

# **The ABC Company**

## **Fourth Quarter Portfolio Review February 2003**

The major equity indices ended up for the fourth quarter, though they finished down substantially for the year. For the quarter, the Dow gained 9.9%; the S&P 500 was up 7.9%; and the Nasdaq rose 13.9%. The fourth quarter rally, touted by many as the long awaited turnaround, was as deceptive as it was dramatic. This rally was led by a rebound in the beaten down technology and telecommunications sectors. Sentiment dominated as investors reacted to excessively pessimistic stock price levels that led many to believe that low prices actually represented good value. Although many low priced stocks in the broad indices actually moved up over forty percent from October 9<sup>th</sup> through the end of November, there were missing ingredients – a return of strong revenue and earnings growth. Earnings in the fourth quarter for the technology sector, broadly speaking, indicate a bottoming in capital spending, a slight but less than normal pickup in year-end activity, but not yet clear signs of a return to both sequential and year-over-year fundamental growth. We do, however, think the ingredients for stronger capital spending by U.S. corporations in 2003 are in place.

As we stated in the third quarter portfolio review, we are nearing the end of the collapse in technology and telecommunications and entering the rebuilding phase. Our quantitative review of 34 fundamental factors across the universe of stocks we follow indicates an increasing number of stocks selling below their intrinsic value. In addition, many of these stocks are behaving abnormally, telling us that the recent declines are not likely to continue for much longer. All of this evidence points to the cause of the market malaise to be founded more in investors' concerns about global issues rather than disappointing developments in individual companies. Our investment philosophy that can produce attractive returns and low risk through the design of a well-diversified portfolio of under-valued, large capitalization common stocks has stood the test of time during the 2000-02 bear market. We believe solid fundamental research and the identification of abnormal stock trading patterns is necessary to identify attractive investment opportunities. This combination of fundamental and technical analysis provides insight into picking good companies that are about to become good stocks. Our work has caused us to reposition your portfolio to participate in the upswing that should come when the attention of investors focuses on company-specific factors that influence the perception of value in more globally stable times.

In the following pages, we present an analysis of your portfolio at the end of 2002 and a review of and outlook for financial markets and the economy. The following sections are included:

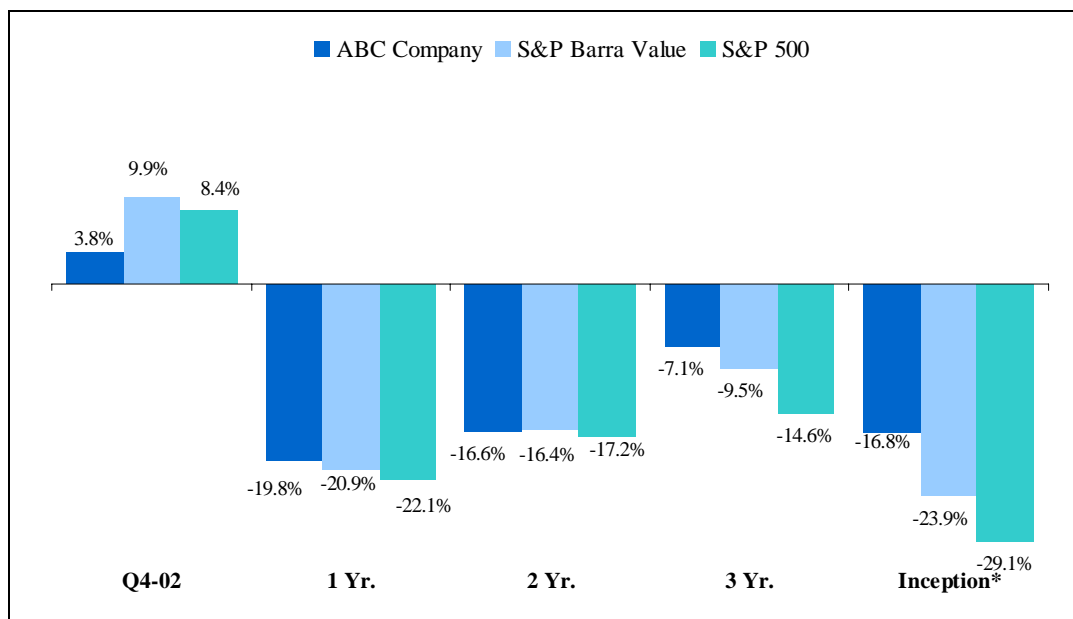
1. Performance History
2. Portfolio Sector Allocations
3. Contributors to Returns
4. Review of Largest Holdings
5. Portfolio Characteristics
6. Focus Stock

