BRADY INVESTMENT COUNSEL LLC

# INVESTMENT REVIEW

## ANNUAL REPORT FOR THE PERIOD ENDING DECEMBER 31, 2004

# 2004

1844 N.CLEVELAND AVENUE
CHICAGO, ILLINOIS 60614
WWW.BRADYINVESTMENTCOUNSEL.COM

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## TO OUR CLIENTS AND INTERESTED INVESTORS

SUMMARY

The investment environment was favorable in 2004 with the S&P 500 equity index up 11% for the year. The rally was helped in part by traders chasing the impressive returns achieved by small cap stocks over the past half decade. Small caps caught the attention of many after having generated positive returns in four of the last five years.

Since 1999 small caps are up 12% on average annually. This upward movement far outpaces the S&P 500's negative 2.3% five-year average annual return and the negative 7.1% average annual return of the S&P Barra Growth Index, which is a standard measure of large cap growth company performance. For 2004, the S&P 600 Small Cap Equity Index was up a notable 23%. This double-digit growth was on top of a 39% gain in 2003.

The 2004 economic backdrop was good and supported the market's gains. GDP ended the year growing at a respectable 3.7% annual rate and supported greater than expected corporate profit growth. S&P 500 per share operating profits increased 16% in 2004 – 4%-6% higher than the consensus forecast at the start of the year. These higher earnings results build on 2003's 29% year-over-year EPS increase.

The Brady Investment Counsel LLC investment strategies demonstrated strong performance in 2004. All three of our strategies performed in line with or better than the bellwether S&P 500 Equity index and our large cap growth investment style index. Our Core large cap growth investment strategy was up 15%. Our Focus strategy was up 17% and our Index market allocation strategy was up 11%.

## INVESTMENT REVIEW, FORECAST AND TRADING

CORE GROWTH STRATEGY

The Core Portfolio is our diversified large cap growth strategy. It was up 15% in 2004. These results compare favorably (more than double) to the 6.1% return achieved by the S&P Barra Growth Index. Positions helping performance included St Joe (JOE), a real estate development company with extensive landholdings in Florida. The company's share performance followed operating results, which have come in well ahead of expectations for over a year.



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Investments in healthcare companies Ventana Medical Systems (VMSI) and United Healthcare (UNH) also helped. In both cases, 2004 operating results were well ahead of Wall Street's expectations. Their stock prices followed.

Positions hurting 2004 performance were Calpine (CPN), Merck (MRK) and Alcoa (AA). At CPN, operating results came in well below our expectations throughout the year. We held our investment believing the shares were attractively valued relative to assets and earnings potential. In 2004, we forecast that good economic growth would create demand for power and CPN's operating results would benefit. We expected the company to report an operating profit in the third quarter, which did not happen. We are currently evaluating our investment in the company's shares.

In September, MRK announced it would pull blockbuster drug Vioxx off the market because of concerns over adverse side effects. Vioxx was an important product for the company generating $2.5 billion in annual sales. MRK's shares were cut by 45% over the next six weeks as the market adjusted its valuation estimates for lower earnings and the potential future liability to settle the matter. MRK management has done many things right over the years including earning a 17% average return on invested assets. We will hold the shares on the belief there will be a payoff from $35 billion the company has pumped into research and development over the last five years.

Finally, AA shares were down on weaker than expected operating results. However, the bad news is more than fully reflected in the stock price of this high-quality company. We like the valuation and continue to hold our position.

## FOCUS STRATEGY

The Focus Portfolio was up 17% for the year. Performance was driven by many of the same factors, both good and bad, impacting the Core Portfolio's performance. Similar to Core, top performing Focus names included JOE and VMSI. In addition, credit card company Providian (PVN) was a top performer. Providian's share price was up 41% and followed the improvement in operating performance that has been underway during the last two years.

CPN, AA and Safeway (SWY) all hurt performance over the year.

SWY's operating performance and share price were weighed down by an employee strike at the company.

## EXCHANGE TRADED FUND (ETF) PORTFOLIO

The Index Portfolio was up 10.5% last year. Performance was aided by our allocation to small cap stocks early in 2004 and, likewise, was hurt by our large commitment and early switch to the large cap growth sector. In January 2004, our market valuation analysis led us to conclude the large cap growth, was attractively valued from a three-to-five year risk/reward standpoint. Therefore we eliminated our small cap weighting in favor of large companies. The Index Portfolio's current sector weights are 50% S&P 500 and 50% S&P Barra Large Cap Growth.



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## TRADING

We enter major trade programs four times per year. This is done shortly after the finish of the calendar quarterly earnings reporting season. Our most recent program was put in place during the middle of November. Attractive investment ideas were difficult to find. As a result we did more selling than buying and raised cash in the fourth quarter taking advantage of the market's strength. The Core Portfolio finished the year with 10% of assets in cash and the Focus Portfolio with 25% cash.

