

QUANTUM CAPITAL MANAGEMENT, L.L.C.

QUANTUM FOCUS

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“A sound banker, alas, is not one who foresees danger and avoids it, but one who, when he is ruined, is ruined in such a conventional and orthodox way along with his fellows, so that no one can blame him.”

—John Maynard Keynes

All Hat, No Cattle

I have a friend, an oilman, originally from Texas, who now hails from Aspen Colorado. If years equal experience and experience equals wisdom, while decorum precludes disclosure of his age, suffice it to say that he was a pageboy in the White House during the Truman administration. I consider him a reluctant intellectual. When less than sober, he is a witty intellectual. One afternoon, while basking in the glow of that optimum point of wit and intellect, he offered the pearl of a phrase, “All hat, no cattle”. The term is typically used as a derogatory depiction of Texas businessmen who appear to be wealthy on the surface but in substance are living on borrowed money, overstating their income, overvaluing their assets and understating or not fully recognizing their liabilities. After collecting myself, (my response was laughter violent enough to knock over my coffee and his drink), I was struck by the metaphor; after all we do have a Texan in the White House and the practice of living on borrowed money and the non-recognition of liabilities as well as the overstatement of income and assets seems to be shared, either wholly or in part, by government, households, and publicly traded companies alike. It is against this macroeconomic backdrop that we invest. Today I would like to discuss our macro view, why we in fact have one, and how I believe it impacts our investment selection process.

I have received some mild criticism from other “bottom up” colleagues who contend that a view of macroeconomic events and their impact on the markets is a waste of time. After all, as a former accounting practitioner and teacher, I am more comfortable hunkering down with an annual report than I am sauntering through the various Federal Reserve websites. Even the great Martin Whitman in his 1999 book, “Value Investing, A Balanced Approach”, stated “Value investors believe that at least for the U.S. economy, spending a lot of time on macro factors, whether for the overall economy or for securities markets (e.g., the S&P 500), is not only a waste of time but also a refuge for incompetents who are

uninformed about any aspects of corporate analysis but can sound intelligent by making predictions about unpredictable things”. Mr. Whitman’s remarks notwithstanding, I believe that to ignore the structural imbalances created by record current account and fiscal deficits along with the unchecked printing of fiat currency, and the resulting inflation whether it be in a basket of goods, housing, productive capacity, foreign reserves or equity pricing, is tantamount to taking a nap on a railroad track.

