Founders Capital Management, LLC

2003 Annual Report
Table of Contents

PRINCIPALS' LETTER
From: Founders Capital Management

—2003: A Year In Which Weight Matters—

In 2003, the stock market reversed its downward trend of the past three years as the S&P 500 gained 26.4%. Given this unusually large gain, we would like to begin by (re)emphasizing:

> *In today's uncertain environment (including low interest rates, a credit-sensitive economy, and ongoing geopolitical issues), we do not expect the S&P 500 to perform in the future as it has in the past.*

In fact, we expect it to perform far less.

Over the past 12 months, we have noticed many investors moving to the perceived safety of bonds at any price and reacquiring portions of Internet and technology companies that produce little or no profits.

This activity brings to mind one of Ben Graham's observations about the market:

> **"The market is not a weighing machine, on which the value of each issue is recorded by an exact and impersonal mechanism, in accordance with its specific qualities. Rather should we say that the market is a voting machine, whereon countless individuals register choices which are the product partly of reason and partly of emotion."**

The theme of this year's letter, as depicted in Norman Rockwell's picture, is "Weighing In." Although the investment community cast a big positive "vote" for the stock and bond markets in 2003, we recommend that individuals keep themselves "weighted" toward fundamentals in the year ahead.

Our forthcoming discussion centers on:
1. The weight placed on economic gain and increasing value
2. The investor's attitude toward fixed-income and dividends
3. Old and new risks to consider when purchasing securities
4. Key "character traits" for managers of businesses

Weighing Economic Gain and Increasing Value

Investors—both individuals and managers—should strive to make investments that generate long-term economic value rather than short-term gains. Oftentimes, however, investors become so overwhelmed with "deal heat" that they pursue both fixed-income and equity investments at any cost. This is like a horse with blinders on racing around the track without a jockey: The horse can't see what is happening around him but continues to charge ahead relentlessly. Sooner, but most likely later (and usually too late), the horse will begin to wonder, "Where am I going?"

Individuals acquire securities for various reasons, but more often than not, they are hoping for a quick run-up in price. Quite a bit of this wishful type of thinking over the past 12 months has led to price sensitivity surrounding equity and fixed-income investments, particularly around bonds. Bonds usually offer a greater safety of principal, but there are several risks associated with this so-called "secure investment vehicle," including a possibility of rising interest rates and increased risk of default. Since bond prices move in the opposite direction of interest rates, as interest rates rise in the future, the value of bonds will likely fall. In addition, the longer the maturity of a bond, the greater the impact on its price when interest rates rise. Finally, since money has become relatively inexpensive, the quality of many entities issuing bonds has decreased, triggering an increased potential for future default. (More on fixed-income securities later.)

In addition to fixed-income securities, certain stocks have also become price-sensitive. The "hot stocks" of the late '90s have significantly increased in price over the past year. We choose not to participate in this frenzy, but rather to continue to acquire portions of companies that create long-term economic value. In other words, we view the current earnings of the companies we own as a bird in hand that is worth more than the future earnings of most Internet and technology companies, which we consider, at best, two in the bush.

While most equity portfolios have risen more than 20% during the past 12 months, can we really say with conviction that the collective companies that represent these holdings have risen in equal value over the same time frame? Obviously not. There are ***very few*** companies that can grow the value of their business at an annual rate exceeding 20%. In fact, the average annual growth rate of intrinsic value for the companies in our portfolio is 10%.

We would like to emphasize that:

> ***The long-term intrinsic value of our portfolio will grow commensurately with the underlying economics of the businesses we hold . . . no more, and no less.***

Identifying the "heavyweights"

In the horse race to become wealthy, many individuals follow the logic that the shortest path between two points is a straight line. But oftentimes, the best path is not the shortest one but the one that touches all the bases. If you "race" through an investment life to reach the finish line of wealth, you'll likely get there not only in a sweat, but poorer as well. It is our opinion that serious damage can be done to shareholders, or to an investment portfolio, if the pursuit of investment opportunities lacks a disciplined approach that provides the perspective required to understand where one is headed. Our disciplined approach to acquiring securities focuses on two areas:

1) Determining whether we are placing our money on a broken-down nag or a thoroughbred. Investors should resist the temptation to run blind, adhering instead to acquisition principles targeting enterprises that:

a) have an excellent and predictable return on invested capital,

b) are operated by focused and passionate management of good character,

c) can be acquired at a "fair price," and

d) possess an adequate margin-of-safety

A company that clearly fit the above criteria this past year was Coca-Cola. A little trivia: If an investor purchased a single share of Coca Cola's stock in 1919 at the initial public offering price of $40 per share, he would have watched the stock price decline more than 50% over that first year, to $19.50 per share. We're sure that at least one investor had to have been disappointed with this performance and opted to sell his share of Coke. Another investor may have decided to hold onto her single share of Coke's business and pass it on to the next generation. Eighty-four years later, her one $40 share had evolved into the real thing—a $5.2 million fortune representing a 15% annual return. (An investor who purchased one share of Coca-Cola's stock at the $19.50 per share price in 1920 would have seen an annual compounded return of around 16%—not bad.) By the way, these returns were achieved through wars, a depression, and several recessions.

After hearing this story, it is natural to wonder: What is the next Coca-Cola? Our opinion is that the next Coca-Cola is right in front of our eyes—the current Coca-Cola. This answer may disappoint people who believe Coke is a mature company with limited future growth. (A prognosticator in a 1938 issue of *Fortune* stated that it was probably too late to buy Coke as the brand was already recognized throughout the U.S. Ironically, a writer in a 2003 issue of *Fortune* stated that Coke has "lost its fizz" and that the soda giant's prospects look flat.)

Following are some statistics for Coca-Cola's products that we believe provide some clues to determining the company's future:

	Annual per capita consumption of Coca-Cola products*	**Population**
North America	414 servings	325 million
Asia	25 servings (10 servings in China)	>3.3 billion
* Including Coca-Cola, Minute Maid, POWERAID, and Dasani water		

Question: Do we think Coke has a lot more room for growth in the upcoming decades? Our opinion is yes….somewhere between "a lot" and "a whole lot."

2) Determining the long-term odds for gain. In acquiring securities, we attempt to ensure that the long-term odds for a fair return on our money are in our favor. The important factors for choosing investments do not lie in the "price momentum" of a security, but in evaluating the inherent long-term economic value of a security and determining the "fair price" to be paid today for this value. Thus, the key questions to ask when evaluating ***all*** securities are:

a) How much money will an investment produce for owners over a defined period of time?

b) What is the value of this time and money today?

When answering these questions, we do not seek to settle on an exact value for a security. What we do seek to know is whether the value of a security is sufficient to justify an acquisition. We can feel comfortable with our "approximate measure" of value as long as we have built a margin-of-safety into our initial purchase price.

Ben Graham used the following allegory to illustrate the point that determining an approximate (vs. exact) value for a security may be sufficient:

> "It is quite possible to decide by inspection that a woman is old enough to vote without knowing her age, or that a man is heavier than he should be without knowing his exact weight."

Put another way: Astute investors recognize when a security is selling at a significant discount to its true value.

We are rather agnostic about the price momentum of individual securities and/or of the stock market as a whole. Our interest is in purchasing a combination of businesses (at fair prices) that are considered thoroughbreds in their respective industries, and then holding on for the ride. We feel so close to our businesses that we think of ourselves as owners/partners in each enterprise and actually view the portions collectively as if they were one company—owned by us.

Toward this end, we will discuss each sector of our business investments, referring to them each as a "division" of our combined company. (As you can see, in our view there is little difference between investing in securities that are publicly held as opposed to owning a portion of a private business.) Our main job, as money management jockeys, is to choose the best-in-class business thoroughbreds and make sure we steer our capital to stay on a good long-term track toward fair returns.

BUSINESS UNIT REVIEW

Our **Food and Beverage Division**: PepsiCo had another fantastic year. Pepsi's worldwide volume is growing at approximately 3%, while Frito Lay continues to grow its year-over-year snack food business by more than 4%. Profits improved more than 12% over last year's performance. Our hats are off to PepsiCo Chairman Steve Reinemund and his team for continuing to deliver a stellar performance. We are pleased to own PepsiCo due to its dominant position in the snack food business as well as its growing non-carbonated beverage business. (Many people associate PepsiCo's beverage business solely with the Pepsi-Cola brand, but Pepsi-Cola is just one product among a large and growing stable of brands that includes Tropicana, Aquafina water, and Gatorade. In fact, PepsiCo's total share of the U.S. beverage business (28%) exceeds that of Coca-Cola (27%).

