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## "WHAT'S GOING ON?"

I am a child of the late 60's and early 70's. One of my favorite singers was Marvin Gaye. To borrow a famous line from one of his songs, in light of the Enron debacle and related matters, I'm obliged to ask "What's going on?"

**Item:** The *Wall Street Journal* reports, "Brokers Get Extra Incentive to Push Funds." The *WSJ* disclosed recently that the brokerage firm A.G. Edwards & Sons has been paying its brokers an extra commission to sell certain mutual funds including Eaton Vance, Evergreen, MFS Investments and Oppenheimer. Customers are generally not told about these added commissions. Morningstar reports that this "induces brokers to sell products they ordinarily wouldn't sell."

**Item:** Bond analyst, Daniel Scotto of BMP Paribas, a French securities firm, tells his clients this past August 23<sup>rd</sup> that Enron's securities "should be sold at all costs and sold now." This warning came just two weeks after Jeffrey Skilling suddenly quit as CEO of Enron and several months before the bankruptcy filing of December 2. Enron expressed its displeasure. The result? Scotto is forced to resign.

**Item:** A fierce debate takes place between two Arthur Andersen partners dealing with the proper method to deal with Enron's accounting practices. David Duncan, the lead partner for Anderson on the Enron account favored the now discredited aggressive accounting approach. Carl Bass of Anderson's professional standards group supported the traditional accounting approach. Result: Mr. Bass is moved off of the Enron account in March 2001 largely, reports *U.S.A. Today*, because of his "reluctance to approve many of Enron's most aggressive accounting maneuvers."

**Item:** A stock analyst writes an internal e-mail warning "There really is no floor to [this] stock." The stock, Internet Capital Group, once sold for \$200 a share.

It now trades for pennies a share. Unfortunately, investors never heard that candid assessment. Instead, they received the very same analyst's reports urging investors to buy, buy, buy.

**Item:** Former partner, David B. Duncan of Arthur Andersen, pleads guilty to obstruction of justice admitting that he orchestrated the wholesale destruction of documents in the Enron matter. Mr. Duncan's effort was a widespread and coordinated one in which shredding machines burned out and employees worked overtime to beat the clock before an SEC subpoena arrived.

**Item:** It appears that the advice to deliberately destroy that evidence was given by Nancy Temple, an attorney in the firm's Chicago office.

**Item:** Mutual funds must "pay-to-play." *Business Week* reports on this "Dirty Little Secret." Some brokerage houses insist that mutual fund companies pay as much as \$500,000 to \$1 million in order to be listed as a possible purchase option for retail clients. *Business Week* reports that a national St. Louis-based brokerage fund permits its 7,500 branches to sell 180 mutual fund families. Yet only 7 families, including American Funds and Putnam, are on the preferred list. Guess how much business those 7 funds get? Can you say 97%? The cost to the investing public is estimated at 0.4% of every dollar invested - a whopping total of \$1.5 billion!

**Item:** The *Wall Street Journal* reports that Salomon Smith Barney star telecom analyst, Jack Grubman, is hopelessly conflicted. "Few analysts embody the conflict between analytical objectivity and cheerleading more than Mr. Grubman," they write, referring to his aggressive buy recommendations for companies such as WorldCom, Qwest Communications and Global Crossing. Just little more than 1 year ago, on March 15<sup>th</sup>, 2001, Mr. Grubman recommended the purchase of these stocks. Through the end of this February they had lost 54.7%, 78.1% and 98.0% respectively. Yet his employer reaped huge investment fees from its investment-banking business with them. Mr. Grubman's income never fell below \$10 million in the years 1997 through 2001. The lesson here is simple: you can't serve two masters, being both an objective research analyst and a cheerleader for investment banking interests. It's got to be one or the other. Your compensation as an analyst shouldn't be tied to your company's investment banking success.

**Conclusion:** What's going on? There is enough self interest to tar everyone here. Business executives, accountants, brokers, analysts, brokerage houses, lawyers,...the list seems endless.

What is a client to do? Return to basics. Look to investment advisors who put the client's interest first. Those who are **trustworthy**. Who are **independent**. These bedrock principles are my guiding philosophy. You will always receive investment advice from me which I believe is in your best interest. And I will only work with excellent, local brokers who are like-minded.

I don't have to fear being fired if I decide to sell a security. My pocket won't be greased by a brokerage house when I recommend the purchase of a mutual fund. I won't have to debate the merits of a shady tax deal with one of my partners. My research sources are not compromised by self-interest. I won't always call them right but I'll always call them in your best interest.

That said, what do I think the markets are up to?

### **The Market is in a Sideways Spin\***

I think this is neither an up nor down market. I think its really a sideways one. As I dictate this report on April 10, 2002 the S&P 500 is off 2.64% for the year. The NASDAQ composite is down 10.66%. The Dow Jones Industrial Average is up 1.87%. What does this mean? I think it means that dividend yield should no longer be underappreciated. In a low return environment dividends will play a major role and the companies that pay them will be rewarded.

The market's average annual return since 1926 has been 11%. Of that number 4.7 percentage points, or more than 40% of the market's average, has been accounted for by dividends. What this means to me is that good dependable companies who have a corporate policy of increasing dividends will do well. What are some of those companies? Phillip Morris. Citigroup. Washington Mutual. Pitney Bowes. Certain REITS, including Vornado Realty Trust and Thornburg Mortgage.

Are they right for everyone? Of course not. But I think every portfolio should consider having some exposure to them.

Investing in dividend-paying companies requires analysis and is by no means certain. Dividends can be eliminated should a company run into trouble. Both Xerox Corporation and Corning suspended dividend payments last July after paying them without interruption for more than 50 years. Furthermore, high-paying

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dividend stocks are likely to be left at the starting gate when the next bull market gets in gear.

Call me a Chinese philosopher but I believe that life and markets are circles. Wheels turning. What's up today is down tomorrow. Regression to the mean. You've got to be ready in the famous words of that balladeer James Taylor to "Roll with the flow and ride with the tide."

### **My Crystal Ball, or "Carnack Says..."**

Not everyone thinks the next few years will be sterling for equity performance. James Paulsen, chief investment officer at Wells Capital Management, believes that lackluster stock returns will last for several years. He notes that earnings growth is not likely to rebound in any significance in the coming quarters. He also points out, and rightly in my judgement, that current valuations are relatively high. "A decade ago, we had forty years of bloat that could be cut and we could invoke a new thing called technology to drive the margins" he observes. Not so anymore. Technology has cut that bloat.

In examining both stock and bond returns since 1925, Mr. Paulsen found that when the market's multiple falls below 18, annualized returns have averaged 17 percent. When the market traded above 18 times earnings, returns averaged a paltry 2.5 percent per annum.

Right now the S&P 500 is trading at 20 times next year's projected earnings. This is why a diversified portfolio is critical. This is why corporate bonds, governments and preferred securities should not be sneezed at. I have clients who are receiving 7%-8% in preferred securities right now. As Yogi Berra might say, "That ain't all bad."

I do believe inflation has been tamed. Mr. Greenspan will likely raise interest rates but on a subdued basis. I don't know where P/E multiples will go but I think probably downward. Mr. Paulsen believes that a portfolio weighted toward bonds will outperform stocks. Not everyone, of course, agrees. His recommended core-holding is 45% equities with a strong emphasis on good dividend paying companies. I think he is right on.