Dear Client: January 16, 2004

HAPPY NEW YEAR!

Executive Summary

Review of 2003 – The stock market indices had their best year since 1999, led by stocks in the technology, materials, consumer discretionary, industrial and financial sectors. Economic growth accelerated during the year, aided by tax cuts, low interest rates, and rising consumer confidence, despite sluggish employment growth.

Outlook for 2004 – Economists are forecasting above-trend real GDP growth of 4%-5% aided by tax refunds, increases in business investment, and a modest rise in interest rates. This should be a positive environment for equities. Our analysis concludes that equity valuations are still attractive relative to current and expected interest rates. Potential dangers include huge trade deficits, which could lead to higher interest rates, elevated commodity prices, continuing slow employment growth, new geopolitical crises, and overly optimistic investors.

Investment strategy – We continue to believe equities are more attractive than bonds at current prices. We expect market leadership to shift from stocks in the information technology, materials and consumer discretion sectors to stocks in the healthcare, energy, and consumer staples sectors. While we wouldn't be surprised by a temporary market correction of 10%-20% sometime during 2004, we expect stock prices to generally appreciate over the next several years commensurate with growth in earnings per share.

Our Investment Committee's top recommendations for 2004 – include Johnson & Johnson (JNJ, $50.45), a package of energy stocks, Tyco International (TYC, $28.30) and First Data Corp (FDC, $39.47).

Review of 2003

Any way that you look at it, 2003 was a great year for investors in the U.S. stock market. The Standard & Poor's 500 average had a total return of 28.7%, and the NASDAQ Composite had a total return of 50.8%. These were excellent returns even compared to the heady returns of 1995-1999. They were especially welcome after three consecutive years of negative returns.

	Total Returns (Price Changes Plus Dividends)								
	1995	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**
S&P 500	37.6	23.0	33.4	28.6	21.0	-9.1	-11.9	-22.1	28.7
Dow Jones Ind.	36.9	28.9	24.9	18.1	27.2	-4.7	-5.4	-15.0	28.3
NASDAQ Comp.	39.9	22.7	22.2	40.2	86.1	-39.2	-20.8	-31.3	50.8

Source: Bloomberg

The stock market indices are still below the record highs achieved in early 2000, but they have appreciated significantly from their respective 2002 lows.

	12/31/03 Value	**2000 High**	**2002 Low**	**Percent From High**	**Percent From Low**
S&P 500	1111.92	1527	776	-27.2%	43.3%
Dow Jones Ind.	10453.92	11723	7286	-10.8%	43.5%
NASDAQ Comp.	2003.37	5049	1114	-60.3%	79.8%

Source: Baseline

While 2003 started with considerable investor uncertainty, it ended with rising consumer and investor confidence. U.S. and coalition forces had a quick victory against Iraq's armies, and while "winning the peace" has been more problematic than expected, the capture of Saddam Hussein in December provided a huge boost. The economy grew at a better-than-expected rate in 2003, aided by tax cuts and an accommodative Federal Reserve. A year ago economists were predicting a rise in interest rates as the economy improved. However, nearly non-existent inflation and weak employment growth encouraged the Federal Reserve to keep short-term interest rates at 45-year lows. The rate on the 10-year Treasury note fell from 3.82% at the beginning of the year to a low of 3.11% in June. Then the rate rose briefly to 4.60% by September, before settling down to finish the year at 4.25%, only 43 basis points (0.43 percentage points) higher than when the year began. Low interest rates were a key factor in keeping consumer spending strong despite record levels of consumer debt and sluggish growth in employment. Even business spending picked up sharply in the second half of 2003. By the third quarter, real growth in Gross Domestic Product (GDP) had accelerated to an 8.2% annual rate, up from a 1.4% rate in the fourth quarter of 2002. Corporate profit growth also accelerated during the year as operating earnings per share of the Standard & Poor's 500 (S&P) increased 18% in the third quarter over the prior year's quarter and are estimated to report a 12% increase for the entire 2003 year.