We also own Coca-Cola, one of the best (if not the greatest) business franchises on earth. Coca-Cola continues to grow its worldwide beverage franchise. Coke's total case volume grew at a rate of about 4% during 2003. Although Europe experienced a 6% growth rate in Coke's products, the volume growth in Asia was around 4% in 2003 (compared to 6% last year) due to a 7% decline in volumes in Japan, as well as accusations in India regarding high levels of pesticides found in groundwater and soft drinks. We will monitor this situation in India, but currently the accusations that soft drinks contain high amounts of pesticides has turned out to be false. Nevertheless and as stated previously, we believe Coke's greatest growth opportunity over the next 20+ years resides in Asia.

Our **Restaurant Division**, led by McDonald's, has turned the corner on its business in the highly competitive fast-food industry. We expect to see McDonald's growth rate slow down until the economy improves and industry-pricing pressures subside. We are excited to see McDonald's growth continue in China through the addition of 100 restaurants. McDonald's new management team, led by Jim Cantalupo, is successfully introducing new products and improving the company's current business. The new salad offering is extremely profitable, and McDonald's announced year-over-year net income growth of 12% in the third quarter alone. For the year, McDonald's U.S. sales expanded by more than 4%—quite a feat in this difficult economic environment. In the future, we expect McDonald's annual systemwide sales and revenue to grow at a rate of 3% –5%, operating income growth of 6%–7%, and return on incremental invested capital in the high teens. We continue to be pleased with the new McDonald's management team and look forward to positive developments in the future. To borrow the company's new advertising theme…*We're lovin' the results.*

[A side note: During December a Holstein cow in the State of Washington was tested presumptively positive for bovine spongiform encephalopathy (BSE or "mad cow disease"). We will be monitoring this event, and the impact on McDonald's. However, McDonald's has stated that this situation has had no business impact on their U.S. sales-to-date. McDonald's currently receives only 15% of its total sales from beef related products, and has led the industry in requiring micro-biological and food safety testing for all raw materials and finished beef products. 100% of McDonald's raw material is tested on a consistent basis for food safety.]

Our **Technology Division**, spearheaded by Microsoft, had a good year. The software juggernaut is producing $1 billion dollars in cash per month and ended the year with more than $50 billion in cash equivalents and short-term investments on its balance sheet. Although heavy competition is expected in the future from Linux (a free operating system being adopted by many corporations), Microsoft has doubled its annual dividend to $0.16 from $0.08, which was payable to shareholders this past November 7th. The core software group is expected to grow at around 8% during 2004 despite continued challenges in the technology business. Microsoft also continues to expand its franchise in the cable, small business, and consumer realms. We are pleased with Microsoft's leadership and continued growth during a time that most technology companies are experiencing a downturn. Microsoft will remain our dominant technology holding.

We are sometimes asked why we don't place a larger portion of our holdings in Internet and technology, especially when many of these companies were projected to have tremendous futures as their prices rose rapidly over the past 12 months. eBay, for example, now has a total market value of around $40 billion dollars, along with annual earnings around $500 million dollars. Amazon.com's market value exceeds $20 billion, against $250 million in annual profits. These and a few other companies are rising in price and actually producing profits. Many others are producing significant losses, however, yet their stock prices also continue to rise. Amazon.com and eBay are well-run and respected organizations, but we are not comfortable purchasing them at prices that are 80 times their current profits. In fact, we would not be interested in acquiring these companies if their prices declined more than 50% from current levels. We would not place our own money in these risky situations, and we will not place your money in areas that make us uncomfortable. Our goal is to **NOT** sleep like a baby (i.e., tossing and turning all night and waking up every three hours). Given our middle-aged status, we still like a good night's sleep.

Of course, many investors choose to disconnect the price of a security from its value and speculate. (We do not think speculation is a sin. We simply have not found it to be financially rewarding.) We must admit to being somewhat baffled by the current rampant speculation among investors, especially in the wake of the severe correction that occurred over the previous three years. For example, the valuation gap between technology and pharmaceutical companies (in which we have a large position) is now rather large. Many large technology companies have more than twice the price-to-earnings multiples compared with large pharmaceutical companies. Yet the drug industry has been a better business over time. The returns on capital are higher than technology, the products have greater protection through patents, and the need for drugs increases over time. So we choose to stick with companies that we understand and know we can purchase at a fair price, even if they are not considered the "hot stocks" by certain investors.

