

# **The ABC Company**

## **First Quarter Portfolio Review**

### **April 2003**

Following three consecutive years of negative returns for the major stock indexes, most investors began 2003 anxiously hoping that the stock market's funk would clear. However, the reality of this year's market performance has been disappointing inasmuch as we have already experienced the worst bear market of our lifetimes without a major economic decline. Although stocks started to show some signs of life over the past three months, market performance was sharply split. During the first quarter, the S&P 500 index dropped 3.15% and the Russell 1000 Value index fell by 4.86%. Conversely, the tech-heavy Nasdaq Composite gained 5.66%. In many ways, the market in early 2003 was reminiscent of 1990, when Iraq's invasion of Kuwait set off another major conflict in the desert sands. Then, as now, bonds and large-growth stocks topped the performance charts as investors grappled with an uncertain market and difficult economic conditions.

Corporate earnings still haven't shown a convincing recovery, but there haven't been any revelations of shocking corporate malfeasance on the order of WorldCom or Enron. In the absence of major psychological traumas, investors have had to contend with pervasive news of geopolitical and economic uncertainty. Given the pain most investors have endured over the past few years and the lingering uncertainty about the future, we continue to depend upon investment basics.

The first three months of the year continued to be difficult and volatile, but we had a very strong quarter -- significantly outperforming our benchmarks. Our screens are indicating that stocks that performed relatively well in an environment of slow economic growth, low interest rates and inflation, higher unemployment and energy costs, may not be the same leaders going forward. During the first quarter, our quantitative review of 34 fundamental factors across our universe of stocks identified several "teltech" companies selling below their intrinsic value. Our solid fundamental research and the identification of abnormal stock trading patterns are proven ingredients in identifying attractive investment opportunities for your portfolio. This combination provides us with the ability to select good companies that are about to become good stocks.

In the following pages, we present an analysis of your portfolio at the end of March 2003 and a review of and outlook for financial markets and the economy. The following sections are included:

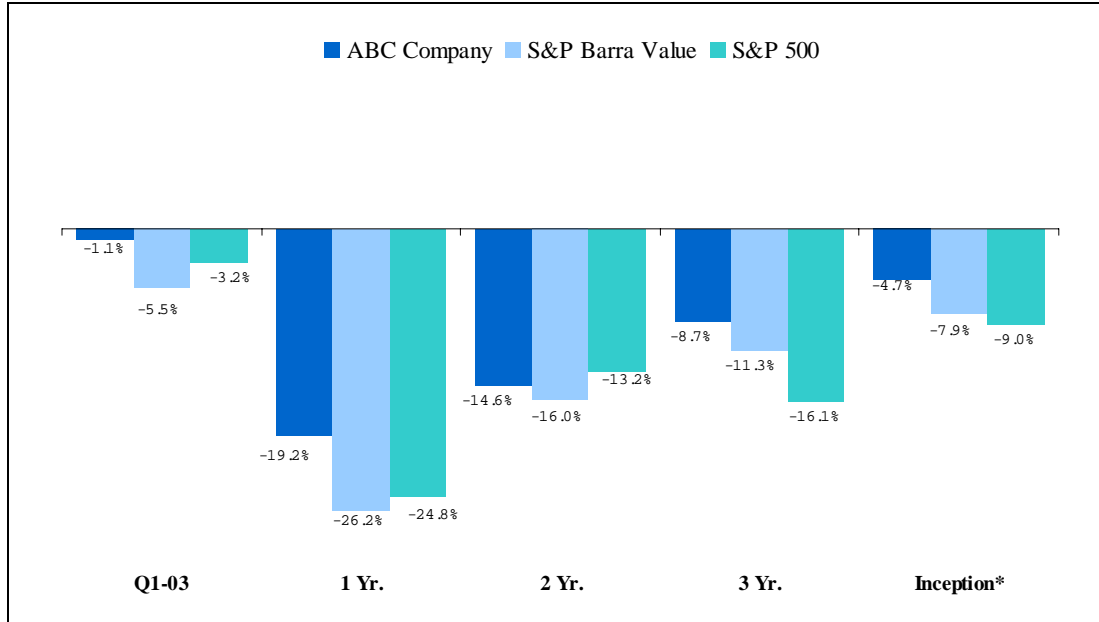
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Thank you for your continued support and confidence in Marquee Millennium Capital Management.