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

Wilfred J. Meckel  
*Senior Managing Director*

Kenneth J. Garvey  
*Managing Director*

## Section 1: Performance History for the periods ended December 31, 2002



\* Cumulative since June 1999

The ABC Company portfolio gained 3.8% during the fourth quarter's "rubbish rally", underperforming both the S&P 500 and the S&P Barra Value indices due to lack of exposure to teltech stocks. During the quarter, stocks that contributed to positive returns in the portfolio were a mixed bag as investors struggled with continued uncertainty and geopolitical risk. Citigroup bounced back from its lows on the company's announcement that it would take a charge toward the anticipated cost of resolving regulatory inquiries and associated litigation. Aetna reported earnings ahead of predictions marking three consecutive quarters of positive earnings surprises. The company continues taking the steps necessary to further reduce medical cost trends to competitive levels, while offering innovative products, expanding distribution capabilities and maintaining its focus on delivering superior customer service. Conversely, Northrop Grumman was a drag on returns during the quarter as a pending acquisition of TRW and subsequent resale of the automotive parts business weighed on the stock. The ABC Company portfolio finished out 2002 with a loss of 19.8% compared to losses of 20.9% and 22.1% for the S&P Barra Value index and the S&P 500 index, respectively. During the 2000-2002 bear market the NYCERS portfolio has had an annualized decline of 7.1%, compared to annualized losses of 9.5% for the S&P Barra Value index and 14.6% for the broader S&P 500 index. Since inception in June of 1999, the portfolio has outperformed the benchmark S&P Barra Value index by more than 7%.

## Section 2: Contributors to Returns during the Fourth Quarter 2002

Citigroup Inc	+0.51%
Aetna Incorporated	+0.48%
Kinder Morgan Inc	+0.47%
Pepsico	+0.46%
Int'l. Business Machines	+0.42%
<hr/>	
Northrop Grumman Corp.	-0.99%
Laboratory Corp. of America	-0.81%
SPX Corp.	-0.65%
Guidant Corporation	-0.39%
Sun Microsystems	-0.24%

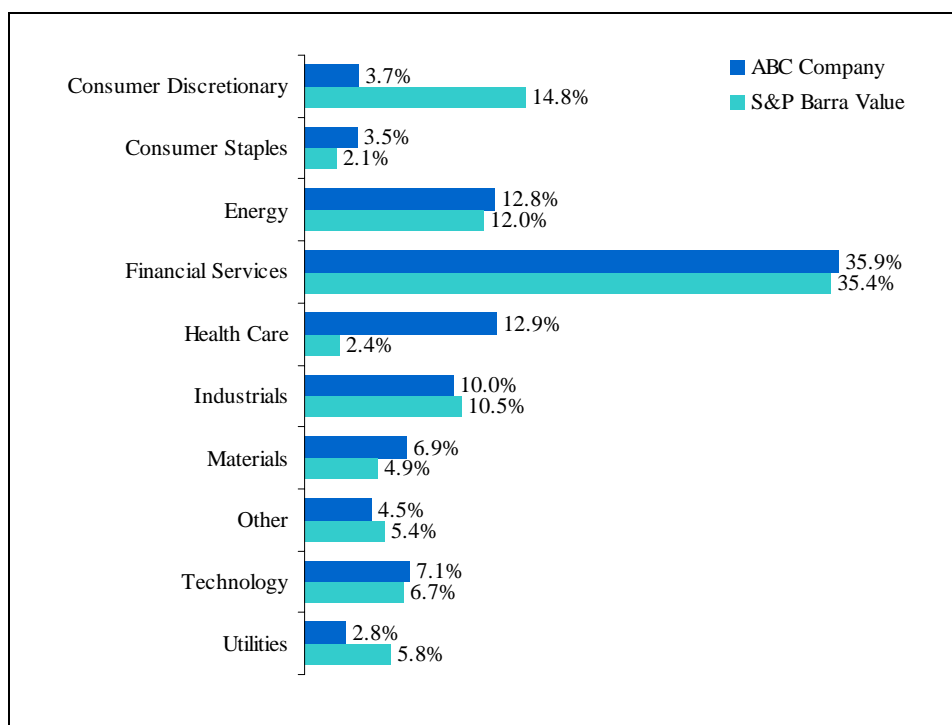
### Section 3: Portfolio Characteristics as of December 31, 2002