The stronger-than-expected economic growth didn't go unnoticed by investors, who favored stocks that stood to benefit the most from an improving economy. As seen below, stocks in the technology, consumer discretionary, industrial and materials sectors led the market during 2003, while stocks in the consumer staples, healthcare, utilities, energy, and telecommunications lagged behind.

S&P Sector	2003 Total Return
Information Technology	46.3%
Materials	37.9%
Consumer Discretion	36.4%
Industrials	32.6%
Financials	30.6%
S&P 500	**28.7%**
Utilities	25.7%
Energy	25.2%
Consumer Staples	15.7%
Health Care	15.0%
Telecommunications	6.8%

Source: Baseline

Investors also favored small capitalization stocks over large capitalization stocks. This behavior is typical of the early stages of a market recovery as investors purchase the stocks that were hurt the most during the previous recession and stock market decline.

Stock Index	2003 Total Return
S&P 500	28.7%
S&P MidCap 400	35.6%
S&P SmallCap 600	38.8%
Russell 2000	47.3%

Source: Bloomberg

Outlook for 2004

The economic environment is substantially more positive compared to that of a year ago. Real GDP growth has accelerated during the past two quarters, and the most recent quarter showed strong contributions from both consumer spending and business investment. Real GDP growth is expected to moderate in the fourth quarter and in 2004 from the unsustainable 8.2% annual rate in the third quarter, but economists are forecasting a higher-than-average 4% to 5% rate for 2004. While consumer spending was the primary contributor to economic growth in 2003, economists expect business investment to be the primary driver in 2004. The tax law changes passed in 2003 will provide stimulus through personal tax refunds in the first half of 2004 and business investments made to take advantage of accelerated tax deductions before the end of the year. Operating earnings per share of the S&P are estimated by analysts to accelerate again in the fourth quarter with growth of 19% over the prior year's quarter, and then moderate to a still respectable average gain of 12% in 2004.

In spite of the expectations for strong economic growth, forecasters believe that inflation and interest rates will rise only modestly during 2004. In a recent survey of 54 economists conducted by the Wall Street Journal, the average forecast expected yields on 90-day Treasury bills to rise to 1.32% by June from 0.91% at December 31, 2003, and on 10-year Treasury notes to rise to 4.75% by June from 4.25%. This group also expected inflation to remain below 2% through the first half of 2004. The Federal Reserve Board has indicated that it believes the risk of deflation or inflation are about equal, and that it expects to keep short-term interest rates low for an extended period of time. Finally, 2004 is an election year, which have been historically good stock market years as the party in power of the Presidency hopes to pull out the stops to stimulate the economy.

If these forecasts turn out to be reasonably accurate, then 2004 should offer a favorable environment for investing in equities. One of the concerns about the stock market is whether many stocks have become overvalued after the strong gains during the past year. Clearly stocks are not as cheap as they were in the beginning of 2003. For example, the S&P had a price/earnings ratio of 16.9 times the 2003 earnings estimate at the beginning of 2003, and it ended the year with a price/earnings ratio of 18.4 times the 2004 earnings estimate. Both price/earnings ratios are above the long-term average ratio of 15, but they are not expensive, in our opinion, relative to current interest rate levels. Most stock valuation models are based on a discount rate that is derived from current interest rates. For example, the Federal Reserves' model uses the inverse of the yield on the ten-year Treasury note as proxy for a "fair value" price/earnings ratio for the stock market. Using this model, a 4.25% yield would calculate a fair value P/E of 23.5. Even if the ten-year Treasury yield rises to 4.75% as forecasted by the economists, the model would calculate a fair value P/E of 21. Other valuation models such as the Discounted Dividend Model and Baseline's Graham & Dodd Model produce similar conclusions. It is also interesting to note that out of the 26.4% price change in the S&P in 2003, only 8.9 percentage points or 34% of the total change came from a higher valuation. The remaining 17.5 percentage points or 66% were due to earnings growth.

