HUSSMAN

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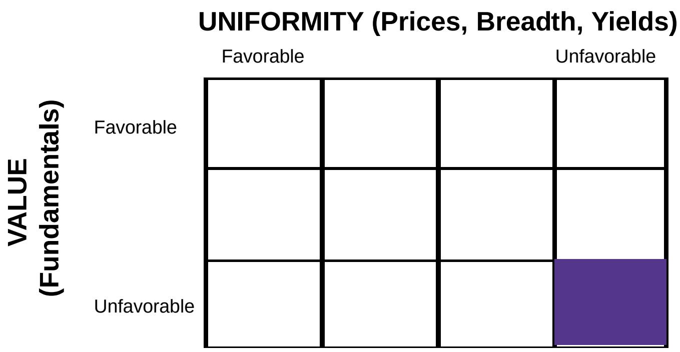
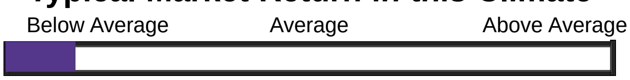
MARKET CLIMATE

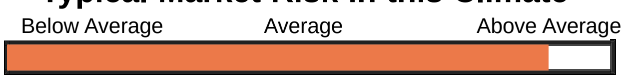
The current profile of valuation and trend uniformity



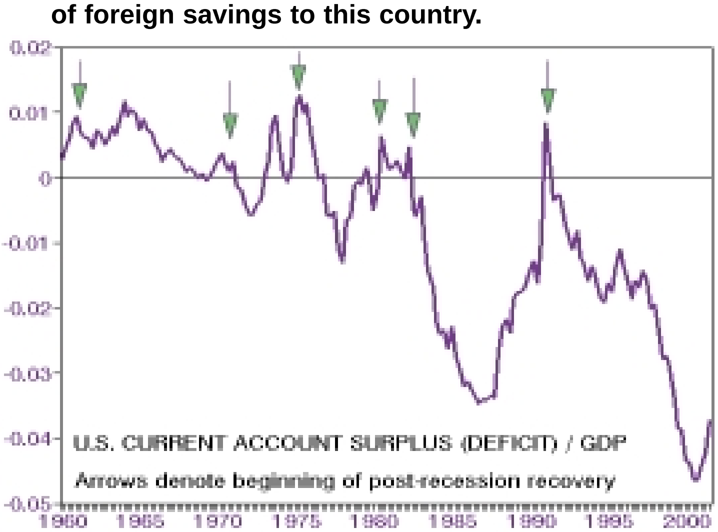
Typical Market Return in this Climate



Typical Market Risk in this Climate



Investment is equal to savings. If a country does not save enough domestically, it imports it from foreign countries. Historically, strong economic expansions have started with a positive spike in the U.S. current account, indicating significant room for growth in U.S. domestic investment, and significant ability to finance it by importing savings from other countries. At present, the U.S. current account remains deeply in deficit, suggesting that U.S. investment is particularly vulnerable to any slowdown in the flow of foreign savings to this country.



THE TICKER

"A total of 257 publicly traded companies filed for bankruptcy last year, representing a new record and a 46 percent increase over the prior year's record of 176 filings. Bankruptcies among publicly traded companies began to run counter to the trend of declining business bankruptcies around 1997… Stress in the corporate sector has been reflected in other measures of corporate credit quality. Standard & Poor's reports that 211 bond issuers defaulted on $115.4 billion in debt in 2001, posting the highest default volume on record, both in terms of the dollar volume and number of defaults..."

"Easy access to the capital markets has proved to be a two-edged sword for some large corporations and may be an important factor in explaining why large companies have experienced higher growth in leverage and bankruptcy rates. During the bull market of the 1990s, large corporations with access to the capital markets could rely on rising equity values to fund investments and justify taking on greater debt… As equity values fall, however, the ability to refinance debt and restructure deals is impaired, which can lead to liquidity and debt problems… Bank Call Report data also reflect the fact that financial trouble has appeared more quickly in credits to larger firms. Since the second quarter of 2000, large commercial banks have experienced higher and more rapidly rising loss rates on commercial and industrial loans than small commercial banks…It appears that credit quality will remain a key issue for insured institutions in 2002."

- *FDIC Bank Trends, January 31, 2002.*

As we warned throughout last year, well before the high-profile bankruptcies of Enron, K-Mart, Global Crossing and others, the main concern of the financial markets in the coming quarters is likely to be debt. In November 2000, we wrote "Our econometric models currently project annualized GDP growth of less than 1% over the coming year, slow enough to trigger continued credit problems in the corporate debt market… government "savings" are likely to contract in an economic downturn as well, further pressuring capital spending… All of which is why we don't believe the 'New Era' will last, and neither should you."

