

# THE LONDON COMPANY

GODDARD CAPITAL MANAGEMENT  
INVESTMENT COUNSEL

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The U.S. stock market is down slightly year-to-date. Increasing signs are pointing toward a challenging market for the year 2005 but should be stable longer term.

The Standards & Poor's 500 Index has been in a cyclical upswing since its October 2002 lows. This improvement in the market was supported by low interest rates and a strong recovery of profits (up 20% in each of the past two years). In contrast, interest rates are now rising, and profit gains are likely to moderate to 10% (or less) for 2005. This is not necessarily a very bearish scenario, except for the fact that valuations of many U.S. equities are still high relative to the sustainability of their underlying growth. Most Wall Street analysts are paying too much attention to the potential for higher valuations, and not enough time is being spent estimating underlying growth. They don't seem to understand that the 1990's are over and that the back side of any stock market bubble is dominated by increased concern about growth.

To gain greater insight into what lies ahead, we find it helpful to note what corporations are doing. They are becoming more liquid, a strategy that is not usually associated with increasing growth. At year-end, it is estimated that the companies whose stocks are in the S&P 500 held over \$600 billion in cash, and corporate America overall held over \$1 trillion in cash. This increased liquidity, which is unprecedented, is a product of a number of trends. Increased productivity is one, but savings here may be harder to generate in the future. Excess capacity in many areas is encouraging increasing consolidation, not more expansion.

Another factor producing more liquidity has been deleveraging of corporate balance sheets. As many of the growth companies of the 1990's have become larger, they are finding it more difficult to identify major reinvestment opportunities that will produce significant future returns. Microsoft is an example. Companies are generally more disciplined in the use of their capital than they were in the past when many entered into ill-advised deals. The common thread running through all these trends is concern about future growth and profitability. The planned purchase of Gillette by Proctor & Gamble is one example. The irony is that corporations still seem to be more concerned about growth than investors.

Equity strategy over the near to intermediate term should emphasize a cash reserve for future buying opportunities at more attractive valuations than are existing currently. Technology stocks still have downside risk. The high point for the price of oil is closer than the potential lower point of the price of oil which may better represent the long-term equilibrium price of oil. Gold and gold stocks may continue to perform relatively well. Be

cautious about any beneficiaries in recent years of the relatively wide spreads between short-term and long-term interest rates. Real estate and the broad financial areas have increasing risk.

Over the very near term, the stock market should rally. The market lift of Monday, March 28 may be the beginning of a moderate upturn. The market is oversold, and investor sentiments are quite negative, so some technical rebound is in order. Nonetheless, the percentage of earnings downgrades has been relatively high in recent months, suggesting the likelihood that further cutbacks in earnings growth expectations lie ahead. Short-term interest rates will rise further. Thus, traders may sell into any near term strength.

Most weakness lies in the banking stocks, resulting from to a negative response to rising interest rates. There is some additional risk in this area of the market, but dividend yield should provide some support. On a longer term investment basis, most of the portfolio appears to be well positioned, but further weakness in more holdings is expected if the market softens further in the months ahead. Our style is beginning to lead again, as it performs well in this type of environment, opposite of the speculative and commodity-driven market of the past two years.

We thank you for your continued confidence. Should you have any questions or comments, please feel free to contact us.

Sincerely,

A handwritten signature in black ink, appearing to read "Stephen M. Goddard". The signature is fluid and cursive, with a prominent initial "S" and a long, sweeping underline.

Stephen M. Goddard, CFA

SMG:mwm