



First Quarter, 2003

THE CASE FOR INVESTING IN GROWTH STOCKS

Over his forty-year career, David Wendell, our firm's founder, was a prolific writer. Many of his Investment Letters have since proven to be timeless. This Letter is based on his work as well as our staff's current investment thinking.

Despite a strengthening economy, the stock market is going through one of those infrequent but recurring periods when feelings hold sway over logic. The fear that gripped the nation following September 11th, 2001 has riveted the investment community. Emotion is influencing share prices far more than cold analysis.

All one can say is that most stocks are going down. They are going down on good earnings reports and on bad earnings reports, on favorable news and on unfavorable news. Stocks with low price/earnings ratios are declining, as are stocks with high price/earnings ratios. Good-quality stocks, poor-quality stocks, cyclical issues and non-cyclical issues are all under pressure.

The whole market seems demoralized. More and more people are assuming that the slump in stock prices will turn the slow economic recovery into a full-blown recession. On top of this, various "doomsday" scenarios lurk in the background, feeding on the uncertainties surrounding a potential war as well as another terrorist attack.

In emotional times such as these, it has always been a sound investment principle not to go along with the prevailing mood. Whenever things have seemed either the brightest or the darkest, the majority feeling about the immediate future has almost invariably proved wrong.

To be sure, there can always be that one exception. And some of the major worries of today are worries we have never had before. We have had many periods when business was slack, profits were squeezed, and the stock market was down sharply. We have also had unpopular wars and mass protests. But never before have we experienced the terrorist attacks of 2001, and never before have we lived with the fear of future terrorist attacks.

These new problems are extremely unsettling and no one can predict the exact outcome. However, new problems are not new to our nation's history. Since the first settlers, our nation's growth has been based on facing and solving a long succession of uncertainties, beginning with surviving the first winter. We not only survived that winter, we also landed on the moon, conquered polio, and won the Cold War. Each of these feats was deemed impossible in an earlier era.

Looking back, the path to the present appears smooth and clear. But to those who traveled that path, it did not seem easy at all. Each generation has always felt that its problems alone were unique and complex. This has been true throughout recorded history.

In the current investment background, where fear clouds reason and perspective is measured in hours and days, it is worthwhile to remember that the outlook is never all black or all white. We believe the following observations are pertinent in assessing the current situation:

1. *Important long-range trends have not been changed by recent events.*
2. *The bear market that began in 2000 is only the second longest of the post-World War II period. Due to strengthening economic fundamentals, it is more likely to end sooner rather than later.*
3. *The earnings and dividend progress of many high-quality companies, as well as their underlying fundamental characteristics, are intact and, in many cases, at record levels.*
4. *The appraisals of many superior stocks are now lower than their average level of the past decade.*
5. *We have recently had the worst succession of bad news we can recall, but the news seldom stays all good or all bad for long.*
6. *The stock market is always unpredictable and its major turning points almost invariably occur for reasons that are obvious only with hindsight.*

These points suggest that it would be foolish to think and act as if the sky were falling down. The fallacy of Chicken Little thinking becomes more evident when the facts are examined in greater detail.

Long-range Trends Have Not Changed

As we have noted in past Investment Letters, it is important to concentrate on what we know about the long-term future rather than get sidetracked by what is unknown about the near-term outlook. No one can accurately or consistently predict over the next few quarters what stock prices will do, which government policies will change, how much the GDP will rise or fall, or where the next big international crisis will occur.

However, there are some important longer-range trends that can be predicted with confidence. The renowned long-term growth investor, the late David L. Babson, noted over 40 years ago that some trends could be predicted with a fair degree of certainty. He christened these "the Predictables":

1. *The population, including those of working age, will continue to grow.*
2. *More people will need more goods and more services.*
3. *Research will develop new products and new techniques, and in the process will create higher demand, additional jobs and greater productivity.*
4. *The dollar's buying power will keep on shrinking.*
5. *Well-managed companies with favorable long-term investment characteristics will continue, as a group, to provide their shareholders with above-average progress in earnings and dividends.*

These trends receive practically no attention in the financial press. Yet, over time they have exerted a far greater impact on investment results than the “unpredictable” near-term outcomes on which Wall Street and the media focus.

Although the current situation seems uncertain, each of these five long-term “predictable” trends has not changed. Populations throughout the world will continue to grow and people will need increasing amounts of goods and services. Research and development will continue to create new products and new technologies and increase demand, jobs and productivity. Inflation will remain a potent force and, over the long haul, well-managed companies with superior investment characteristics will continue to turn in above-average progress in earnings and dividends.