We strongly believe that the pace of corporate debt defaults and bank problems will accelerate in the coming quarters. Sources of new money, such as the commercial paper markets, have become highly selective. When investors are unwilling to lend more money by buying freshly issued commercial paper, even temporarily weak earnings can make debt service suddenly unmanageable.

Why do these problems keep surprising investors when they are entirely predictable? Operating earnings. The "debt service ratio" - debt service payments as a fraction of operating earnings - has soared to a record high. It is critical to understand that "operating earnings" don't subtract off debt service. Investors don't even realize that they have virtually no claim to the "earnings" numbers being reported to them, or how intolerably large corporate debt obligations have become.

JUST FOR KIDS

Rather than launching right into operating earnings, which are boring, let's learn how to make a quarter disappear.

Borrow a quarter. Preferably, you want to be able to do the trick with more valuable things, like half-dollars, or the entire retirement savings of your employees, but let's start by obtaining a quarter from an excited audience member. This is known as an *IPO*.

Hold the quarter in your right hand, face up between the tips of the thumb and forefinger like it's a little trading floor. Your knuckles should face the ground, palm facing up. The three other fingers of your right hand should be gently bent inward, forming an archway over the palm.

Make a "C" shape out of your left hand, thumb on the bottom, and 4 fingers curved on top. Move the C shape toward your right hand, with your left thumb going through the archway and the fingers of the left hand now covering the quarter. This is known as *lack of transparency*.

At this point, the quarter is no longer visible to observers. Your hands are cupped so widely over each other that you could fit Joe Battapaglia into the cavity they have formed.

Now drop the quarter into the right palm. This is known as an *off-balance-sheet transaction*. Let it land near the point where the right ring finger meets the palm. Keep the thumb and forefinger of the right hand up, and leave the space between them intact, where the quarter used to be. Curl the three fingers of your right hand gently over the quarter.

Now, close the left hand. Not too tightly - leave a little air inside, since you want everybody to think there is actually a quarter in there. This is known as *inflating the assets*. As you pull the left hand away, the forefinger of your right hand should pop out from the pinkie side of your closed left fist, and gently point toward the empty left hand. For the sake of misdirection, it's essential to keep your right thumb and forefinger in the air, so the only thing that seems different is that the quarter has been lifted away.

You can now tap the wrist of your left hand lightly with the right forefinger a couple of times, to convey an extra measure of security and shift everyone's attention to the empty hand. This is known as an *analyst conference call*.

Unfortunately, every once in a while some spoilsport will call out "It's still in your right hand." These people are known as *public accountants*. Obviously, you want to have "consulting arrangements" with these people on the side.

It also helps if you can get a few people to rave about how skillful you are, how securely you seem to be holding that quarter in your (empty) left hand, and how certain you are to turn that quarter into a handful of them. These people are known as *brokerage analysts*. Since they get paid to sell tickets to your show, they're pretty much in your pocket already. You should also have people who talk breathlessly about how much money is flowing into your left hand. These people are generally known as *Maria Bartiromo*.

Finally, and this is important, follow your closed (and empty) left hand upward and to the left with your eyes. You want to convince people not only that the quarter is safely in your left hand, but that it's dynamic - on the move. This is known as *earnings guidance*.

The right hand should look natural, not clenched. Do not, under any circumstance, look at the right hand or move it quickly. Focus all of your attention and motion on the empty left hand. As you watch it move higher, slowly move the right hand to your side. Still watching the left hand, do any sort of mystical move you prefer, like having somebody blow on the hand, or opening the hand with a sprinkling motion as if you were dissolving the quarter into powder.

While everyone's attention is focused on the empty left hand, feel free to quietly slip the quarter into your pocket, generally known as the *Cayman Islands*.

Congratulations. You are now eligible for listing on NYSE.

THE OBSERVATION DECK

The primary reasons that investors are seeing their retirement savings vanish is that they have been misled as to how stocks are valued, and the professionals who manage their money are so afraid of missing hot stocks that they ignore the realities beneath the hype. Enron may be the most egregious example, but it is far from the only one.

There is a simple distinction between investing and speculating. Investment means buying a security at a price that appears attractive in view of the future stream of cash flows that will be delivered to shareholders over time. Speculation means buying a security in anticipation that its price will increase.

Speculation does not concern itself with value. It is concerned with factors that will make somebody else pay more. Those factors need not be rooted in true cash flows that can be claimed by shareholders. The only question is what will make the next guy pay more, even if the next guy is a complete idiot. Many companies have learned that in a speculative environment, deception trumps disclosure. Operating earnings are the perfect means to this deception.

