Sather Financial Group, Inc.
Registered Investment Advisor

Third Quarter Commentary
Hurricane Isidore May Have Left Us, But The Storm On Wall Street Remains

There is no sense in rehashing the difficulties encountered by the financial markets in the third quarter. It has been challenging and emotional to say the least. ***The current environment has overshadowed a recovering economy, a rebound in corporate profits and a return to more reasonable stock market valuations***. Unfortunately, investor psychology continues to be battered by geopolitical tensions and a crisis in confidence in the integrity of corporate America and Wall Street. Given this environment, many have been led to believe that Wall Street is a dangerous place.

Call me sick, disturbed or mentally challenged, but I am getting positively excited over the market and its offerings. When I make comments of this nature it is apparent that my logic may not be obvious. As such, it might be informative to illustrate one example comparing the returns of a boring common stock (Philip Morris) to that of the ten year U.S. Treasury. See the attached case study.

Needless to say, as the market becomes more and more manic and depressed the more people are likely to believe that the world truly is coming to an end. ***This mentality creates a rush out the stock markets door with the end result being many great companies left behind at bargain prices***. While Alan Greespan talked of "irrational exuberance" six years ago, today, Wall Streets mood is nothing but "irrational depression." In this environment most investors, and that certainly includes the idiots on Wall Street, follow the herd and allow their emotions to overcome common sense. ***The intelligent investor, however, knows that irrational behavior creates very rational opportunities.***

In assessing the emotion of investors and consumers it is interesting to look at the highly touted Consumer Sentiment Index, which has dropped recently. It is no surprise that we would all like the economy and financial markets to settle down. Every evening we turn on the news and a bunch of journalists tell us the sky is falling. It is enough to get most people feeling negative. However, don't read too much into this rating of sentiment. Despite growing pessimism, consumer spending is not slowing down. On the one hand you have people talking about how depressed they are, while at the same time they continue their spending. Why do we care—because ***consumer spending makes up about two thirds of our nearly $10 trillion U.S. economy***. However, ***spending and sentiment are not closely tied together. More importantly, we have not had a single year of falling consumer spending since 1938***.

Another factor to consider is that of ***unemployment, which stands at a quite reasonable 5.7%.*** To put this figure in perspective the unemployment rate was 7.8% following the 1990-1991 recession and 10.8% after the 1981 recession. When people have jobs they will continue to spend. ***August Personal Income and Spending figures are both expected to grow by .5%***.

Why is unemployment at a reasonable level given the behavior of the financial markets? To begin with, corporate America is profitable—despite what the evening news leads us to believe. Overall ***third quarter profits are expected to rise 7.3%.*** Also, ***interest rates are at a 40 year low***. Cheap borrowing costs allow companies to expand and finance operations in a more efficient manner. Don't look for the Federal Reserve to increase rates too soon.

Further support for keeping people employed and corporations healthy are signs about businesses' willingness to spend money on equipment and software. ***Investment in equipment and software grew 3.3%--the first gain since the third quarter of 2000.*** Companies are also starting to replenish their stocks of goods. ***Inventories increased by $4.9 billion in the April to June period, the first gain in inventory investment since the final three months of 2000***.

In evaluating all of this information it is imperative that we stay cognizant of the fact that logical investing (I did not say speculating) is quite often counter intuitive to the prevailing wisdom on Wall Street and certainly to the emotion of the masses. This is where opportunity presents itself and the phrase "it is darkest just before dawn" is most applicable.

Call with questions.

Sincerely yours,

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Case Study: Philip Morris common stock versus a Ten Year U.S. Treasury Bond

Philip Morris (MO), as most are aware, is the largest seller of premium cigarettes in the world. While they just sold Miller Brewing, MO continues to be the largest food company in the U.S. They own Kraft, Oscar Mayer, Velveeta, Miracle Whip, Jell-O, Kool-Aid, Post Cereals and another little food company called Nabisco. Given this, it is a safe assumption that as long as humans are on the face of the earth they will continue to purchase Philip Morris products.

Currently, Philip Morris sells for less than $38 per share. For every one share an investor owns of that company they participate, as an owner, in $4.35 in net earnings. The reason that anyone owns common stock is to participate in the earnings of the company. From our perspective, a $38 investment in MO brings an investor an 11.44% return on their investment ($4.35 earnings per share / $37.86 price per share). Just on the surface, most investors would agree that an 11% return on their money is pretty good. To sweeten the deal a bit more MO is currently paying a 6.8% dividend! That is great cash flow whether you are investing in MO for growth or income or both. Also, don't forget that MO is very conservatively financed and could pay off all of their long term debt, with net earnings, in just 1.5 years. While the 11% return is quite attractive just on its own it becomes that much more enticing when one considers that the return of 11% is growing larger on a regular basis. As such, your return on initial investment actually has the ability to get even better.

In comparison, we'll review the fundamentals of the ten year US Treasury bond. I am using this as an example for a couple of reasons. To begin with, the US Treasury bond is considered to be the safest investment in the world in terms of default risk (remember that there are at least ten different types of investment risk and default is just one of those). Additionally, the Treasury was chosen because several clients have asked about it.

From our perspective a ten year US Treasury is a sure fire way to hurt yourself—especially when you consider your other options. In effect, when you buy a Treasury you are loaning the US Government money for a period of ten years. In return, the government is going to pay you a whopping pre-income tax return of 3.7% per year (interest rates are at a 40 year low). The comparison of MO's dividend to the interest on a Treasury is pretty easy—6.8% versus 3.7%. The investor must then pay tax on each.

However, the dividend is just one factor. Remember that the Treasury is never going to decide after five years to increase your return for any reason. MO on the other hand does regularly increase their earnings and dividends. Furthermore, it is important to compare the return on the Treasury to what MO is actually earning. As stated above, a person who invests $38 in MO participates, as an owner, in $4.35 in earnings. How much would you have to invest in a US Treasury to also earn $4.35? To earn the same amount you would have to invest $117.56 in a Treasury compared to $38 with MO---209% more!

The big benefit to the US Treasury is that it is free of default risk. However, you give up an unbelievable amount for that default guarantee. Additionally, once you factor in income taxes (30%) and cost of living adjustments (3 percentage points) you will actually lose money, in terms of purchasing power, if you buy a US Treasury now and hold it to maturity.

For these reasons, the investment in MO becomes the clear choice, in our opinion, for the long term investor. We reiterate long term simply because we have no idea what the stock market price of MO will be today, tomorrow or a year from now. However, we do believe that MO will be worth substantially more in ten years, especially given its consistent track record of increased earnings.

While this is by no means an endorsement or recommendation for everyone to rush out and buy MO, it should show some of the logic that goes into comparing certain types of investments.