What are the risks to this 2004 outlook? Of course there are always geopolitical risks. There could be another major terrorist attack, setbacks in Iraq or Afghanistan, or another SARS outbreak. The huge U.S. trade and budget deficits could cause higher interest rates and lower growth in GDP than expected, as foreign investors tire of a falling dollar and reduce their purchases of U.S. securities. If job growth stalls in the U.S. and interest rates rise, debt-laden consumers may pull back their expenditures on homes, autos, and other discretionary products. Businesses may invest less than expected due to excess capacity and the extraordinary growth in productivity. Finally, valuation models can only provide long-term guidance on the relative value of the market. In the short-term, stocks have historically moved both well above and well below “fair value”. If the earnings expectations currently reflected in stock prices turn out to be too optimistic, then stock prices most likely will decline to bring them in line with the revised expectations.

Investment Strategy

Our investment strategy, as described in last month’s newsletter, remains the same. We continue to believe that equities provide better long-term value at current prices than do fixed-income securities. We don’t expect price/earnings ratios to expand further in a rising interest rate environment. Thus, we expect returns from equities over the next several years to be commensurate with growth in earnings. However, it wouldn’t surprise us if the broad stock market indices suffer a temporary decline of 10% to 20% sometime during 2004. Stock markets never move up in a straight line, and given their experience during the market decline from 2000 to 2002, investors may be quick to sell if their expectations are not met. Since we expect stocks to generally appreciate in line with earnings over the next several years, we plan to use any such temporary decline as an opportunity to invest excess cash reserves held in accounts.

For several reasons we think some of the best opportunities for 2004 lie in the sectors that lagged the market in 2003. First, the valuations are more compelling in the lagging groups. Conversely, the valuations in the leading sectors, such as information technology, materials, and consumer discretionary are getting very expensive. Second, as the economic recovery moves into the middle stages, investors historically have taken profits from the economically-sensitive sectors that lead the initial phase of the recovery and rotate into the quality growth sectors that will show more competitive growth rates as the recovery matures. Finally, many of the stocks in these sectors have above-average dividend yields, which we believe will become more important to investors as returns from capital appreciation moderate from the robust returns in 2003. We think select stocks in the health, energy, and consumer staples sectors offer some of the best values in the current market. We also continue to like certain stocks in the financial and industrial sectors that remain solid values for the long term.

Investment Committee’s Top Recommendations for 2004

Based on our investment strategy and our knowledge of specific company fundamentals, here are the top recommendations from our Investment Committee for 2004.

<u>Johnson & Johnson (JNJ, $50.45)</u>

Johnson and Johnson (JNJ) is a leading global manufacturer and marketer of health care and consumer products. JNJ's consumer segment markets widely known branded products such as Tylenol, Band-Aid, and Johnson's baby line of products. The company's pharmaceutical franchises are primarily in the areas of contraceptives, gastrointestinal, hematology, pain management, and central nervous system. JNJ's medical device and diagnostic segment manufactures products for circulatory disease management, minimally invasive surgical procedures, orthopedic joint reconstruction, and spinal surgeries.

Johnson & Johnson significantly underperformed the market in 2003, posting a total return of -2.1% versus a total return of 28.4% for the S&P 500. JNJ enjoyed strong relative performance from the end of 2000 through 2002 (+4.9% versus -31.3% for the S&P 500), but materially underperformed the market in 2003 as investors focused on companies with greater earnings sensitivity to an improving economy. At present, the stock trades at 19x estimated 2003 earnings of $2.64, well below an average P/E of 26x over the last 10 years, despite a consensus long-term annual earnings growth estimate of 12-13% and historic earnings growth of 14% annually over the past ten years. During 2003, Johnson & Johnson peaked at $59 on April 4; from that point through the end of the year, the stock declined 10.7% while the S&P 500 advanced 26.5%. In addition to investors favoring more cyclically-oriented stocks in 2003, some of JNJ's stock price weakness during 2003 was attributable to industry issues (i.e. recurring threats of price regulation for some pharmaceutical products), as well as headline noise surrounding the risk of increased competitive threats in the drug-coated stent business.

