Sather Financial Group, Inc.
Registered Investment Advisor

June 9, 2004 Commentary

Typically, we are quite positive on the long term outlook of the US stock market and its ability to deliver long term gains. We are tempering our enthusiasm and as such are altering our stance and strategy in terms of asset management. The net effect of this strategic change is to move 25% to 50% of our clients assets into what is considered to be today's most hated asset—cash and its equivalents. In this endeavor we will also consider short term domestic fixed income and foreign fixed income.

This decision is made knowing the following:

1. Today, ***personal, corporate and governmental debt is at all time high levels***. A bull market has never emerged from a time of high debt. Also, we must remember that the higher the level of debt, the higher the commensurate risk level.
2. We cannot fully understand the full impact of leverage on prices and investor psychology until the low cost leverage is removed. What we do know is that tremendous access to low cost debt drives the prices of all goods and services up.
3. ***Personal savings rates are at all time lows*** and therefore people have lesser amounts of money to invest.
4. Historically, consumer spending comprises about 60% to 65% of Gross Domestic Product (GDP). Today, consumer spending is 70% of GDP. This expansion has been fueled by debt.
5. At the beginning of the bull market which started in 1949, the ratio of "dollars of debt" to "dollars of GDP" stood at a 1 to 1 ratio. Today, that ratio is now three parts debt for each one part of GDP.
6. ***Debt today is at its highest level, relative to GDP, since the 1929 stock market bubble. We all remember what happened in 1929.***
7. In 2003, the ***average household spends 18% of its disposable income just to service debt***—and that's with interest rates at all time lows.
8. Since 1980 the average home in the US has tripled in value. Sadly, the average homeowner still only has 20% equity in their home—despite the 300% increase in values. This means that homeowners have been withdrawing equity from their homes to support an out of control lifestyle.
9. Given the era of low interest and mortgage rates that we have encountered, we thought that most, if not all, people had locked in fixed rate mortgages. Unfortunately, the growth in variable rate mortgages has exploded. While this is good for lenders, it is a disaster waiting to happen for those borrowing on a variable rate note.
10. The United States' ***trade deficit is at all time high levels, the budget deficit is at runaway levels and the value of the US dollar continues to fall***. Owning companies with sizable foreign operations will aid investors in hedging the drop in the value of the dollar.
11. The median stock is more overpriced now than it was during the 1999—2000 bubble. In 2000 we knew that tech, telecom and internet stocks were ridiculously overpriced. However, the average stock outside of those industries traded at a mere 13 or 14 times its earnings. Today, ***the average stock across the board trades at a 19.5 price to earnings ratio. The all time high was 20.7***. As such, we might have another 6% upside, but the downside risk is much larger.
12. The Federal Reserve has openly said that they will be raising interest rates soon to combat rising commodity prices and other inflationary fears. Once interest rates start increasing the era of easy money and low cost debt will be over. Interest costs will go up, stock prices will probably go down.

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The above statements are facts. These issues alone are reason enough to implement this change before we start considering other important, yet less definable issues, such as the presidential election, China, terrorism, the price of oil, etc.

Obviously, we think there are certain large hurdles for the US stock market.

In assessing these hurdles, ***<u>we would rather be early in terms of increasing liquidity than late</u>***. Furthermore, we would rather be more conservative than overly aggressive with a clients money. While we do not cherish the idea of holding cash and cash equivalents, the opportunity cost of cash is at its lowest level in 30+ years.

We can still find many relative values in the stock market when comparing one stock to another. However, the job our clients have charged us with is not only creating wealth, but also preserving wealth. Knowing this ***<u>we may be sitting in this conservative posture for quite some time—it would not surprise us to maintain this posture for the next 18 months</u>***. Again, we think that given the situation we are in it is far better to err on the side of conservatism. That said, if we find stocks that present compelling valuations we will not hesitate to add these to our portfolios. Unfortunately though, stocks with these favorable characteristics are a rare breed today.

Finally, people hire us to make intelligent decisions on their behalf. And ***<u>while we see some obstacles in front of us, there are also large opportunities if we remain patient and disciplined.</u>*** These are the keys. In time the market will adjust. And we will be waiting to take advantage of this adjustment which will result in fine companies being priced at bargain levels. Until that happens, we will remain ever vigilant in our efforts to protect client assets.

Call or stop by with questions.

Sincerely,

Dave Sather, President
CERTIFIED FINANCIAL PLANNER™