AAM AUXIER•ASSET MANAGEMENT LLC

Auxier REPORT

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Overview

The corrective, healing process continues as corporations worldwide have been redirecting capital spending into balance sheet repair. This has recently led to superior returns in the corporate bond area. Interest rate spreads on distressed debt, versus treasuries, have narrowed dramatically from the peak 20-year spreads reached in October 2002. First quarter global debt defaults fell from 8.3% to 6.7%. The 17% decline was the largest since 1992 (MERRILL LYNCH). In March, the US high yield distressed ratio fell from 23.3% to 18% - the biggest one-month decline since December 1991. Good value exists in senior corporate debt as most loan covenants favor the senior lenders in tough economic times. Additionally, we have found attractive bonds in Canada (e.g. Canadian Hydros) as the US dollar continues to decline and rates have been increasing from a stronger economy.

Areas of Misperceived Risk

It appears that US government bonds have a high degree of interest rate risk, barring further economic deterioration. Conventional does not mean conservative. A 30-year Treasury bond purchased at current levels could decline over 30% if interest rates were to rise by three percentage points. A 15% loss would result if rates rose just one point. The volatility in the bond market has been very high and investors need to quantify the risk at this time. US government deficits could reach $400 billion this year, leading to new record bond issuance. The US dollar continues its slide, adding to foreign investor losses while boosting domestic price pressures. This quarter, the Employment Cost Index showed the largest increase in 14 years. The Consumer Price Index is still 3% higher than it was a year ago. Modern day governments don't go broke, they print money.

Housing is another area where the belief is that house prices only go up. The International Monetary Fund recently highlighted the risk of housing bubbles, which over 40% of the time actually lead to crashes. In many parts of the country we are seeing record house price-to-income ratios.

Currently, people are running scared over Severe Acute Respiratory Syndrome (SARS). To put it in perspective, over 30,000 people a year die from influenza in the United States.

On terrorist threats, fewer people have died in armed conflict over the past fifty years than in any fifty-year period in recorded history.

The technology component of the market still trades at price-earnings ratios in excess of 30 times if stock options are properly expensed. In the 25 years leading up to 1999, the technology component typically traded at a market valuation closely tied to the earnings percentage. Today, tech earnings account for about 7% of the S&P earnings while they make up over 15% of the index.

Overlooked positives
The Supreme Court has capped punitive damage awards. A major asbestos settlement is in the works as well. Tort reform is desperately needed and these are encouraging signs.

Corporations have been relentlessly cutting costs the last three years. If sales pick up, earnings could show strong leverage.

Once the last Gulf War was concluded in 1991, the general market did not have a meaningful correction from January 17, 1991 through January 16, 1992. This despite the thrift crisis, a severe junk bond decline and record oil prices. That year oil ended up dropping from the high 30s to the low teens. This acted like a major tax cut. The junk bond market rallied over 35%. Today, we have the utility, telecom, advertising, travel and airline sectors (to name a few) in deep recessions. Oil prices are starting to drop and the corporate bond market is starting to improve. Already, Iraq is projected to produce 800,000 barrels a month and has the potential of being the second largest global producer of oil outside of Saudi Arabia.

Attractive areas
Senior debt continues to benefit from balance sheet restructuring.

The pricing environment for the insurance industry is the best since the mid-1980s (Travelers, Berkshire Hathaway).

Processor companies are out of favor but are attractive due to their predictable nature and recurring revenues. Many of these companies are selling at multiyear low valuations (e.g. Concord EFS, First Data, Efunds, Automatic Data). A side note, Concord EFS, the largest producer of debit cards is being acquired by First Data for roughly $14 per share in First Data stock.

The utility industry is suffering from a crisis similar to the thrift crisis in the early 90s. The weight of $800 billion in borrowed money has created opportunities as companies are forced to take drastic measures to the benefit of the senior creditors. Debt forced sales can create compelling bargains.

The drug industry and hospital chains trade at steep discounts in valuation despite powerful marketing strengths and strong demographic trends (IMS Health, Pfizer, Guidant, Baxter).

Many smaller to mid-sized companies are under followed by analysts due to the cutbacks by brokerage firms, increasing the odds of mispricing.

The Ideal Investment
We are constantly looking for the exceptionally well managed business with sustainable earnings power selling at a large discount to underlying value. We like it when the risk of loss is low. Strong defensive characteristics together with improving fundamentals are optimal. We stand

ready to act when a major opportunity occurs in the form of a material misappraisal by the market.

Time for rational thought and homework on individual securities
Most of the stocks I thought were cheap at year-end dropped further in the first quarter. December 2002 was the market's worst December since 1931. Last year marked the worst market decline since 1974, with the S&P off over 45% from highs set in 2000. Many European markets suffered even greater declines. Add a weak first quarter and many individual stocks are being washed out. A number of industries are in downturns with stocks trading at steep recession lows. In the 1990s we benefited tremendously by buying into the low prices for banks resulting from the thrift crisis. As an example, Freddie Mac dropped from over $100 a share to $32, and then rallied back to a price in excess of $200 within 4 years. Recessions and gloom help to provide the bargain price levels needed to make the investment process rewarding.

In closing I have included condensed excerpts from Roger Lowenstein's book, <u>Buffett: The Making of an American Capitalist</u>. "With Iraq's seizure of Kuwait, in August 1990, the 'credit crunch' snowballed into a full-blown recession. Corporate bankruptcies and junk bond defaults lit up the map. Banks, just reborn from the foreign debt crisis, found they were up to their ears in homegrown deadbeats, such as LBOs and commercial real estate. A contagion of bank failures moved like a storm front from Texas to Colorado, New England and the Mid-Atlantic States. Serious people gathered at investment seminars and discussed whether Citicorp or Chase Manhattan would fail. Berkshire stock had collapsed with the rest and was 40% off its peak. But it was at such times that Buffett was his best . . . when the world turned gloomy, his instinct was deadly."

"During 1990 - the worst year for banking since the Great Depression - Buffett bought 10% of the stock of Wells Fargo. California real estate was just beginning to turn down; the misery of the banks was expected to be deep and long-lived…"

Those shares of Wells Fargo purchased for less than six dollars each (adjusted for subsequent splits) are today worth $47. The point is, industry recessions should be viewed as a time to go shopping.

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