Operating earnings are the common name for EBIT - earnings before interest and taxes. Operating earnings also exclude "extraordinary losses", which in most cases can be defined as "exactly enough to make operating earnings beat expectations by a penny." It is becoming increasingly common for companies to under-depreciate assets (to boost operating earnings) and write them off as “extraordinary” losses instead. Again, the only concern is to make the next guy pay a higher price. Regardless of whether or not earnings can actually satisfy debt obligations, or how aggressively bad investments are being written down from book value, investors need never know. Operating earnings exclude all of these undesirable realities. Out of sight, out of mind. Unfortunately, a stock is not a claim on operating earnings.

A stock is a claim on *free cash flow after debt service*. Beware of analysts touting stocks on the basis of "huge free cash flow" when they have not subtracted out interest payments. **Free cash flow after debt service is equal to operating earnings, minus interest, minus taxes, minus amounts required to replace depreciated assets, minus normal annual amounts allocated to new investments.**

Note: we say *new* investments because we've already subtracted off the amount required to replace depreciated capital. If you like, you can ignore depreciation and subtract off the entire amount normally allocated to capital investment - both new investment and the replacement of depreciation. The effect is of course the same.

Why subtract off investment? Well, if those investments pay off, the payoff will be included in future cash flows, and the future growth rate will be higher. But the investment (both new investment and replacement of depreciated capital) is deducted from operating earnings to arrive at the free cash flow actually available to shareholders. If you're discounting the stream of expected future operating earnings without subtracting off the capital investment required to produce it, you're double counting. Technically, the value of stock given to employees and management through stock options should also be deducted from operating earnings in order to derive the free cash flow available to shareholders.

In other words, if you are valuing a stock on the basis of operating earnings, you're counting as yours all kinds of things that are in fact being allocated to debtholders, managers, employees, replacement of depreciated capital, and the government. Can there be any question that excluding debt service and investment losses from the headline earnings figure simply reduces the scrutiny of investors on debt and bad investments, with predictable consequences?

It's as if investors are collectively putting their fingers in their ears and humming "hmm hmm hmmm… I can't hear you." Which is why they don't pay attention until they get hit by a brick. We suspect that Enron was the warm-up pitch.

We would seriously prefer to be bullish and optimistic about economic and market prospects. It's more fun, and they put you on TV more often. But capital preservation is essential. We would really prefer the market to adjust in a way that stops misallocating capital. The tech bubble allowed America's scarce savings to be terribly diverted and wasted. The billions of corporate write-downs in recent months are a testament to this. Much of the reported earnings of recent years are now being quietly written off of the books, as is excessive "goodwill" from companies overpaying for their acquisitions. Yet all that analysts can say is that these write-downs will boost future earnings because companies will no longer have to amortize the bad investments over a period of years. Oh goodie.

The tragic fact is that rather than becoming less popular in the face of soaring bankruptcies and investment write-downs, operating earnings are becoming increasingly ubiquitous. CNBC now prominently features operating earnings in order to make "apples-to-apples comparisons." Meanwhile, *Barron's* allotted only a footnote to the announcement that Standard & Poor's has shifted to using operating earnings when calculating the S&P 500 P/E ratio.

Make no mistake. Operating earnings include not only the income claimed by shareholders, but also the interest claimed by bondholders. If you are going to value stocks on the basis of operating earnings, then the very next calculation you make had better be to subtract off the debt.

For many companies, even if you appropriately account for capital spending and growth, the result of this subtraction is a *negative* number. You'll even get a negative number if you use the peak level of earnings attained during 2000. In many cases, this is an indication that the stock is fundamentally worthless, and the debt itself is not supported by cash flows. Think Enron. This is also the case for many networks that have plunged to nearly nothing.

By our calculations, the group also includes several telecom companies still holding substantial value, such as Qwest, Level 3, Adelphia, and Nextel, several energy companies including Calpine, and certain large lending institutions.

We don't sell short individual stocks, because even though we trust our ability to identify overvalued stocks, those stocks don't reliably decline over the short run. Still, we know what we want to avoid. There are many stocks which we believe have substantial fundamental value, but where the stock prices are trading as much as 50-100% above these fundamental values.

The most extreme valuations include mass retailers such as Wal-Mart, Target, Home Depot, Best Buy, Kohls, and Lowe's, and large drug and healthcare companies such as Amgen, Abbott Labs, American Home Products, Baxter, Forest Labs, Johnson & Johnson, Medtronic, Stryker, Tenet, and United Heathcare. Extreme overvaluations also extend to many other large blue chip stocks, consumer stocks, and financials, including GE, IBM, United Technology, Pepsico, Budweiser, Anheuser Busch, Colgate Palmolive, American International Group, Fannie Mae, Freddie Mac, Concord EFS, First Data, and others. Basically, make a list of the largest capitalizations on the market. Throw a dart. The stock you hit is probably dangerously overvalued.