Johnson & Johnson's lagging stock price performance in 2003 places the stock at one of its most undervalued levels in many years, both in absolute terms and relative to the market. Over the next several years, we believe Johnson & Johnson can achieve revenue growth of 7-9%, net profit margins of 18-20%, and a return on equity in excess of 25% annually. We believe this level of financial performance will support a P/E ratio of at least 20x to 25x; consequently, we believe Johnson & Johnson can trade in excess of $60 per share during 2004 and in a range of $90-$120 per share four to five years out. JNJ's relative risk is low given the consistent nature of its businesses, the favorable demographic trends affecting its key growth markets, its ability to generate significant amounts of free cash flow, and its AAA-rated balance sheet. Our dividend discount model valuation approach suggests a current fair value for Johnson & Johnson of $60 per share, indicating that the stock is undervalued by approximately 20% at current levels.

<u>Anadarko Petroleum (APC, $50.25)</u>
<u>Apache Energy (APA, $41.46)</u>
<u>ChevronTexaco (CVX, $84.72)</u>
<u>BP plc (BP, $48.01)</u>

We decided to recommend a package of four companies in the energy sector because of the earnings volatility associated with this industry. We think these companies are undervalued because current prices are implying long-term oil prices of less than $23/barrel and natural gas prices of less than $3.75/MCF, while we believe energy prices will be considerably higher than that over the next several years. The demand for energy is expected to accelerate due to the rapid growth of developing countries, especially China and India, where expanding industrial investment and increasing consumer discretionary income are demanding more energy supplies. The OPEC and other oil-producing countries have some capacity to increase production of oil and gas in the short term, but faster-than-expected depletion of some older fields and under-investment in industry infrastructure have restricted this capacity. In addition, OPEC has signaled its desire to keep oil prices above their previously stated targets to compensate for the lower value of the U.S. dollar. In the

U.S. and Canada, natural gas supplies are tight due to high natural depletion rates that have begun to surpass the industry's ability to find new reserves. In addition, the recovering economy should increase industrial demand for natural gas. As a result, some economists expect natural gas prices to average about $4 to $6 per MCF over the next several years.

Anadarko and Apache are among the largest and best-managed companies that are pure plays on oil and gas production (i.e., little or no exposure to refining, chemicals, and distribution). ChevronTexaco and BP (formerly British Petroleum) are among the largest fully integrated major worldwide energy companies and are also considered to have excellent management and significant reserve growth potential. Anadarko and Apache offer the best potential for capital appreciation, while ChevronTexaco and BP pay generous dividends.

<u>Tyco International (TYC, $28.30)</u>

Yes, this is the same company whose senior executives are being tried for stealing $600 million from the company and which has been criticized for its aggressive accounting. However, that is all in the past. New management has been installed, and the books are now being kept using more conservative accounting rules. While former management may have overpaid for some of its acquisitions, the companies that Tyco purchased were, for the most part, good businesses. Today Tyco is a leading producer of fire and security systems (est. 30% of FY2004 sales), electronic components (28%), healthcare products (24%), valves and other engineered products (13%), and plastics and adhesives (5%). Most of these businesses are recovering with the improving economy, and Tyco's earnings are expected to increase significantly over the next several years. Operating earnings per share are estimated to increase about 15% in 2004 (September) to $1.50 and 20% in 2005 to $1.80.

Tyco has also seen improvement in its balance sheet. At September 30, 2003, Tyco had cash of $4.2 billion, total debt of $21.0 billion, and stockholders' equity of $26.4 billion. Net debt (total debt less cash) was 38.9% of total capital. Tyco is also expected to generate significant free cash flow (cash generated from operations less dividends and capital expenditures). Free cash flow is estimated to increase to over $4 billion in 2004, up from $3.2 billion in 2003.

