in mandatory regulatory filings. However, it does require the careful reading and detailed study of the "small print" contained in thick financial documents. We strongly believe that detailed scrutiny of a

company's financial statements is the foundation upon which to build an investment case; failure to read "the fine print" is a recipe for potentially large losses.

Investors are also blaming analysts employed by brokerage firms for their losses. Accusations of incompetence and conflicts are running rampant. It has been our observation that most analysts are hard working and sincere. We believe that the role of the "sell side" analyst is to provide information upon which portfolio managers base their decision. In blaming analysts for losses, professional investors are implicitly stating that they do not add any value. In essence they are saying that they do not make the investment decision but rather blindly follow analyst's buy/sell recommendations. If that is the case then why pay professional money managers? Why not seek out the best analysts and simply follow their recommendations? It would be interesting to pose these questions to a money manager who blames analysts for their poor investment decisions.

Corporate governance is now a popular topic of discussion. Again, scrutiny of corporate governance practices has intensified since the stock market mania came to a painful end. Although interesting proposals have been put forth the practical impact of such public debate on management behavior is likely to be minimal as long as large shareholders continue to own the shares of offending companies.

We have a simple solution to poor corporate governance; avoid the shares of such companies! There are two major arguments against avoiding/selling shares of firm's with poor corporate governance practices. One argument put forth by large institutional investors is that because of their size they must own shares in many companies; even those that don't meet their criteria. Our response is to own a larger percentage of the companies that one is comfortable with. Furthermore, there are many creative strategies that effectively achieve any desired level of diversification.

Another argument is that index funds by definition must own every component of an index. Proponents of indexing believe that active management of an investment portfolio cannot outperform a benchmark; thus fundamental analysis is of no use. However, index managers who "target" certain companies for corporate governance abuses are inherently contradicting the whole notion of indexing. An analysis of a firm's corporate governance policies is perhaps one of the most important elements in carrying out a fundamental evaluation of a potential investment. Indexers are thus engaging in an activity that they claim has no value!

While the above discussion is a brief synopsis of theoretical arguments I have observed that nothing is more effective than concrete action! Managements threatened with a falling stock price will pay attention and seriously listen to shareholder proposals.

PCM was founded on the principles of fiduciary responsibility and prudence. We try to ensure that our logic and investment conclusions are sound. We spend countless hours reviewing our analysis and seeking differing views from respected sources. It this continuous analytical process along with our detailed valuation work that provides us with the confidence that we will protect and grow your capital. In a treacherous marketplace we can assure you that we are "eternally vigilant."

Gary, Domenic and I wish you and your family the season's blessings. We hope that 2003 brings you all much happiness and good health.

Vito Maida
December 2002