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"I Want to Take You Higher"

This is the title to a wonderful song sung by Sly & The Family Stone in the late 60's. The question today is "Is it also a predictor for what the market will be doing in the future?" I happen to think it is.

Many have asked me why song lyrics often play a significant role in my reports. I guess it's because songs and music have always been an important part of my life, particularly the music of the late 60's and early 70's. That's why past reports have reprised the words of James Taylor, Aretha Franklin, the Rolling Stones and Marvin Gaye, to name a few.

In the fall of 1964 I experienced for the first time the blinding light of sudden adult freedom which comes to 18-year-old college freshmen, especially those released from the cloistered environments of northern prep schools, in the beautiful college town of Chapel Hill, North Carolina. Before Billy Cunningham had scored his first basket for Dean Smith's Tar Heels that December, I had attended a rock concert by the Rolling Stones, heard a jazz and blues performance by the Genius, Ray Charles, and observed a literally breathtaking performance given on campus by the Godfather of Soul, James Brown. That was an influential time for an impressionable young man who played second chair alto saxophone in his school's jazz band (and quite poorly at that I might add.) The sounds and words to the songs gave special meaning to my life then and still do. Parenthetically, my interests today in jazz, soul, rhythm and blues and funk can be traced directly to that time of my life and the music I heard. Anybody want to go to a Tower of Power concert?

Sylvester Stewart, Sly Stone as he was called on stage, was a San Francisco-based DJ having spun records at both KDIA and KSOL, before he launched his musical career in the mid-60's. His seven-member musical group exemplified racial harmony, ethnic diversity and importantly a significant place for women in its line-up at a time when racial and gender diversity was the exception rather than the rule. Sly led a seven-member group composed of four African-Americans and three caucasians, five men and two women.

Now we know Sly surely wasn't talking about smoking old copies of *Barron's* when he crooned that he wanted to "take us higher." Nevertheless, the words still have currency today.

In last summer's report I brought back Marvin Gaye's query, "What's Going On?" when corporate executives were acting with criminality and stock analysts were hopelessly conflicted, leaving the markets in turmoil. Last fall I turned to the Stones' lament, "May Be The Last Time," as the markets continued their third year of a consistent downward slide. So this summer I turn to the lyrics of Sly Stone, a Bay Area artist, as a metaphor for what I hope will be tomorrow's market.

The Markets & Economy

The second quarter of 2003 has seen all markets rebound substantially. The S&P 500 has shot-up more than 20% since its March lows, making the biggest quarterly jump in more than three years. On June 4th, only 11 stocks trading on major U.S. stock markets hit fresh lows while 962 spiked to new highs. The Russell 2000 Index of small stocks, which usually outperform other sectors early in a bull market, was up 24% in the second quarter as of June 5th. It was the best rally in three years for that segment. And since that time things have continued to improve across the board, in all sectors and in both the equity and bond markets.

And what about the economy? As I came into work today, July 15th, the top four stories "above the fold" on the *News Journal* business page were all positive ones. The first headline was "Smaller Companies Plan Hiring." The article pointed out that small business owners (those companies incidentally employ half of all U.S. workers) are now, at long last, boosting their hiring practices. Moreover, more small business owners expect business conditions to improve in the next 6 months than have felt that way in more than a year. The second article was positive news for the mergers and acquisitions people as Yahoo was reported to have agreed to acquire Overture Services, the pioneer in the pay-for placement online web search arena.

The third article reported that two banks' profit reports exceeded Wall Street earnings estimates for the quarter, those banks being Citigroup and Bank of America. Citigroup pulled a second rabbit out of its hat when it also announced it was raising its dividend an astounding 80%! The fourth article reported that Wilmington's MBNA announced that loan losses and delinquencies declined last month as more consumers kept up their loan payments. This led analysts to predict increased profitability for Charlie and Company. Four good stories, zero bad ones. That's pretty good anecdotal evidence that the economy will, indeed, take us higher.

The *Wall Street Journal* recently reported that in its quarterly survey of 54 leading, national economists their overwhelming consensus that the economy will rebound in the second half. "I feel better about the prospects for the U.S. and global economy than I have for four years" said Allen Sinai, chief economist at Decision Economics Inc. Just a few short months ago this same economist was warning about a possible recessionary downturn. He now estimates that households will have an additional 47 billion

dollars to spend

in the last half of this year, thanks to the combination of income-tax cuts, child tax credits and marriage penalty relief passed last month by Congress and signed by President Bush. Yes, Toto, tax policy does make a difference!