Our **Pharmaceutical Division**, led by Pfizer and Merck, remains under pressure as prescription drug pricing continues to be a political lightning rod, patents expire, generic drug competition becomes prevalent, and R&D continues to be not only increasingly costly but inefficient. (On average, it takes more than 15 years and costs more than $800 million to bring a new drug to market.) Nevertheless, we would like to reiterate our investment interest. It is highly probable that R&D methods will become more efficient over the next decade through efforts to decode the human genome. In addition, the high cost of clinical trials may come down as new technologies such as proteomics and systems biology enable better computer modeling of clinical outcomes. Merck and Pfizer are leaders in their industry and are very profitable. As the pharmaceutical industry transforms, we believe they will evolve successfully.

Our **Financial Service Division** continues to do very well. The intrinsic value of Berkshire Hathaway, our largest financial investment, grew at approximately 15% in 2003 and added more than $850 million in equity per month to its balance sheet. As a large amount of cash comes in from insurance float and profits from wholly owned businesses, Warren Buffett continues to allocate this accrued capital in a manner that exceeds the returns available to normal investors.

Over the past year, Berkshire Hathaway acquired Clayton Homes, a vertically integrated manufactured housing company; and McLane, a large food distributor previously owned by Wal-Mart. These businesses are big, profitable, and will add value to Berkshire shareholders over time. Warren Buffett purchased these businesses for around seven times pretax earnings, when the average company in the Standard and Poor's 500 index trades at twice this price—approximately fourteen times pretax earnings. As long as Mr. Buffett can acquire and allocate capital in ways that we are not able to, we will hold Berkshire Hathaway's stock.

> ***Note: Sometime in the next few months, you will receive Berkshire Hathaway's annual report. We urge you to take an hour to read through Mr. Buffett's letter to shareholders. We promise you won't be disappointed.***

Our **Retail Division** continues to work through a difficult economic environment. You will notice that we decided to sell GAP in the third quarter. Our reasoning behind this sale was not due to the profit we made on this investment in a short period of time. We took a long-term perspective on GAP and decided that the new management team had begun to base GAP's clothing designs on current fashion trends vs. the classic clothing GAP had focused on in the past. We do not fault this logic but became uncomfortable with the potential for inconsistent future results as GAP tries to forecast new clothing trends. A few bad forecasts could lead to large losses, and ultimately GAP's results could be difficult to predict.

We are pleased with the strides Home Depot continued to make during 2003. Home Depot added more than 200 stores in 2003 and plans to add an additional 175 stores in 2004. The company's emphasis on the customer is paying dividends, as same-store sales and financial results continue to improve. Home Depot is on track to deliver sales growth of 9%–12% and earnings growth of 9%–12% during 2004.

The grocery retailers—namely, Kroger and Safeway—continue to struggle in the down economy as they compete with Sam's Club, BJ's, and Costco. Because this industry is highly fragmented, we believe the large grocery store chains will continue to grow, albeit at a slower pace. The economics of the business are changing rapidly, with narrowing profit margins. These entities remain profitable, however, and we expect to do fairly well with our investments in this area. (We may not hit a home run in the grocery arena, but singles count when developing a portfolio of businesses.)

Our **Media Division**, led by Liberty Media, is adding value to shareholders in unique ways. Most individuals have never heard of Liberty or of its well-regarded Chairman, John Malone. John Malone established TCI, one of the largest cable companies in the U.S. In 1999, TCI was acquired by AT+T, along with Liberty Media, a subsidiary of TCI. In 2001, AT+T spun off Liberty Media into a separate entity and John Malone became Chairman. John Malone is an outstanding allocator of capital in the media arena; he knows the industry well and invests in outstanding assets that grow over time. We are pleased to be a co-owner of the media franchise he is growing and acquiring. Liberty's main private holdings are: Discovery Channel, QVC, USA Networks, Encore, and STARZ! Liberty also holds a significant stake in public companies including Time Warner (4%), Motorola (3%), Viacom (1%), News Corporation (>18%), Sprint PCS (19%), and InterActive Corporation (>18%). When we add the public and private values of these entities, we obtain a per-share price that is north of the current selling price.