Wilfred J. Meckel  
*Senior Managing Director*

Kenneth J. Garvey  
*Managing Director*

**Section 1: Performance History  
for the periods ended March 31, 2003**



\* Annualized since June 1, 1999

At the end of the first quarter, the ABC Company portfolio declined 1.1% compared to losses of 5.5% and 3.2% for the S&P Barra Value index and the S&P 500 index, respectively. During the quarter, stocks that contributed to positive returns were primarily in the healthcare industry. Laboratory Corp. of America benefited from resumed investor confidence after the company clarified that Q4 results were both company-specific and being resolved acceptably. Relative to its earnings per share and revenue growth rates exceeding 20% for 2003, the stock is still undervalued. Aetna ended a much-improved year with fourth quarter 2002 earnings easily surpassing expectations by a large margin. In fact, the company was able to surpass expectations in every quarter of 2002. The company plans to continue its winning ways in 2003. Conversely, King Pharmaceuticals was a drag on returns due to uncertainty over the company's proposed acquisition of Elan Corporation. In April, King determined not to proceed due to various breaches and misrepresentations on the part of Elan. Black & Decker did poorly because of weak performance from the critical HD channel, slowdown in home renovation and weak holiday sales. The ABC Company portfolio outperformed the S&P Barra Value index by 7% and the S&P 500 index by 5.6% for the one year ended March 2003. Since inception in June of 1999, the portfolio has had an annualized loss of 4.7% compared to annualized losses of 7.9% and 9.0% for the S&P Barra Value index and the S&P 500 index, respectively.

**Section 2: Contributors to Returns during the First Quarter 2003**

Laboratory Corp. of America	+0.93%
Aetna Incorporated	+0.39%
Burlington Resources	+0.36%
Barr Labs	+0.34%
Kinder Morgan	+0.19%
King Pharmaceuticals	-0.53%
Black & Decker	-0.41%
MBIA	-0.36%
Freddie Mac	-0.29%
Dell Corporation	-0.28%

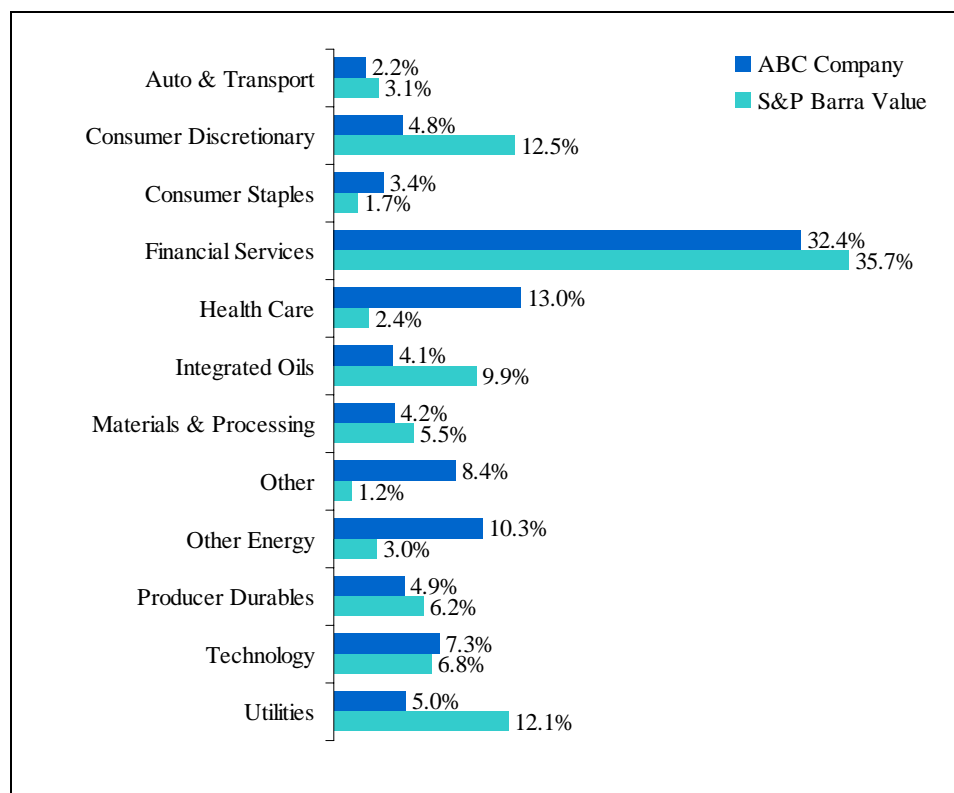
### Section 3: Portfolio Characteristics as of March 31, 2003