Core positions eliminated in November included Network Appliance (NTAP) and Southwest Airlines (LUV). We also reduced our holdings in JOE and Wyeth (WYE).

We did find a few attractive long-term opportunities and initiated investments in Cisco Systems (CSCO), Applied Materials (AMAT), and Duke Energy (DUK). We also added to our holdings in motorcycle manufacturer Harley-Davidson (HDI), to FISERVE (FISV) and to First Data (FDC).

In the Focus Portfolio we recently sold investments in CPN, MEDI and Mattel (MAT) and initiated investments in FDC, Microsoft (MSFT) and Comcast (CMCSK). We will look to fill out our new positions in 2005, and put idle cash to use on market weakness as it occurs throughout the year.

## FORECAST

Our equity market view for 2005 is positive but guarded. We are cautious due to the market's rally late last year -- the S&P 500 was up 9.3% in the fourth quarter. This late year surge borrowed from 2005 return potential.

At 18X forward earnings the market's valuation is neutral. It becomes attractive when compared to long-term interest rates as there have only been two other times the market's P/E has looked cheaper relative to the inverse of the 10-year Treasury note yield. The first was at the start of 2003 and in that year the S&P 500 was up 29%. The other was at the start of 2004, when the market was up 11%.

Economic and earnings growth will work in the market's favor in 2005. We forecast GDP to grow 3.0–3.5%. EPS should increase 6% which, while not terribly impressive, is in line with the historic long-term average annual gain.

Inflation and the potential impact it could have on interest rates is a negative. Inflation appears to be on the rise. If the acceleration in general price increases is sustained, the markets will react accordingly. The December core PPI was up 2.2% year over year. This is the second consecutive year the December rate has accelerated and marks the highest rate of increase since 1998, when the core PPI was up 2.6%. In addition, in the second half of 2004, wages increased at a faster rate than productivity. If this imbalance were to continue, the inevitable result would be too many dollars chasing too few goods, which is inflationary and would cause interest rates to rise.

What could happen to the market P/E if interest rates were to increase? In 1998 the 10-year Treasury yield was 4.6%, which is not dramatically different from today's 4.2%. Then the market's forward P/E was 24X. Therefore, there is history of higher P/E ratios in a similar-to-higher interest



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rate environment. However, in 1998 the long-term trend for rates was down and near-term economic prospects were much stronger than they are today. Both factors contributed to the then higher P/E.

When we compare the last time core inflation was above a 2% annual rate for a sustainable period, we have to go back to the 1990-1995 period. Then the 10-year Treasury yield averaged 6.8% and the average P/E was 15X. That kind of multiple would put the S&P 500 at $975 or 20% below the current level. While we are not forecasting a drop of this magnitude, we do want to make clients aware of at least one potential and important downside risk to the 2005 equity market.

Our long-term equity market view remains positive. We project the market's long-term total returns to range between 6%-8% annually. Returns should be in line with growth in operating EPS, which we project to average 6% plus the current 2% dividend yield. Returns will be closer to the high end of the range if interest rates stay near historic lows and, conversely, closer to the low end if rates move higher.

Dividends are one potential positive surprise to our forecast. The S&P 500 current payout ratio is 30% versus the long-term average of 40%. Therefore, there is room for dividends to grow faster than earnings.

Now is the time to begin building exposure to large cap growth companies. The sector's relative valuation is attractive. For perspective, at 12/31/99 small caps traded at a 40% discount to large cap growth when valued on a trailing 12-month P/E basis. By 12/31/04 that discount had nearly disappeared, all but 1.7%. Small cap companies are inherently more risky than large. Very few make it to become a large company and many go out of business trying. Therefore, on average, small caps should sell at a discount to large. The last time small cap P/E ratios had risen to par value with large caps was in the middle 1990s just before the big run made by large caps -- growth companies in particular. Large companies outperformed small by 500 basis points per year for the next five years.

We like small caps and have not abandoned them altogether. We think they make a solid investment choice, particularly for those with a very long time horizon. We will be watching closely for an opportunity to get back in the small cap game. However, at this point in the market cycle, we feel it is prudent for long-term investors to increase their allocation to large cap growth stocks.

## CONCLUSION

We are pleased with our 2004 investment performance. However, one year's results are short term. In the short-term it is possible investment performance for any or all of our three equity strategies to move ahead of or fall behind the market averages. Our focus is on producing superior long-term risk adjusted results. We have great conviction in our investment approach and will continue to build the client portfolios with quality growth companies that are attractively valued relative to business fundamentals. With that in mind, we feel assured in meeting our clients' long-term investment needs.



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