MANAGEMENT'S DISCUSSION

Fixed-Income and Dividends

> *Any commitment of capital to an investment that offers a low rate of return is not advisable.*

Exceptions to this general rule may be made when an investor needs a short-term place to put his money until an appropriate long-term opportunity comes along. In evaluating short-term versus long-term opportunities, an investor should pay close attention to interest rates. For example, if an investor decides to purchase long-term government bonds that mature in 30 years (currently offered at approximately 5.2%), he may assume that he is maximizing his returns, as the interest paid on these securities is higher than the 1%–3% currently paid on shorter maturities. In reality, the risk associated with this long-term contract is actually greater, as the value of these bonds is highly sensitive to fluctuations in interest rates. At most times, this investor would be better off placing his money in fixed-income securities with shorter maturities, or in bonds that are undervalued due to some market inefficiency.

During 2002, we stated that we were watching our long-term fixed-income investments. In the 3rd quarter, we took action. We sold our longer-term fixed-income investments, which are more sensitive to interest rate increases, and placed them in shorter-duration treasury securities. Because interest rates were at 45-year lows, and the principal on fixed-income securities moves in the opposite direction to interest rates, we had grown increasingly concerned that rising interest rates would significantly impact the gains that we had experienced on these long-term securities in the previous 12 months. We are now waiting patiently to reallocate this capital toward fixed-income securities that will provide us a "fair return" that is commensurate with the risks we are willing to take.

And now for our view on several other fixed-income instruments that have emerged as popular alternatives during this low-return period: High-yield, fixed-income securities; and convertible securities.

High-Yield, Fixed-Income Securities
High-yield, fixed-income securities (known as "junk bonds") emerged during the 1980s as organizations issued well-below-investment-grade securities primarily to raise money for acquisitions. Here's how it works: When a company purchases another business for a few billion dollars, it may issue an almost equivalent amount of high-yield bonds to investors, along with a promise to pay annual interest of +8%. (It should be noted that these bonds used to be offered with coupons in excess of 15%.) An overlying reason for issuing high-yield bonds versus additional stock to support an acquisition is to avoid diluting ownership from current shareholders, while maximizing their future returns.

We caution investors to stay away from newly issued junk bonds. These securities oftentimes end up in default and are usually restructured, as too much debt is issued as a result of an overpriced acquisition. The original bond owners end up receiving a small percentage of their original investment while stockholders usually wind up receiving nothing.

Of course, when one investor makes a mistake in purchasing a newly minted junk bond, an opportunity can be created for another investor when the bond falls out of favor. If the purchaser decides to sell his fallen bond, the astute investor could be in the position to make a lucrative business judgment in response to another individual's emotional decision to sell. In opting to buy, the opportunistic investor should determine that the business has a high probability of returning the original principal and interest on the investment within a reasonable period of time. This is the opportunity we seek in the small number of instances in which we buy high-yield debt (we'll sneak in the other name—junk bonds).

Convertible Securities

Another entree on Wall Street's higher-risk, fixed-income investment menu is the opportunity to convert fixed-income securities into equity, or shares of common stock. This "kicker" is supposed to instill greater confidence about the yield the investor receives as part of his fixed-income investment, as well as the opportunity to participate in the appreciation of the company's stock price. Theoretically, convertible securities offer greater upside potential than traditional bond or preferred stock offerings. (The issuer usually offers a convertible feature as a "sweetener" to enhance the marketability of a bond or preferred stock issue.)

Because the conversion feature is usually offered at a significantly higher price than the current common stock price, investors should look at convertible issues primarily as fixed-income investment opportunities. The investor that is inclined to purchase convertible securities for the conversion opportunity should do so with a clear understanding of the intrinsic value of the company relative to the conversion terms associated with the preferred issue.

Note: We have not seen any opportunities in the fixed-income/conversion area that interest us. Most of these issues are convertible at a price that is far above the price we would consider paying for the company's stock and offer paltry yields for the high risk they present.

Dividends

Management may decide to distribute unrestricted earnings to owners using one of two methods:

1. A "pure" dividend payment strategy, whereby owners will be taxed on the income, or
2. Repurchasing shares in the open market, conferring to owners a larger slice of the ownership pie and delaying capital gains taxes well into the future.

With the current tax change on "pure" dividend income, and the subsequent raising of dividends by many companies, we should address our view on corporate dividends.