	<u>ABC Company</u>	<u>S&amp;P Barra Value</u>
Number of Holdings	46	350
Weighted Average Market Cap.	\$39 billion	\$49 billion
Ten Largest Holdings (as % of portfolio)	33%	29%
P/E Ratio	14.9x	15.1x
Price/Book Ratio	2.1x	1.6x
Dividend Yield	1.5%	2.4%
Largest Cap Holding	\$273 billion	\$235 billion
Smallest Cap Holding	\$3 billion	\$185 million

The number of holdings in the ABC Company portfolio was 46, up from 44 at the beginning of the year. The portfolio had a weighted average market capitalization of \$39 billion, down from \$40 billion in the prior period. The portfolio had an average P/E ratio of 14.9x, down from 16.5x, with a price-to-book ratio of 2.1x and a dividend yield of 1.5%. The portfolio's sector weightings outlined below are not the result of a top-down decision but are a by-product of our stock selection process. The largest deviations from the S&P Barra Value index are:

- 1) **Overweight: Healthcare.** We continue to identify undervalued opportunities within the healthcare industry. Pharmaceutical companies and health maintenance organizations continue to have attractive valuations and upside potential.
- 2) **Underweight: Consumer Discretionary.** We have not identified many undervalued opportunities in the consumer discretionary sector. The consumer has propped up economic growth for the last several years, a trend that is likely unsustainable. Uncertainty surrounding Operation Iraqi Freedom and the long-term costs related to war continue to weigh on the consumer picture.

### Section 4: Sector Weighting Analysis as of March 31, 2003



### Section 5: Key Holdings in Portfolio as of March 31, 2003

Laboratory Corp. of America	Second largest independent clinical laboratory; cost efficient leader of industry consolidation trend; increasing growth and profitability from higher margin specialized test capabilities; attractive valuation versus expected earnings growth rate.
Pepsico	Leading consumer staples company; major brands include Pepsi-Cola, Frito-Lay, Quaker Oats, Gatorade and Tropicana; rising sales across all product areas from strengthened distribution systems and addition of new products; gaining market share from Coca-Cola; effective move into non-carbonated beverages.
Burlington Resources	Natural gas-leveraged, predominantly onshore exploration and production company; predictable reserves and lower production costs provide competitive advantage during expected increase in natural gas prices; attractive valuation versus estimated reserves.
Greenpoint Financial	Combines large metropolitan thrift franchise (New York City) with leading national specialty housing finance business; attractive valuation versus peers despite recent price appreciation; sale of manufactured housing loan portfolio strengthens balance sheet for stock repurchases; expected to benefit from consolidating NYC banking market.
Prudential	Leading financial service provider including life insurance, investment management and employee benefits programs; attractive valuation versus peers; improving return on equity; active share repurchase program.

### Section 6: Focus Stock -- Darden Restaurants, Inc. (NYSE: DRI)

**Sector:** Consumer Discretionary

**Industry:** Restaurants

**P/E Ratio (2002 Actual):** 14.0x

**P/E Ratio (2003 Expected):** 13.0x

**P/E Ratio (2004 Expected):** 11.3x

**Price:** \$18 (as of 4/11/03)

**Price/Book Ratio:** 2.5x

**Price/Sales Ratio:** 0.7x

**Dividend Yield:** 0.5%

**Market Capitalization:** \$3.3 billion

#### Description and Introduction

Darden Restaurants is the #1 casual dining restaurant operator in the world. The company owns and operates over 600 Red Lobster seafood restaurants, close to 500 Olive Garden Italian restaurants, as well as units in two emerging concepts, Bahama Breeze (Caribbean theme) and Smokey Bones (BBQ and Sports bar). The company owns its facilities and operates across the US, with a small presence in Canada.

DRI dates back to the 1960's when Bill Darden opened a Red Lobster in Lakeland, Florida. General Mills bought the chain in 1970, added the Olive Garden concept, and expanded both brands with great success. In 1995, General Mills decided to refocus on its packaged foods business and spun off the restaurant business as an independent entity. Since then, Darden has been a public company and grown its two primary brands while adding those mentioned above.

#### Investment Thesis

During the 1990's, DRI exhibited rapid growth – earnings have grown at more than 16% per year since the company has been public, with an acceleration in the last 5 years. Return on equity has increased to more than 20% and cash generation has been high, financing expansion as well as significant share repurchase. The stock

peaked in early 2002 at close to \$30 after a period of very strong same store sales. Slowing sales (to single digits) and an expected slower pace in earnings (from +22% to +7%) caused the stock to decline during 2002, and reach a price close to its current level.