Arguments for deflation, Arguments for inflation

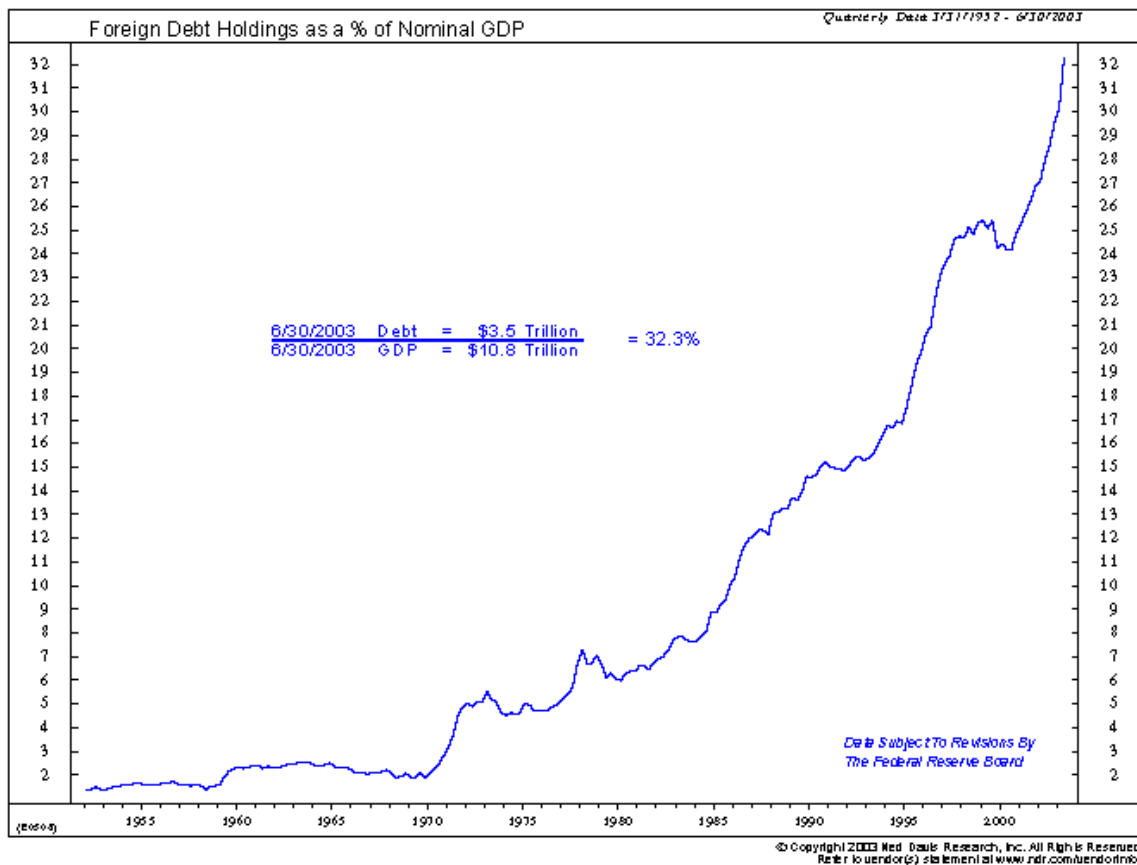
There are a host of great thinkers and writers who believe that structural imbalances worldwide will cause a destructive deflation. There are others still, just as informed, who feel that the very same imbalances will lead to high inflation. In other words, even if thoughtful people agree on the diagnosis they can disagree on the prognosis. This conundrum has implications with regard to our sector and stock selection in *Quantum Small Cap Growth* and it has even more far reaching asset allocation implications in our *Quantum Balanced* portfolios.

It is a complex subject, and because of this complexity and my concern over whether or not I could convey the message in an understandable manner, I have been reticent about writing. However, to paraphrase someone whom I probably quote too often, James Grant, I will try to leave my readers less confused after they read this essay than before they started reading it.

To start, let’s chat about the imbalances inherent in a fiat monetary system. Richard Duncan in his recent work, “The Dollar Crisis – Causes, Consequences and Cures”, discusses the fact that throughout history, economies have been marked by periods of boom and bust. The abandonment of the gold standard and the adoption of a fiat currency system (a fiat currency is one that is backed by the full faith and promise of the government that prints it ... and nothing else), causes larger booms and busts than would typically be expected in a gold backed currency system where the printing of money and thus the level of liquidity would be constrained by the amount of gold in ones reserves. The reason for this boom and bust cycle is that during periods when liquidity (money or credit) is abundant, our entrepreneurial spirit takes over and we leverage ourselves, whether we are US real estate developers or Chinese cell phone manufacturers. Like a bowl of milk to a puppy, easy credit to an entrepreneur will be feasted upon until he can feast no more. Consequently, a disproportionate amount of liquidity flows to capital investment and our ability to produce (capacity) expands. As consumers, we can only consume so much, e.g., we can only buy so many houses and so many cell phones. Typically this growing imbalance between the capacity to produce and the propensity to consume eventually results in busts defined by higher unemployment, plant downsizings, foreclosures and other reductions in capacity to bring that imbalance back in line. The bust that follows a boom brought about by credit expansion is inevitable. If a government, unrestrained by any type of monetary governor, decides to stave off this inevitable bust by printing money or extending even more credit, then the bust may be delayed but not avoided. The resulting repercussions will be more acute and could result in a financial catastrophe.