Many investors believe that a corporation's announcement of a higher dividend automatically leads to higher returns. This is not necessarily the case and, in fact, may lead to decreasing returns over time. Several corporations that are extremely competitive or capital-intensive are paying out dividends to prop up their share price, even though these dividends represent restricted earnings needed for ongoing life support of the business. In reality, even these corporations' retained earnings may not lead to increasing economic value.

The reason retained earnings may not necessarily lead to increased economic value is found in the accounting methods used on the depletion of assets. In theory, depreciation allowance should equal the amount of money needed to purchase a replacement asset. If the depreciation rate is correctly calculated, and the replacement cost of the asset remains stable over its useful life, there is a so-called wash. Due to rising costs and inflation, however, the total accumulated depreciation may not be nearly enough to replace the worn-out asset. If the depreciated amount is not sufficient to cover the purchase of a replacement asset, capital from retained earnings must make up the difference.

To illustrate how the depreciation of buildings and equipment used in a business may not cover today's replacement cost, let's evaluate the purchase of a new automobile—a replacement for a

Volvo that is 100 years old (in car years). Let's say that an individual purchased a Volvo 10 years ago for $19,000. If the car were expected to last 10 years, it would be depreciated at $1,900 a year over the useful life of the car. If the individual decided to purchase a new Volvo after 10 years, however, the same model would actually cost $38,000---100% more than the purchase price of the initial Volvo. Clearly, the $19,000 total depreciation expense is no longer sufficient to cover the replacement of the new car. The individual would need to tap savings (i.e., retained earnings), in addition to the depreciation allowance, to purchase a new Volvo.

How should management set a dividend policy for a company? If management is overseeing a competitive business and holding (or growing) its position in the marketplace, the decision to keep or return unrestricted earnings should pivot on the economic value that can be produced for owners. For example, a business that generates a 6% return on equity would probably best serve its owners by returning unrestricted earnings, as owners could most likely invest this money to earn a return greater than the 6% produced by the company. In contrast, a business that produces a 20% return on equity would probably best serve its owners by retaining unrestricted earnings (assuming management would effectively use the capital to achieve the same high return), as owners would be challenged to obtain an equivalent or greater return through a different investment. If management cannot find a suitable opportunity to invest unrestricted earnings at a higher rate of return than shareholders could obtain elsewhere, then unrestricted earnings should be returned to shareholders.

A final note on dividends: Many corporations today have chosen to borrow additional funds to shore up underfunded pension plans and replace their worn buildings and equipment, while continuing to increase their dividend payments to shareholders. This "borrow from Peter to pay Paul" mentality is evident not only in corporations but throughout our society and could represent a large risk to the future economy.

Investment Risks

The federal government, state governments, corporations, and individuals have exponentially increased their total debt as interest rates have been driven to their lowest point in a generation.

The federal budget deficit topped $374 billion in 2003 and is expected to surpass $500 billion in 2004. (This year's $374 billion figure was more than double the 2002 deficit of $158 billion.) The current deficit is the largest dollar amount on record, driven skyward principally by the slow economy, tax cuts, and significant spending on the Iraq war. The federal deficit as a share of the overall economy is around 3.5% and could reach 5% next year, equaling the 5%-6% peak of the mid 1980s.

Turning now to the U.S. trade deficit, we also see a great increase over the past five years. In 1997, our trade deficit grew annually at $100 billion. In 2003, the annual trade deficit will exceed $400 billion and may reach $500 billion in 2004. In the November 10th issue of *Fortune* magazine, an article by Warren Buffett addressing America's growing trade deficit pointed to the fact that the trade shortfall is slowly selling the nation out from under us. In the article he cites that:

> *"….foreign ownership of our assets will grow at about $500 billion per year at the present trade-deficit level, which means that the deficit will be adding about one percentage point annually to foreigners' net ownership of our national wealth. As that ownership grows, so will the annual net investment income flowing out of this country. That will leave us paying ever-increasing dividends and interest to the world rather than being a net receiver of them, as in the past.*

> *We have entered the world of negative compounding—goodbye pleasure, hello pain. Our annual trade deficit now exceeds 4% of GDP. Equally ominous, the rest of the world owns a staggering $2.5 trillion more of the U.S. than we own of other countries. Some of this $2.5 trillion is invested in claim checks—U.S. bonds, both governmental and private—and some in such assets as property and equity securities. In effect, our country has been behaving like an extraordinarily rich family that possesses an immense farm. In order to consume 4% more than we produce—that's the trade deficit—we have, day by day, been both selling pieces of the farm and increasing the mortgage on what we still own.*
>
> *To put the $2.5 trillion of net foreign ownership in perspective, contrast it with the $12 trillion value of publicly owned U.S. stocks or the equal amount of U.S. residential real estate or what I would estimate as a grand total of $50 trillion in national wealth. Those comparisons show that what's already been transferred abroad is meaningful—in the area, for example, of 5% of our national wealth."*