Companies like IBM and GE are particularly disturbing because of the inexorably rising profit margins and return on equity that we are forced to swallow whole, year after year, if their numbers are to be believed. Add the fact that much of the earnings-per-share growth is created by making acquisitions of slower growing, lower P/E companies, and one might think that the new, larger level of earnings should be awarded a smaller multiple than the prior earnings were.

We don't quite understand why Fannie Mae (Federal National Mortgage) trades at all. But then, there are lots of things we don't understand, like fluid mechanics. The company earns 0.65% on assets (and falling), with $725 per share in debt (and rising) accounting for 97% of its capital, and the bulk of their assets recently refinanced at low rates. Fannie Mae's earnings, consistent as they have been in recent years, don't seem at all robust to even a modest increase in delinquencies and chargeoffs on their outstanding mortgage loans. And if there is one thing that is soaring in this economy, it's delinquencies and chargeoffs. We don't question the earnings, or the valuation of those earnings if predictability was assured. But the effect of government backing is to secure Fannie Mae's bondholders from default risk, not to secure Fannie Mae's stockholders from the writedown or wipeout of their equity should small changes occur in the mortgage lending market. We would just as soon avoid this one too.

The bottom line is simple. Many companies and brokerage analysts are all too eager to turn the financial markets into an arena for speculation rather than investment. There are two things that ordinary investors can do to counter these efforts.

First, do not use historical earnings-per-share growth as the basis for evaluating P/E multiples. Companies are far too adept at engineering growth in earnings per share through acquisitions of companies having lower P/E ratios but no inherent growth potential. This problem extends even to the largest companies such as GE, which trumpets its forecasts of consistent 17-18% earnings growth, while virtually whispering that most of this growth will be driven by acquisitions of low P/E financial companies.

Second, for every company you follow, know the amount of debt per share. It is literally impossible to value a company using a multiple of operating earnings if you don't subtract out the debt. The resulting calculation will still be imperfect, particularly for companies that have heavy capital spending requirements, but it will at least get you closer than using operating earnings alone.

As for more detailed analysis and portfolio management, that's exactly where we try to earn our stripes.

ECONOMIC PERSPECTIVES

The Wall Street Journal reports that over 70% of the economists they've surveyed project a substantial gain in GDP in the first quarter - a figure that rises to over 95% forecasting a second quarter gain and over 98% forecasting a third quarter gain. For all practical purposes, the vast majority of economists now view the recession as complete.

From an investment standpoint, the difficulty is that even if this view turns out to be correct, it does not follow that stocks will deliver robust returns. Measured from peak-to-peak, S&P 500 earnings have historically been well confined to a 6% long-term growth channel. This means that even if the P/E ratio on the S&P 500 remains constant at current extremes *forever*, stock prices can be expected to grow at a roughly 6% annual rate. Add in a 1.4% dividend yield, and the total return on stocks is 7.4% annually over the long term. Again, this assumes that the P/E ratio on the S&P 500 remains at current extremes forever.

Most post-recession bull markets had more going for them. Instead of leaving the price/peak-earnings ratio at 21, the bear markets that accompanied past recessions took the price/peak-earnings ratio to an average of just *8.9*. Over the following year, the price/peak-earnings ratio expanded to a still undervalued *11.6*. No prior bull market began with at a ratio significantly above the historical average of 14.

Prior post-recession bull markets were very strong precisely because they involved sustainable increases in both earnings and price/earnings ratios, beginning from deeply undervalued levels.

Moreover, the prospects for a quick turnaround in the economy may not be nearly as clear as widely believed. Most of the encouraging indicators in this regard are *rate-of-change* indicators. The widely followed ISM (formerly NAPM) indices are foremost among them. These surveys track the month-to-month change in conditions such as new orders, inventories, and employment. The difficulty is that the plunge following the September attacks was so abrupt and sharp that *even a modest stabilization in the economy creates an upward spike in the rate-of-change*. We question the widespread willingness to take these positive changes with as much weight as if the preceding decline had been more gradual.

Past economic expansions have been paced by very strong rebounds in housing, automobiles, and capital spending, all coming off of very deep troughs. In the latest downturn, housing and autos never declined at all. Indeed, they were the primary reason that GDP did not decline substantially. Much of the strength in late 2001, however, may have been borrowed from 2002.

As *The Economist* points out, five of the six most recent recessions have included a double-dip, in which GDP growth turned positive for a quarter or two as inventories rebounded, and then turned down again as final demand failed to follow through. We hope for a recovery, but further risks should not be ignored. *- John P. Hussman, Ph.D.*

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