The world has gotten smaller and since our trading partners accept US currency and US debt as payment for their manufactured goods, our monetary policy, (i.e., how much of it we are willing to print) affects the world economy as much as it affects our own. The following sardonic excerpt comes from the Sept. 12th issue of Grant's Interest Rate Observer. *“From the American vantage point on transpacific debtor–creditor relations, there is nothing to be improved upon. Asians produce; Americans consume. Asians ship merchandise east; Americans move dollars west. And then something even more wonderful happens. The same American dollars rapidly move east again, there to be invested in U.S. Treasuries, Fannies and Freddie's (it's as if the money never left!). It is a puritan lie about not being able to have your cake and eat it too. Americans have it and eat it 24/7.”*

Because we buy (at last count) about \$550 billion dollars worth of goods from other countries in excess of what we sell to them, we are going further in debt by the same \$550 billion each year or approximately 5% of GDP. *(Please see the accompanying chart E0508 courtesy of Ned Davis Research.)*



The abandonment of the gold standard has allowed, through the build-up of US current account deficits, a shift in manufacturing to developing nations that has provided, to date, the opiate of cheap consumable goods and low interest rates. However, we all know there is no such thing as a free lunch and the trade-off for cheap sneakers and other manufactured goods has been a burgeoning current accounts deficit. In addition, our fiscal deficit is

growing annually in no small part because of the capacity created overseas by our own excess liquidity (money printing) and the resulting competitive pressures that cause compressed profit margins, domestic unemployment or underemployment and lower tax revenues. It was not too long ago that Ross Perot was ridiculed for his public comments in which he described the “great sucking sound” of jobs leaving our country. Apparently the academics felt that every factory worker, auto worker, machinist etc. would become a computer programmer. Given the recent mandate from high tech companies such as IBM to move software development offshore to India and other developing nations, it seems to me that perhaps Mr. Perot’s hearing was just a little better than most.

It is anticipated by the Congressional Budget Office that, in 2003 we will generate approximately \$1.77 trillion in tax revenues and spend approximately \$2.33 trillion. This results in a fiscal deficit of \$560 billion. How can we spend more than we take in? Easy, issue Treasury Bonds and hope that foreigners (approximately 50% of our government debt is purchased and held by foreigners) will continue to consider us creditworthy at current interest rate levels. It is our view that given the current level of government debt and at the current trajectory of our fiscal deficits, that it would not be unreasonable for a foreign creditor to require a higher rate of return from a debtor (the United States), that does not appear to be as creditworthy as it was a few years ago when, in fact, it paid a higher rate of interest on the same obligations.

One of the reasons that I am concerned about interest rates can be best explained by the table below, which is borrowed from a speech by Warren Buffet in 1999 about the relationship between interest rates and equity prices. As you can see, from 1964-1981 the Dow Jones Industrial Average rose less than one point, from 874.12 to 875.00. Essentially flat for 17 years. From 1981 to 1998 the DOW rose from 875 to 9181.43. A gain of more than ten fold. To what can we attribute the out performance in the latter 17 year period? Was it GNP growth? Does not a higher GNP signify a stronger economy and correlate with higher stock prices? Well, not exactly. You see at the bottom of the table that GNP growth was 373% during the period of market underperformance 1964-1981 versus GNP growth of 177% in the latter period of superior market performance. What did occur however is outlined in the table under interest rates. The long term Treasury bond was quoted at a rate of 4.20% in 1964 and it rose to a rate of 13.65% in 1981, offering at the same time an increasingly attractive investment alternative to equities as well as an impediment to equity profitability, growth and valuation. Just the opposite was the case in the ensuing 17 year period. Interest rates declined from 13.65% in 1981 to 5.09% in 1998, and although capital gains on bonds ameliorated some of the pain from the drop in rates, the coupon was considered small potatoes when measured against the growing profitability and the even greater prices that investors would pay for equities when measuring stock appreciation against an ever decreasing benchmark/alternative, what they could earn from long term bonds.