	<u>Methodists Balanced</u>	<u>S&amp;P Barra Value</u>
Number of Holdings	44	352
Weighted Average Market Cap.	\$40 billion	\$51 billion
Ten Largest Holdings (as % of portfolio)	33%	29%
P/E Ratio	16.5x	16.1x
Price/Book Ratio	2.0x	1.7x
Dividend Yield	1.5%	2.4%
Largest Cap Holding	\$226 billion	\$235 billion
Smallest Cap Holding	\$3 billion	\$279 million

At the end of 2002, the number of holdings in the ABC Company portfolio was 44 with a weighted average market capitalization of \$40 billion, up from \$38 billion in the prior period. The portfolio had an average P/E ratio of 16.5x, down from 17.8x, with a price-to-book ratio of 2.0x 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.** Primarily guided by pharmaceuticals, this sector generally tracked the overall market in 2002. We expect select subcomponents to outperform in 2003 - namely managed care giants such as Wellpoint Health Networks. Within the pharmaceutical sector, our top ranked stock is presently Pfizer.
- 2) **Underweight: Consumer Discretionary.** While the consumer has carried the economy for 2001 and 2002 at the expense of corporations, we don't expect this sector to continue to outperform. Tensions with Iraq and rising oil prices will likely put spending on hold and result in a decreased rate of spending overall for 2003. Our stock selection process has not identified any "value" opportunities in this sector.

### Section 4: Sector Weighting Analysis as of December 31, 2002



## Section 5: Key Holdings in Portfolio as of December 31, 2002

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.
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.
Prudential Financial	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.
Aetna Incorporated	Successful restructuring by leading health care provider with dominant market position; recent targeted membership losses, premium increases and expense reductions in health care segment indicate successful revision of business strategy; increasing cash flow from operations; expect significant EDITDA increases in 2003 and 2004.
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.

## Section 6: Focus Stock

### Laboratory Corporation of America (NYSE:LH)

**Sector:** Health Care

**Industry:** Health Care Facilities

**P/E Ratio (2001 Actual):** 18.8x

**P/E Ratio (2002 Expected):** 13.7x

**P/E Ratio (2003 Expected):** 11.4x

**Price:** \$25 (as of 1/30/03)

**Price/Book Ratio:** 2.3x

**Price/Sales Ratio:** 1.5x

**Dividend Yield:** nil

**Market Capitalization:** \$3.7 billion

### Description and Introduction

Laboratory Corporation of America (Lab Corp), based in Burlington, North Carolina, is the nation's second largest clinical laboratory company with expected revenues in 2003 greater than \$3 billion. The company offers over 4000 clinical tests and performs diagnostic procedures on specimens from approximately 300,000 patients each day. Lab Corp's services more than 200,000 clients nationwide including physicians, managed care organizations, hospitals pharmaceutical and biotechnology firms, other clinical laboratories and many Fortune 1000 companies.

Applications include HIV/AIDS and Hepatitis C diagnosis and monitoring, oncology and genetics. The company is also strong in clinical trials testing related to new drug development.

## **Investment Thesis**

Quantitative: As “growth by acquisition” is no longer a driver of Lab Corp’s business model, the company’s institutional ownership is transitioning from “growth” style managers to the “value” and “GARP” strategies. We believe the stock is forming a base as the new buyers gradually acquire the sellers’ positions.

Once the growth-oriented (former) owners have moved on, we believe the stock will be poised to clear the base and move higher as the company delivers on the earnings growth it expects for 2003 and beyond.

Fundamental: Lab Corp is well positioned to benefit from its significant position in a fundamentally attractive industry. With virtually all of the meaningful consolidation opportunities already executed, acquisition and consolidation are no longer able to drive a 25+% earnings growth rate. However, the clinical laboratory testing business’ organic growth potential still benefits from improving capacity utilization, acceptable pricing power and growing demand for both traditional and specialized testing services due to demographics and other dynamics.

As the #2 player in the industry, Lab Corp is leveraged to these positive factors plus certain company-specific attributes that include: margin leverage from a 20+% growth rate in the company’s traditional leadership area of specialized genomic and esoteric testing, attractive and growing free cash flow, leadership in developing/partnering new testing technology, improving bad debt expense trends and synergies from completed acquisitions.

Management guidance for 2003 indicates a revenue growth rate of 5%-8% and increased earnings by 20% over 2002 without the benefit of potential share repurchases (\$150 million authorized). Both management and much of Wall Street also believe that any shortfalls in testing volume during 2002 were company-specific operating problems and not indicative of fundamental industry trends. Lab Corp is confident that they have taken the necessary steps to address those issues and that the added cost of doing so is fully reflected in the 2003 guidance.

