

Loach Management Company Inc.

Client Letter January 2003

2002 Review

The following is a quote from the December 1960 letter from Warren Buffett to the Partners of the Buffett Partnership Limited.

“My continual objective in managing partnership funds is to achieve a long-term performance record superior to that of •the Industrial Average.... Unless we do achieve this superior performance there is no reason for existence of the partnerships.

“However, I have pointed out that any superior record which we might accomplish should not be expected to be evidenced by a relatively constant advantage in performance compared to the Average. Rather it is likely that if such an advantage is achieved, it will be through better-than-average performance in stable or declining markets and average, or perhaps even poorer-than-average performance in rising markets.

“I would consider a year in which we declined 15%. and the Average 30%. to be much superior to a year when both we and the Average advanced 20%.

“Over a period of time there are going to be good and bad years; there is nothing to be gained by getting enthused or depressed about the sequence in which they occur. The im-

portant thing is to be beating par; a four on a par three hole is not as good as a five on a par five hole and it is unrealistic to assume we are not going to have our share of both par three's and par five's...

“With this background it is not unexpected that 1960 **was a better-than-average year for us.** As contrasted with an overall loss of 6.3%. for the Industrial Average, we had a 22.8%. gain for the seven partnerships operating throughout the year. ..

Of course Buffett went on to outperform the “Average for all but one of the next 42 years, and by a mar-

“I would consider a year in which we declined 15%. and the Average 30%. to be much superior to a year when both we and the Average advanced 20%.”

Warren Buffett

gin that was closer to fifteen percent that to ten percent. One the keys to this success is this aversion to risk. His approach starts with method of stock selection that avoids popular and exciting stocks. Because these stocks carry very high prices in bull markets, and because of these high prices, the highest risk in a market correction.

This quote is appropriate now because now because it is important to remember that performance is rela-

tive, and that under-performance is much more dangerous over-performance much nicer in a bear market.

For Buffett rule number one is "never lose money." Rule number two is "never forget rule number one" It is quite likely that his ability to out-perform the market is based on the philosophy expressed in this quote. If you can successfully avoid the big bath it is much easier to beat the market in the long run.

On this basis 2002 was a pretty good year. Our average account was down by \$4.7% while the S&P 500 was down 23.4% and the Wilshire total market average was down 22.1%

The Dow Jones industrial average was only down 16.8%, but this average only measures the performance of 30 stocks versus 500 in the S&P and over 6000 in the Wilshire. Of all the averages I prefer the Wilshire when measuring relative performance because it has the broadest base, and best repre-

Table One - Fifteen Year Performance

	Losch Management		S&P 500 Index		NASDAQ Index	
	Period	Cumulative	Period	Cumulative	Period	Cumulative
1988	17.07%	17.07%	12.40%	12.40%	15.40%	15.40%
1989	48.06%	73.33%	27.25%	43.03%	19.24%	37.60%
1990	-0.05%	73.25%	-6.56%	33.65%	-17.81%	13.10%
1991	20.99%	109.61%	26.31%	68.81%	56.86%	77.40%
1992	49.72%	213.83%	4.46%	76.34%	15.45%	104.81%
1993	5.40%	230.78%	7.06%	88.79%	14.73%	134.98%
1994	14.73%	279.50%	-1.54%	85.88%	-3.20%	127.46%
1995	47.90%	461.28%	34.11%	149.28%	39.92%	218.26%
1996	6.66%	498.66%	20.26%	199.79%	22.71%	290.54%
1997	43.40%	758.48%	31.01%	292.75%	21.64%	375.05%
1998	25.94%	981.17%	26.67%	397.50%	39.92%	564.69%
1999	-2.89%	949.93%	19.53%	494.66%	85.59%	1133.60%
2000	16.40%	1122.12%	-10.14%	434.36%	-39.29%	648.92%
2001	16.89%	1328.53%	-13.04%	364.68%	-21.05%	491.27%
2002	-4.72%	1261.11%	-23.37%	256.09%	-31.53%	304.84%

Annualized

18.84%

8.84%

9.76%

Table One Compares our performance to the S&P Index and the NASDAQ Index. The cumulative column shows total gain for entire pe-

riod. For instance \$100,000 invested in an index fund tied to performance of the S&P 500 would have grown to \$356,000. \$100,000 Invested in a

fund that tracked the NASDAQ would have grown to \$405,000. While our record would have grown the \$100,000 to \$1,361,000.

Table Two - Ten Year Performance

	Losch Management		S&P 500 Index		Wilshire Index	
	Period	Cumulative	Period	Cumulative	Period	Cumulative
1993	5.40%	5.40%	7.06%	7.06%	8.58%	8.58%
1994	14.73%	20.93%	-1.54%	5.41%	-2.52%	5.84%
1995	47.90%	78.85%	34.11%	41.37%	33.40%	41.20%
1996	6.66%	90.76%	20.26%	70.01%	18.84%	67.80%
1997	43.40%	173.55%	31.01%	122.73%	29.17%	116.74%
1998	25.94%	244.51%	26.67%	182.13%	21.72%	163.82%
1999	-2.89%	234.55%	19.53%	237.23%	22.05%	221.99%
2000	16.40%	289.42%	-10.14%	203.03%	-11.85%	183.84%
2001	16.89%	355.19%	-13.04%	163.52%	-12.06%	149.61%
2002	-4.72%	333.71%	-23.37%	101.93%	-22.08%	94.49%
Annualized		16.27%		7.28%		6.88%