• Dow Jones Industrial Average
Dec. 31, 1964: 874.12
Dec. 31, 1981: 875.00
• Dow Jones Industrial Average
Dec. 31, 1981: 875.00
Dec. 31, 1998: 9181.43
• Gain in Gross National Product
1964-1981: 373%
1981-1998: 177%

• Interest Rates, Long-Term Government Bonds
Dec. 31, 1964: 4.20%
Dec. 31, 1981: 13.65%
Dec. 31, 1998: 5.09%
Today: 5.17%

Source: "Warren Buffett on the Stock Market."

Given the historically high valuation of equities and the nosebleed valuation levels of the stocks that are leading the market I feel that we are at long term risk of underperformance in equities as an asset class and we are at short term risk of a destructive correction. Despite initiatives in corporate governance, there continues to be an abandonment of not-so generally accepted accounting principles of matching (revenues with expenses), conservatism and independence. The treatment of recurring items as nonrecurring items on income statements and disregard for the liberal use, cost and dilutive effects of employee stock options, overstates real earnings. Vickers reports that corporate insider sales (vs. buys) of company shares are at a 17 year high. With the proliferation of Hedge Funds and the resurgence of momentum investing, it appears that the lesson learned from the start of the bear market, particularly March of 2000 to October of 2002, is not "buy a stock as you would a fractional share of any business", but is instead "If it goes up, buy it and if it goes down, get out fast." Should this liquidity fed, tax-cut driven, hedonically adjusted and jobless recovery falter, there will be a mass exodus for the exits in equities.

A Little Housekeeping

Joe Perna has joined Quantum after a stint at Wilmington Trust where he was Vice President of Institutional Equity. I have known Joe for many years dating back to the early 1980's when he left town to go west to play college football. His intellect proved more durable than his knees and he returned back to the east coast where he graduated from the Wharton School at the University of Pennsylvania. Joe served as a fighter pilot in the USAF and currently holds the rank of Lieutenant Colonel in the Reserves. Irrespective of the tone of our commentary, there has been an emphasis on the bottom up research of small cap equities and the management of our Quantum Small Cap Growth portfolio which we manage exclusively for our institutional clients and use as an asset class allocation in our Quantum Balanced portfolio. Since there seems to be an inverse correlation between my golf game and how well our portfolios perform, Joe has assumed the marketing and institutional liaison duties at Quantum. I will continue to lead the research and portfolio management effort.

In Closing

Our portfolios have performed well year to date, primarily because of our allocations to *Quantum Small Cap Growth*, REITs, and emerging markets and to a lesser extent commodities and foreign debt. We have reduced our REIT allocation from 15% to a base allocation of 10%. We have increased our commodities allocation from 15% to 20%. As stated in our January 15th letter we are bullish on commodities; partly because of the Supply/Demand dynamics but primarily because we are bearish on the medium against which their value is measured, currency. As of the date of this letter we have taken profits and sold most of our technology holdings. We still hold 3COM (COMS) because we believe that is a story that is yet to be told. We are starting to look at Treasury Indexed Inflation Bonds again, although we are taking our time and maintaining a short duration in the bond allocation. We took a small position in Harmony Gold (HMY), but we are not gold bugs. We feel most comfortable with the risk management properties of a basket of commodities and Treasury Indexed Inflation bonds. We are still excited about the opportunities in emerging markets from both a current valuation and long term macro basis.

I thought the thinly veiled sarcasm (concerning cake) contained in the passage from Grant's above, as well as the Keynes quote at the beginning of this communiqué would generate a chuckle. However, the implicit message in each should be solemnly respected. The sword of Damocles that hangs over our heads is the chance that our neighbors overseas will cease to continue to fund our deficit spending at current interest rate levels. Excess liquidity has made undervalued asset classes a rarity and the intermediate effects of our structural imbalances whether a hyper inflation, destructive deflation or something in between are not clearly visible. We do not have the luxury of subscribing to the imperative of Keynes "sound banker". We take the privilege of managing money seriously. We are paid to have an opinion. However, when we see an inflection point, in the absence of a clear opportunity, we will exercise caution and protect what we have.

Best Regards,

John J. Hughes

Please send questions or comments to jhughes@quantumadv.com

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