In the financial markets, long-term trends remain intact as well. Some studies have analyzed over 200 years' worth of data on stocks, bonds, treasury bills, and inflation. It is worth noting that in the last 75 years alone we have seen the stock market crash of 1929, the Great Depression, the attack on Pearl Harbor, the Cuban Missile Crisis, the 1973 Arab Oil Embargo, the Gulf War, as well as the terrorist attacks of September 11th. Each of these was a major event that at the time created national anxiety and turmoil.

Of the various studies done on the financial markets, all have one thing in common: over the long run, stocks have significantly outperformed other types of investments. Since 1925, the compound annual return of stocks was more than twice the compound annual return of bonds. Looking at real returns over the last 200 years, the relationship is essentially the same -- stocks outperformed bonds by almost 2 times even when inflation is excluded.

Over the past few years, the bond market has surged while the stock market has had three consecutive years of decline. But past history indicates that four down years in a row is unlikely. In fact, since 1800, only two such periods have happened: from 1836 to 1839 and from 1929 to 1932. The underlying fundamentals of our economy, financial markets and banking system are far stronger than they were in either of these periods.

Earnings and Dividend Progress Remain Intact

Naturally everyone would rather see stock prices go up rather than down. But experienced investors know that the fundamental characteristics underlying a company are more important than its share price. As can be seen in the following table, the progress in earnings and dividend growth of many high-quality companies, such as the ones we have recommended over the years, remains strong even in these emotional and turbulent times:

Company	3-Year Compound Annual Change Through 2002		Operating Earnings Per Share*					S&P Ratings
	Earnings Per Share*	Dividends Per Share*	1999	2000	2001	2002	2003E	
	Abbott Labs	7.5%	11.7%	1.66	1.78	1.88	2.06	
Alberto-Culver 'B'	15.8	11.4	1.56	1.76	2.00	2.42	2.70	A+
American Int'l Group	7.4	11.4	2.18	2.43	2.80	2.70	3.85	A+
Amgen	11.6	nil	0.99	1.05	1.18	1.38	1.75	B+
Anheuser-Busch	14.3	8.9	1.47	1.69	1.89	2.20	2.45	A+
Automatic Data Proc.	14.3	15.3	1.20	1.40	1.62	1.79	1.85	A+
Cintas	10.7	18.5	1.06	1.24	1.34	1.44	1.55	A+
Cisco Systems	6.5	nil	0.43	0.64	0.21	0.52	0.60	B+
Coca-Cola	10.8	7.7	1.30	1.48	1.60	1.75	1.90	A-
Colgate-Palmolive	14.4	6.9	1.47	1.70	1.92	2.20	2.45	A
Home Depot	16.8	24.0	0.98	1.12	1.25	1.56	1.75	A+
Johnson & Johnson	15.0	13.3	1.49	1.70	1.91	2.27	2.60	A+
Linear Technology	-1.0	33.5	0.70	1.15	0.92	0.68	0.80	A
Medtronic	16.1	17.0	0.85	1.01	1.16	1.33	1.60	A-
Merck	8.6	8.6	2.45	2.90	3.14	3.14	3.40	A+
Microsoft	5.5	nil	0.80	0.89	0.93	0.94	1.00	B+
Paychex	21.5	34.7	0.43	0.62	0.73	0.77e	0.85	A+
Pfizer	22.3	18.8	0.87	1.02	1.31	1.59	1.80	A+
Starbucks	27.5	nil	0.29	0.38	0.49	0.60	0.70	B+
State Street	13.6	17.0	1.50	1.82	2.00	2.20	2.25	A+
Stryker	29.4	18.6	0.81	1.10	1.34	1.75	2.10	B+
Sysco Corp.	22.0	21.7	0.60	0.80	0.95	1.09	1.25	B+
Wal-Mart	12.5	16.4	1.25	1.39	1.49	1.78	2.00	A+
Walgreen	16.4	4.9	0.66	0.78	0.90	1.04e	1.20	A+
Wrigley, Wm.	10.2	6.5	1.33	1.45	1.61	1.78	1.95	A+
Average	14.0%	16.4%						
S&P 500	-2.2%	-1.2%	51.68	56.13	38.85	48.50	54.00	

*All figures are based on a December calendar year.

Sources: Standard & Poor's, Value-Line

One of the worst mistakes an investor can make is to assume that every change is permanent and to ignore long-term trends. Experienced investors know that over a period of years, the superior trends in earnings and dividend growth of high-quality companies will eventually be reflected in their share prices. Time, patience, a long-term point of view and a healthy attitude all contribute to investment success.