It was at this stage that DRI began to appear on our screens – both fundamental and technical. The data pointed to an issue that had significant opportunity. A leader in its field that was being punished for seemingly transient problems was selling at a bargain price. On further analysis, we concluded that the company was being penalized for the effects of the overall economy, a pending war, and bad weather in its primary geographical area. We concluded that the underlying success of the company was not impaired and the basic thrust of the investment thesis was intact. Darden had done a superb job of generating unit sales in the past, and should do so again. Demographic factors (population, age and income), and eating out trends are favorable. DRI has been successful in pulling traffic through effective advertising and promotion – we expect this success will continue. Opportunity for continued expansion is there – both for the primary brands as well as the newer concepts. The ability to finance this growth is also there with a high level of profitability and a strong balance sheet.

Our analysis concluded that this was indeed a compelling opportunity. The valuation work corroborated this conclusion. The fundamental screens showed a significant under valuation, and our cash flow discount model did the same. Finally, a comparison of DRI with its peers indicated below average absolute and relative PE metrics.

### **Conclusion**

Our expectation is that DRI will regain its favorable comp store trend (the March report was positive) and that the multiple can reach its old level in the mid-to-high teens and our price target of 23 in a 12-24 month time-frame.

## **Review of and Outlook for Financial Markets and the Economy**

Financial markets around the world were subjected to rising uncertainty as “coalition” forces moved closer to an invasion of Iraq. The outcome of the war was never in doubt, however the failure of the United Nations to resolve the conflict coupled with various world powers choosing sides put pressure on equity markets. Skyrocketing oil and gas prices depressed consumer confidence and the inability to pass a badly needed economic stimulus package added up to another weak quarter for the stock market.

After a better than expected 8% bounce in the S&P 500 index during the fourth quarter, this broad measure of stock market performance fell 3% in the first quarter of 2003. The Russell 1000 Value index, fell almost 5% during the first quarter after a solid 9% gain in the fourth quarter. Considering the extent of global tension during the first quarter, the stock market didn't give up as much ground as would have been expected.

Fortunately for staunch stock market investors, stimulative government policies remain in effect. The Federal Reserve has continued to encourage an economic rebound by maintaining a low interest rate policy, holding the Fed funds rate at 1.25%. These low interest rates are not good news for fixed income investors, however they are designed to get the economy growing again. Easy monetary and fiscal policy, as espoused in president Bush's proposed economic stimulus package, provides the underpinning for a solid economic rebound. One drawback is that fiscally conservative politicians oppose the sizeable tax cut characterizing the president's budget proposal. As a result, the Senate has moved toward limiting the size of the fiscal stimulus package. History suggests that budget deficits on the order of 5% of GDP are necessary to get the economy back on solid footing. On a trillion dollar economy that means a budget deficit of at least \$500 billion. The stock market's wobbly performance of late testifies to the reality that it will take more than peace in the Mid-East to accelerate consumer confidence and get the stock market back on a sustainable up-trend.

As concern over the Iraqi conflict winds down, the severe acute respiratory syndrome (SARS) threatens to grow to pandemic proportions. Rapidly spreading around the world but particularly dangerous in the Far East, this

disease has slowed world commerce dramatically due to individual fears of contracting this extremely contagious illness that has no known antidote. Airlines have been particularly hard hit—again—as travelers in both business and economy class postpone travel abroad. Cruise ships are struggling as well with no sign of a solution. Until there is some reliable method of containment that will truncate the spread of this disease, global economic activity will be penalized. As a result, economists are revising lower their expectations for economic growth in the second quarter of 2003 after what is expected to be a sub par 2% real growth rate for the first quarter of this year.

In the final analysis, money is made or lost on a stock-by-stock basis. In this realm, earnings per share make or break stock prices. Investors continue to seek out those companies that have a reasonable chance of equaling or beating earnings estimates by Wall Street analysts. If a company can stay on the good side of Wall Street, stock price appreciation is quite likely even though the general market may be slithering sideways. On the other hand, companies that disappoint Wall Street can experience investor wrath with severe declines in the price of their stock. Good fundamental research and reliable earnings are key for successful stock selection.

Over the coming months we expect to see continued government stimulus to get the economy back on a solid growth path. Corporate earnings appear to have turned up as early as the first quarter of 2002 and sustainability of earnings' improvements will lay the groundwork for a general stock market advance. Some economists who use valuation models for the stock market based on earnings and interest rates are now saying that the market is at least 40% undervalued. Historically, such levels of under valuation have proven to be an opportune to be invested in stocks. We remain confident that government policies can get the economy back on a growth track and improving stock prices should follow right along.