Table Three - Five year Performance

	Losch Management		S&P 500 Index		Wilshire Index	
	Period	Cumulative	Period	Cumulative	Period	Cumulative
1998	25.94%	25.94%	26.67%	26.67%	21.72%	21.72%
1999	-2.89%	22.30%	19.53%	51.41%	22.05%	48.56%
2000	16.40%	42.36%	-10.14%	36.06%	-11.85%	30.95%
2001	16.89%	66.40%	-13.04%	18.31%	-12.06%	15.16%
2002	-4.72%	58.55%	-23.37%	-9.34%	-22.08%	-10.27%
Annualized		9.65%		-1.94%		-2.14%

Table Two covers Ten year performance, and shows that a \$100,000 theoretically invested in the S&P would have grown to \$201,900. The same \$100,00 in a fund that exactly tracked the NASDAQ Index would have increased to \$194,500. While at Losch Management our average account grew \$100,000 to \$433,700.

For the Five years ended December 31, (Table Three) \$100,000 invested in an S&P index fund would have decreased in value, to \$92,700,

\$100,000 in a fund that tracked the Wilshire index would have decreased to \$89,700.

At the same time this \$100,000 account would have increased to an average of \$158,500 at Losch Management Company.

The key to achieving a satisfactory long term result is relative performance and particularly relative performance in bad markets. Yes Bull markets are when you make money

but Bear markets are more important measure of how well your money is being managed.

Granted this is an argument that makes us look pretty good, so is obviously self severing, but then who are we to argue with Warren Buffett?

Bear Market

March 2000 to December 2002

Losch Management		S&P 500 Index		NASDAQ Index	
Period	Cumulative	Period	Cumulative	Period	Cumulative
Mar-00-Dec-00	32.09%	Mar-00-Dec-00	-3.38%	Mar-00-Dec-00	-46.72%
Jan-01-Dec-01	16.89%	Jan-01-Dec-01	-13.04%	Jan-01-Dec-01	-21.05%
Jan-02-Dec-02	-4.72%	Jan-02-Dec-02	-23.37%	Jan-02-Dec-02	-31.53%

Table Four is the one I like best. It shows that we out performed the S&P buy a cumulative 82.7 percent since the bear market emerged in March Of 2000. Divide by 2.75 years for the time covered by this chart, and the annual rate of out-performance is approximately 30% per year.

If you had put \$100,000 in an S&P index fund in March 2000 it would have been worth \$64,000 on December 31, 2002. That is considerably better than NASDAQ. A fund tracked that average would have been worth

\$28,800 on December 31. During the this period our average account would have appreciated to \$147,100.

Fearless Forecasts for 2003

At my age you would think that I would know better that to try to predict economic trends, but bad habits are hard to shake,

1, Interest Rates

The Fed may not have to raise interest rates in 2003, but sooner or later, inflation will reappear. And rates will move higher.

2. Corporate Earnings.

A tough pricing environment will create a headwind for profits in all regions, but even a mild earnings recovery will allow equity prices to move higher, given buoyant liquidity conditions.

3. Stock prices

The short term picture for stocks has improved, but valuations and investor disillusionment make a major bull market unlikely.

History suggests that burst asset bubbles are followed by a broad trading range that can last for many years. This is an environment where buy and hold is not necessarily the best investment philosophy. Fortunately traditional value investing does work.

Value investing involves buying stocks that are selling significantly below intrinsic value and selling them when they approach full value. This approach works well in the current market because it constantly lowers portfolio risk.

This Value investing should not be confused with market timing, even though they sometimes look the same. Because this approach means buying only at a discount to intrinsic value, purchases tend to occur at market bottoms and sales come after there has been a period of recovery. The distinction, and it is an important one, is that you are buying individual stocks and not the market.

You try to ignore the market and focus on the price of individual companies that meet your criteria. Purchases and sales should be based on the Value of the company not what you think the market is going to do in the next six months.

4. Foreign Stocks

European and emerging market equities should outperform Wall Street. The Asian markets look the best bet. Japanese stocks are primed for a bounce. Russian oil and gas stocks look very cheap when compared to their international competition.

5. Bonds

The low in bond yields has probably been seen, barring a major economic or financial shock, Interest rates have been declining since the early nineteen eighties, but it hard to see how

they can go much lower.

As if the Picture for bonds was not already bad enough President Bush has introduced a proposal to eliminate the double taxation of dividends. This could have a negative effect on bonds in general, and municipal and treasury securities in particular

6. Currency

The dollar seems to be headed lower on a multi-year view, but it will probably be gradual process given the weak condition of overseas economies. Any dollar weakness will be mainly against the euro and commodity currencies rather than the yen.

7. Commodities

The grinding bull market in commodities should continue, helped by strong demand from Asia. Oil prices could surprise on the upside, even after the Iraq situation is resolved. Longer run, a shift toward hard assets will benefit commodities, including gold, and is likely to benefit some emerging economies such as Russia that have abundant natural resources

Eventually this rise in commodity prices is likely to lead to a return of inflation, maybe, sooner than most people think. The Inflation in the seventies started with strong upward moves in commodity prices.

8. Insurance

The world is a less safe and less certain place. Businesses and investors will thus demand higher risk premiums. All of this should help to keep insurance prices high for the next couple of years at least.