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***Through the Looking Glass***

In 1872 Lewis Carroll wrote through *Through the Looking Glass*, a sequel to *Alice's Adventures in Wonderland*. In *Through the Looking Glass* the inquisitive Miss Alice found herself in a fantasyland where everything was reversed. She encountered talking flowers, madcap kings and queens, and strange mythological characters when she became a pawn in a bizarre chess game involving Humpty Dumpty, Tweedledee and Tweedledum, as well as other nursery rhyme figures. Nothing was as it seemed.

Fast forward 133 years and you will find that nothing much has really changed. Some companies' financial statements have us believing down is up and up is down. Witness GM and Lucent Technologies.

Current Alice-in-Wonderland accounting rules imposed by the Financial Accounting Standards Board (FASB) require companies to record the annual change in the net asset or liability of their pension plan as earnings. For example, if the net change is positive, this is a "pension credit" that is the issue. However, pension credits are not cash. Nevertheless, in today's Humpty Dumpty accounting world, pension credits, while reported as earnings, aren't earnings at all.

Lucent, for example, reported a \$2 billion profit in 2004, yet \$1.1 billion came from pension credits rather than from equipment sales. In 2005, 82% of the earnings (\$972 million) came from its pension fund's pension credit rather than from equipment or software sales and service! Tweedledee would be proud.

Miss Alice would be equally amused by GM. GM's stock lost more than 50% in 2005, hitting a 23-year low in the process, and leading some observers to wonder if the company can even survive. This took place at a time when GM included a net asset (pension credit) of \$30 billion from its pension plan on its year-end 2004 balance sheet. What's "curious" is that the plan is actually under-funded by approximately \$7.5 billion. Tweedledum would be proud.

For 2006 FASB proposes to change current pension assumptions to compel companies to account for their plans on their balance sheets in a more realistic light. Were GM required to do so this year, that would wipe out most or, indeed, even all of the automaker's existing shareholder equity.

Under FASB's plan the positive \$30 billion figure on GM's balance sheet would be replaced with a negative \$7.5 billion one, reflecting the amount by which the plan is presently under-funded. At the end of 2004 GM's shareholder's equity was \$28 billion, so this approach would materially and breathtakingly slash shareholder's equity, even after credit is given for corporate income tax payments.

It's because of shenanigans like these, pulled not only by Lucent and GM but a multitude of others as well that we at Westover believe that if earnings is a company's Queen, then cash flow is its King. You can't really monkey with cash now can you Alice? Even Humpty Dumpty would have to agree with that!

#### It Was a Very Good Year

As Frank Sinatra might have crooned, "2005 was a very good year" for Westover. Westover increased its assets under management by approximately 40%. We also transitioned our investment advisor regulation from the state level to the SEC. For a one-person shop that means we must be incredibly vigilant. For 2006 we have started to scan all documents, e-mails, reports, etc. in order to preserve hard copies for the regulators. The goal is to get as close to a "paperless" office as is realistically possible.

We have also focused aggressively on techniques to make us more efficient and better at our core business in order that we can maintain our highly personalized one-on-one relationship with our 50+ clients. We expect to grow that client base to 100 over the next 5 years. Although we gladly make exceptions in the right circumstances, we typically look for assets of one-half million dollars and up to manage in order to provide the account-specific attention our clients expect.

#### The Stock Market, Then and Now

2005 saw the second consecutive year of just modest gains in market indexes. Every U.S. equity index posted a single-digit percentage increase. Specifically, and with dividends included, the Dow Jones Industrial Average was up less than 2%, the NASDAQ Composite up 2%, the S&P 500 4%, the Russell

2000 4% and the Wilshire 5000 6% for the year.

This pedestrian performance came against the backdrop of generally good economic news in which both moderate inflation and stable growth were the watchwords. Corporate earnings also were quite good, with 25 of the Dow 30 increasing their earnings year-over-year in 2005, for example. However, as every coin has two sides, the Federal Reserve continued to raise interest rates while oil prices shot through the roof. On the political scene Iraq proved quite unsettling to the markets.

If first impressions count, 2006 has started with a bang. All three major indexes - the Dow Industrials, the NASDAQ Composite and the S&P 500 - have risen on each of the first five trading days of 2006. This hasn't happened in more than 15 years. All three each stand on January 10<sup>th</sup> at respective 4½ year highs with the Dow getting back over 11,000 for the first time since June 2001.

Despite that strong start, Wall Street analysts have as divergent a view of the projected final 2006 stock market returns as I've seen in many years. J.P. Morgan's analyst believes the market will fall 10%. Richard Bernstein, Merrill Lynch's chief U.S. strategist, believes that rising interest rates orchestrated by the Federal Reserve will trump continued corporate earnings performance and that the market will fall 2%.