Some readers may point out that we have encountered deficits in the past, and borrowing activity has led to positive future economic results. This is true, except that the current borrowing is not being used to finance investment in national infrastructure, such as in building transportation and communications systems. Our current borrowing binge is directly tied to Americans' collective compulsion to consume. In other words, there is no future return associated with this borrowed money—only a repayment through savings.

In addition to borrowing at the national level, state governments have joined the credit crowd. During 2003, the state of Illinois sold $10 billion of 5-year and 10-year pension-fund obligation bonds. The coupon on these so-called safe bonds offered an investor the opportunity to earn up to 3% annual interest. (General Motors has also completed an offering of $13 billion in bonds to contribute to its underfunded pension trust.) These organizations are now turning around and investing a large portion of the raised funds in the stock market. Why do these organizations believe they can confidently place these borrowed funds in the stock market? Many consultants and investment professionals most likely have assured the state of Illinois and General Motors that the stock market historically offers an annual return of 8% or more over the long run.

The implied theory is that when an investor borrows money at a rate of 3%–5%, the loaned money can be reinvested at 7%–8%, positioning the investor to claim a profit on the difference between the money earned (via investing) versus the money paid (the cost of borrowed money). For example, if we borrow $1,000 with an obligation to pay interest of 5% ($50), and turn around and invest the $1,000 at an earnings rate of 8% ($80), we can feel extremely smart about making a $30 profit off our borrowed sum. The concern surrounding this example is not the theory but the extent to which this practice has been carried out, leading to speculative behavior among all participants. The alarming part of this equation is that this activity can be traced to individuals. Many individuals refinanced their house this past year under this same premise—to borrow money at a low rate and place an ever-increasing amount of their equity in the rising stock market. This dangerous approach creates possible credit risk as total U.S. debt now exceeds our Gross Domestic Product (GDP) by more than 300%. What is forgotten in this scenario are the volatility of the stock market and the fact that a market downturn impacts the ability to repay the borrowed funds. In summary—looming credit risk.

In addition to looming credit risk, we need to remind ourselves of the other risks inherent in any future investment. For instance, most investors are familiar with the issues associated with equity investments. Traditional risks with stocks include volatility and a potentially large loss of principal. Recently, we have begun to focus on a lesser-known form of risk called "aggregation risk."

Protecting against aggregation risk involves assessing the portfolio of equity holdings to ensure that one unexpected event does not permanently impact the value of many holdings. For example, an investor may think that with holdings in an insurance company such as AIG, an industrial company such as GE, and a transportation and defense company such as Boeing, his portfolio is diversified. He may not realize the domino effect that airline bankruptcies may have on all three holdings. These companies are among the largest creditors in the airline industry (providing aircraft financing), and their values would be significantly impacted in the event of large airline bankruptcies.

Given today's challenging investment environment, we want to assure you that we are mindful of the risks that surround us. We are allocating capital in such a manner as to minimize the various risks, including any domino effect a financial or non-financial event could have on our holdings. We don't hold multiple stores located in malls, businesses primarily located within the boundaries of one area, or companies that have large amounts of debt or that sell products by allowing consumers to delay the purchase for many months. Although we cannot forecast an unforeseen event (financial or non-financial) and protect the "price" of our assets, we have taken precautions to ensure that an unforeseen event does not impact the long-term "value" of our assets.