Tyco's stock appears to be undervalued compared to other industrial companies, mostly due to the problems of the past. At the current price, Tyco's stock is valued at 18.4 times the 2004 estimate and 15.2 times the 2005 estimate. Many of the other industrial stocks are trading over 20 times their 2004 estimates, and yet most are expected to show more modest earnings growth than Tyco. As Tyco demonstrates consistent earnings growth, we expect the stock to close the valuation gap to its peers.

<u>First Data Corporation (FDC, $39.47)</u>

First Data (FDC) is the leading global electronic payment and processing services provider, with dominant market positions in two segments of the market: credit card transaction processing and electronic funds transfer through its Western Union division. First Data reports its results over four lines of business: (1) Card Issuer Services (25% of revenues), (2) Payment Instruments (Western Union—42% of revenues), (3) Merchant Services (36% of revenues), and (4) Emerging Payments (2% of revenues). First Data is the leading player in each of these segments.

In 2003, FDC announced its intention to acquire Concord EFS, which is a leading processor of debit card transactions. This merger should close in 2004, and while it may be slightly dilutive to FDC's 2004 earnings, it should benefit FDC longer term in 3 ways: (1) it broadens FDC's avenues of growth to include debit transactions, which have had faster growth than credit transactions in recent years; (2) it should increase FDC's ability to cross-sell products and services across its customer base; and (3) it should allow FDC to realize some cost savings across the entire enterprise.

First Data has been an outstanding long-term performer, advancing 606% since going public in early 1992, versus a 237% total return for the S&P 500 over the same period of time. Revenues over that time have grown from $1.2 billion to approximately $8 billion for 2003, while net income has risen from $141 million in 1992 to approximately $1.4 billion in 2003.

Despite stellar financial performance over the past decade, FDC shares lagged the market substantially in 2003, advancing "only" 16%, versus a 28% total return for the S&P 500 and a 47% increase in the S&P Information Technology Sector (FDC was the 7th worst performer in the sector in 2003 out of 83 companies in the group). We believe that FDC's stock lagged in 2003 for 2 primary reasons: (1) uncertainty regarding the outcome of the Concord merger (which is now largely resolved with its recent approval by the Department of Justice), and (2) the market's preference in 2003 for companies with a higher degree of sensitivity to an improving economy.

FDC's relatively uninspiring stock price performance in 2003 creates the opportunity for better absolute and relative stock price performance going forward. FDC currently trades at the bottom of its historical valuation range; if FDC were to trade at its average valuation over the past decade relative to current earnings, the stock would trade at $55 or 37% higher than current levels. FDC's average P/E since its 1992 IPO is 25x; current consensus estimates for 2004 earnings are $2.17 per share, yielding a 2004 price target of $54. Dividend discount model analysis, using a long term growth rate of 14%, current year earnings of $2.17, and a risk premium of 5% indicates a net present value of future cash flows of $48, approximately 20% higher than FDC's current market price. While FDC shares may lag the market as long as investors are focusing on companies with leverage to a faster-growing economy, we believe that First Data is well-positioned to grow at above average rates over the long term given its dominant position in the electronic transactions and payments sector, which should benefit over time from growing volumes at the expense of paper-based forms of commerce (primarily checks and cash). Our five-year price target is $80 (20x estimated 2009 earnings of $4.00 per share).

These companies represent only seven out of the 20 to 40 stocks that we typically hold in a client's equity portfolio and the 81 stocks that currently are on the Company's Comprehensive Approved List. The Investment Committee has chosen the above companies as their top recommendations because they believe that they offer the most compelling combination of strong long-term fundamentals and an attractive current price. However, that doesn't mean that these stocks will be placed in every client portfolio. Because of the unique requirements of each account due to differing client objectives, tax issues, and existing security or industry concentrations, we may decide not to own some of these securities in certain accounts. Consequently, a recommendation in this letter does not assure the inclusion of that company in your portfolio. Nonetheless, the probabilities of the selection of these stocks for your portfolio improves where the Firm has been granted discretion to make changes. Your call to your investment manager to request that your portfolio follow the Firm's model portfolio for your investment objective should further enhance the participation in our current security research opinions and the application thereof to your assets.

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