An economist I follow in particular, Dr. James F. Smith, senior fellow and director of the Center for Business Forecasting at the Kenan Institute of Private Enterprise (that's in Chapel Hill in case you didn't know) also notes that our economy is improving steadily. "It is unlikely there will ever be a better time to invest than today," he writes. He notes that we have had six consecutive quarters of real GDP growth.

Since March of 2001 our efficiency and productivity, as measured by GDP, has increased every quarter. Consumers are earning and spending more money than ever before. The housing sector continues to be the strongest part of the economy with interest rates at 40-year lows. Personal income has hit a new record high as disposable personal income hit the 8 trillion dollar benchmark for the first time. Dr. Smith says the outlook for continued growth in personal incomes and consumptions remains excellent. That, coupled with the increase in worker productivity should bring industrial production back, too. Dr. Smith predicts that the Dow Jones Industrial Average could "easily set a new record in the next 12-18 months." Boy, wouldn't that be nice!

Westover

What is it that distinguishes us from other private asset managers? We provide individualized attention to each and every one of our clients. Our boutique size gives us the ability to watch every portfolio every day. And we do. Our hand-crafted portfolios emphasize risk-adjusted returns. We thoroughly analyze each client's specific investment goals and needs. We construct each portfolio reflecting each client's personal objectives. And we move fast when we need to.

Our investment horizon is a long-term one. We adhere to the principals of asset allocation. The result is reduced volatility and increased investment opportunities for our clients.

We follow a disciplined process. This means that we don't buy good companies simply because they are good companies. We only buy a good company when its stock is selling at a discount to its fair value.

Some Things We Like*

What's in Westover's bag of tricks for this quarter? My two favorites are a mid-cap growth biotech firm, IDEC Pharmaceuticals (IDPH), and a large-cap value aerospace conglomerate, General Dynamics (GD). Both are under-valued according to the Joseph A. Bank School of Stock Investing as taught by Westover Capital Advisors. And what exactly is that? A Ha! You'll have to wait 'til my next quarterly report to find out.

IDEC has proposed to merge with Biogen. Assuming completion, the combined company will be a biotech powerhouse, accomplishing economies of scale more quickly than either could on its own. I don't believe the merger price is excessive, and I'm generally non-pleased with mergers for that very reason.

Sales should increase at a compound annual rate of 25% through 2007. While gross and net margins will decline, free cash flow (cash from operations minus capital spending and acquisitions) should stay solid. The business combination should add about \$5 per share, I think, to its overall value. It's selling at a Westover-determined 30% discount now. Nevertheless, IDEC remains a risky stock in a risky sector. It is appropriate only for those portfolios who welcome significant risk over the long haul.

General Dynamics is another great company. In each of the last ten years it has delivered at least a 15% return on equity and has averaged more than 25% ROE. Its sales have increased at a compound annual rate of 20% since 1997 and its operating profit margin has improved during that period of time from 11% to 12.4%.

Over the next five years U.S. defense spending is set to increase as much as 6% annually. Years of defense budget cuts have left U.S. weapons systems in need of replacement and repair. GD is positioned to take advantage of these higher defense needs as well as the increased security spending in the war on terrorism. It is one of only two firms prepared to meet the ship-building needs of the U.S. Navy.

It acquired Gulfstream Aviation in 1999 thereby diversifying its cash flow streams. Right now Gulfstream is beating down the stock but I think that's a short-term issue. Warren Buffet's NetJets is Gulfstream's biggest customer.

GD's management is generally considered superb. It's selling at a 25% discount, according to Westover's analysis. Any discount of 20% or more for this baby is an excellent one. Get GD while it's hot!

* It should not be assumed that the recommendations made herein will be profitable or will equal or exceed the performance of securities not discussed herein. Securities highlighted in this newsletter may or may not be held in an individual client account. The performance of these stocks, as well as those previously discussed, is not a guarantee or predictor of future stock performance results under any circumstances.

Have a wonderful rest of the summer. If you want, come visit me here at Westover. We'll sing some songs and compare notes on our respective favorite musical artists and eras. Let's see if Westover can't take you higher.

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