On the other side of the coin, Citigroup, Morgan Stanley and Goldman Sachs all believe the S&P 500 will gain more than 12%. And Ed Keon of the Prudential Equity Group calls for a market upside of 22%. On balance, I think the market will have an upside and that the upside will be more positive than 2005, perhaps on the order of 10%. Beyond that, I don't to have a crystal ball that clearly sees Through the Looking Glass.

#### A Little of This and a Little of That\*

We really mean "little" here; we're talking small-caps.

If you like trying to ferret out good values, you might check out VAALCO Energy (EGY). This little small-cap growth stock (\$260 mil) presently trades at \$4.60 per share. It's an

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\* 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.

independent energy company that acquires, develops and produces crude oil and natural gas. It has properties and exploration activities along the Texas Gulf Coast as well as offshore in Gabon, West Africa.

What I like about it are its numbers and the fact that it can't fall very far. Your downside is really stopped out, provided you are not frightened by a stock that sells for less than \$5.00 a share. Its forward P/E is 8.2 which is approximately 80% of the industry average. Its return on assets is a healthy 28.6% compared for its industry 11.0%. It has a strong upwards earnings trend, having earned \$0.16 per share in 2003, \$0.39 per share in 2004, \$0.48 in 2005 and \$0.56 (projected) in 2006.

If you are interested in dividend payers, here is a tiny sleeper you might also watch, Cherokee Inc. (CHKE) which has a market cap of \$316 mil. Cherokee enters into licensing agreements with wholesalers and retailers, contracting with companies such as Target to manufacture and market clothing apparel and accessories under the Cherokee name. It pays an incredibly healthy 6.0% dividend. It's always a nice surprise to find a good dividend payer among the small core retail consumer goods sector. It presently trades at \$36.02 per share. Its forward P/E is 18.0 and its return on assets is a mind boggling 54.2%. Its earnings trend, like that of VAALCO Energy, is on a nice upward trend. In '02 it earned \$1.46 per share, in '03 \$1.54, in '04 \$1.68, '05 \$1.97 and it's projected to do \$2.00 or more next year.

Exchange Traded Funds (ETFs) are just what the name implies. They are baskets of securities traded like individual stocks on an exchange. ETFs can be bought and sold throughout the trading day and to that degree they are unlike regular open-end mutual funds. They can be sold short and bought on margin. In brief, anything you might do with a stock you can do with an ETF. Most charge lower annual expenses than even the least costly index mutual funds.

One ETF to consider is the Asia 50 Index (ADRA) which is trading at \$85.12 now. Let's put a little money on that segment of the market and see how we do. Year-to-date it's up 5.78% and it's up 29% for the last twelve months. Hopefully, we won't be too late to that party.

## Listen to the Music

This section of my report is, I think, enjoyed by more people than any other section. Last quarter we asked a question along these lines: What is the one degree of separation, in the Kevin Bacon sense of the phrase, between the young sultry Texas blues and jazz Grammy-award winner Norah Jones and the former Beatle George Harrison? The answer, as many of you knew, is Ms. Jones' father, Ravi Shankar, who was the Indian sitar guru to Harrison during that phase of the Beatles' career. Jim Erisman, one of the best trial lawyers in all of America and who practices right here in River City, was last quarter's winner.

For this quarter I'll keep it short and simple. Again, you're on "scout's honor" not to Google or use anything but your old noggin in noodling the answer. Since this report reaches my readers in many places (Washington state to England) and at different dates and since I want to give everyone a fair chance at being the first to answer, I won't open the door to find your response until 9:00 AM on Tuesday, January 24<sup>th</sup>.

In light of the devastation suffered by the Gulf Coast when Katrina struck, let's go to the bayou to search out the answer to this quarter's inquiry. Tell me the name of the New Orleans-based singer who broke onto the national hit music scene with a 1966 song called "Tell It Like It Is." At Westover that's what we like to think we do too. Only the title to our song is "Independent and Objective Investment Strategies for Preserving and Enhancing Your Wealth." That's tellin' it like it is.

Here are a few hints:

- (1) While he's best known as a solo artist, he has also performed in a group with his brothers for more than 30 years.
- (2) His older brother Art was the keyboardist and founder of the Meters. Another brother Charles played saxophone with B.B. King.
- (3) In the late '80's and early '90's he was "rediscovered" by a female California crooner with whom he sang several popular duets. Several of their hits reached the top of the pop charts including "Don't Know Much", which won him four Grammys.

The first person to give us the correct answer will receive a \$50 gift certificate to be used at the restaurant of the winner's choice.

Good luck with your guess and make sure your investment advisor tells it like it is. And when you squint your eyes to read the fine print in the pages of the *Wall Street Journal*, please don't let some company offer you an Alice-in-Wonderland looking glass!

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