Business and Management Ethics

In last year's letter, we discussed dishonest management teams that misrepresented themselves and the companies they led. With the current investigation into the mutual fund industry, it seems that dishonest behavior is in vogue throughout the financial service industry. Apparently, many mutual funds were providing special trading opportunities to certain institutional clients. Under an "atypical" circumstance (that soon became typical), XYZ fund would allow ABC client to make quick buy and sell decisions that were not available to normal investors. For example, let's say after the stock market closes, ABC client reads that many of a mutual fund's largest holdings reported higher-than-expected earnings. If XYZ fund closed for the day at a net asset value of $15, investors could be confident that the higher-than-expected earnings announcement would lead to a rise in the fund price the following day. Prior to the funds opening the next day, XYZ fund would allow ABC client the ability to purchase shares at the old price of $15. Other investors in the fund did not have this opportunity, since this illegal trading is not permitted. Besides the enormous fees inherent within mutual funds, this egregious action adds to the cost investors must bear as fund returns are "watered down" through profit-skimming. Ironically, it is many of these same money management firms that were standing in the front of the line in recent years screaming for corporate governance reform in the face of misdeeds by company management. This poor behavior demands that investment firms come clean with their principles regarding management of client wealth.

In Closing

Founders Investment Advisors and The Terrion Group are pleased to announce that we have combined our businesses. We will be changing our name to Founders Capital Management to better describe our business activity. Under this setting it is reasonable to ask: What does the combination of our two firms mean for you? One of the greatest benefits that we can offer is business consistency. As separate entities, we have been asked several times, "What if something bad happens to one of you?" Now, we will be able to say with confidence that under this scenario our clients would be in good hands with our combined partnership. We are now in this all together. Most of our family and friends money is entrusted to us, and we would not hesitate to pass this trust on to remaining partners if “something happed” to one of us. Honesty, integrity and a sense of fairness, along with a passion for business, are common themes among the three of us. Each of us are comfortable knowing our family is in the right hands if one of us were unable to continue managing the business.

Given this monumental time in our company and the many issues surrounding investor trust today, we thought it would be a good idea to take advantage of this opportunity to fully communicate our management principles. We have attached our founding principles as a supplement to this letter, and we encourage you to read them. But before we present our founding principles, it is fair to say that there are certain things we can promise, and certain things we cannot promise. We cannot promise that you will experience market-beating returns every year, nor can we promise a positive result every year (although our goal is to accomplish both). What we can promise is that we will always strive for success. Our definition of success is to give a 100% passionate effort to create wealth for each client. We will pay attention to detail, and we will be fully engaged in our business. We also promise to be forthcoming when we make mistakes, and we promise to learn from those mistakes. For better or worse, we are an open book. We will care for each client’s money as if it is our own, and we will set the bar high with an unflagging commitment to complete integrity, honesty, and sincerity.

We thank you for your continued confidence and support. We wish you the best in the upcoming year and look forward to serving you in 2004.

FOUNDING PRINCIPLES

We regard Founders as a collection of special members that have a unique attitude toward investing. *We consider ourselves in partnership (although we are not a partnership) with our members and invest our own wealth alongside that of our clients. (In other words, "we set ourselves at the same table.") This ensures that we treat our members' wealth the way we would like to have our wealth treated. This unique approach provides our members confidence that we are using the most effective methods to achieve our goals as we* ***mutually build long-term wealth.***

Founders takes active and direct control of managing wealth and makes all investment decisions. Founders offers a fee-based investment service and purchases securities directly for our members. There is no conflict within our firm—the client comes first. There are no "hidden" commissions or fees within a portfolio. We seek to minimize trading and to identify the "best execution" when purchasing a security.

Founders focuses on risk management when managing wealth. *Risk management serves as a foundation for successful investment. We believe it is extremely important that investors understand the risks they are taking when investing in securities. It is important to directly match an investment portfolio to risk tolerance, as a mismatch can lead to volatility that is uncomfortable for our members. We invest in quality securities at the right price that will be held for a period of years. This enables Founders to monitor investments more closely than if they were in various mutual funds with constantly changing positions, and to keep investment management fees lower.*

Founders has a distinctive viewpoint, one that is rooted in seeking long-term value. *Founders bases its investment practices on value-based investing. We are disciplined and make investment decisions only after we have thoroughly measured the long-term value of a stock and/or bond. We are agnostic about the market and its direction, and we apply a rational thought process when we acquire any security. Our goal is to purchase quality securities that will obtain the highest compounding yield over the greatest length of time, ensuring that we have a "margin-of-safety" on each individual investment.*

Founders will fully communicate with members and assist them in achieving their investment objectives. *It is our opinion that members benefit from a fiduciary and due diligence standpoint if they receive a high level of communication and commitment from the managers they have chosen to invest their funds. We are committed to keeping members informed of our investment choices, and we will be open with our reporting, discussing the pros and cons of each of our investments.*