The company is committed to using free cash flow in 2003 and 2004 for acquisition-related debt repayment, stock repurchases and developing more partnerships with other diagnostic testing manufacturers. Any acquisitions are expected to be “bolt on” and modest in size.

Valuation: Lab Corp’s current valuation at less than 14x expected 2002 earnings and under 12x expected 2003 profits is, in our view, extraordinarily attractive compared to the fundamental strengths and growth prospects of both the company and the industry in which it competes. In our view, the sell-off in the stock following the company’s disclosure of operating problems in a key market was overdone insofar as the lower revenue impacted the income statement when productivity metrics were at their most vulnerable due to the recent inclusion of a large recent acquisition (Dynacare) in the latest financial results.

We expect that Lab Corp will, at a minimum, trade at a “market multiple” to expected earnings (currently 15-16x) that is consistent with the long term earnings growth rate of 12%-15% that we believe is a realistic, and even conservative, sustainable expectation.

## **Conclusion**

As of December 30, 2002, we believed that Laboratory Corporation of America, at approximately \$25 per share, offered a potential 50+% upside opportunity in the next 12-18 months to around \$38. Accordingly, we are comfortable maintaining the stock’s current weighting as one of the portfolio’s 5 largest holdings in front of the company’s 4th quarter earnings release scheduled for mid-February.

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

The 2002 national elections produced a surprising victory for republican candidates and, as a result, majorities of republicans in both houses of Congress gave President Bush the opportunity to move forward in prosecuting the war on terrorism and providing additional stimulus to the economy. As a result of renewed optimism for the prospect of tax cuts and increased government spending, the stock market, as measured by the S&P 500, rose 8.4% in the fourth quarter and the NASDAQ, a better proxy for technology stocks, rising an impressive 13.9%.

Early in the first quarter of 2003, President Bush unveiled his second program of tax cuts and spending increases to stimulate economic growth. The centerpiece of his program was the exemption of dividends from taxation—a needed impetus for the stock market that continued to wallow in a three-year bear market. Unfortunately, the combination of increasing controversy over this aspect of the president's proposal, the escalation of the war plans for invading Iraq and the disappointing earnings reports of selected major corporations has contributed to further weakness in the stock market.

Other factors impacting the stock market are the reality that the consumer, who has kept the economy out of recession, is showing signs of fatigue. After reaping the benefits of low interest rates in buying cars and refinancing homes, there aren't many other places to go to increase overall consumer spending. As a result we have witnessed continued declines in measures of consumer confidence even though inflation and interest rates remain near record lows. The problem could be that corporations' efforts to increase profitability ultimately has a negative impact on consumers who see increasing layoffs as predictor of future economic problems.

Political and financial instability in South America also has far reaching effects. The crisis in Argentina continues, as does weakness in Brazil in the aftermath of national elections. Far more important for U.S. energy consumers is the political turmoil in Venezuela where strikes have virtually shut off oil shipments from that country to the U.S. As a result, the price of oil and gasoline has risen steadily over the past three months. These problems do not seem close to a solution so that energy prices may continue to influence consumer attitudes.

While these temporary factors are causing continued uncertainty in equity markets, we view them as temporary. Of more importance are government policies committed to stimulating renewed economic growth:

- The Federal Reserve cut the Fed funds rate target by 50 basis points in November of 2002, taking it to a 40-year low of 1.25%. The Fed said it has further room to ease if the economy does not respond. Historically easier Fed policy has been a predictor of strong stock market advances.
- A rising budget deficit is an indicator of real federal stimulus. When the government spends more than it takes in, it is likely that economic activity will expand. From a large surplus in 2000, the Federal government is now running deficits of over \$150 billion and is likely to get much larger. Since business spending is still lagging and the consumer may be weakening, the government must increase spending to avoid a double dip recession.
- Inflation remains low. Recent reports of the producer price index and the consumer price index reflect an inflation rate of less than 1%--very low by historic standards.
- Corporate profitability is improving due to rising productivity and cost cutting efforts. The bursting of the technology bubble has not worked its way fully through the economy so many of the tech stocks continue to languish, as profitability for many of these companies remains elusive. Forecasts of earnings growth for the balance of this year predict a steadily improving profits picture.

As we make our way through 2003, we expect that the Iraq situation will be resolved, removing one weight contributing to stock market volatility. The finalization of the president's stimulus package will add more resources to the economy and should perk up the consumer as the rebates did in 2001. Commitments by corporate management to improved profitability should be reflected in improving earnings of these companies. Not all companies will be able to produce such gains. Therefore investment selection will be a key factor in adding value to portfolios in 2003.