

# J.L. BAINBRIDGE & COMPANY, INC.

◆ PROFESSIONAL MONEY MANAGEMENT ◆

## 2004 ANNUAL REPORT

### INVESTMENT RESULTS

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For 2004 J.L. Bainbridge & Company, Inc. achieved a 14.6% rate of return on all money managed in its equity investment program. In conjunction with 1994, 1995, 1996, 1997, 1998, 1999, 2000, 2001, 2002 and 2003 returns of 10.2%, 38.4%, 20.3%, 23.2%, 29.9%, 5.6%, 16.9%, -3.2%, -8.5% and 13.8% respectively, a January 1, 1994 investment of \$100,000 has grown to a December 31, 2004 value of \$418,492 which equates to an increase of 318% over the past eleven years. The annually compounded return over the past eleven years is 13.9%. These results assume reinvestment of dividends and are after transaction costs and our management fee.

### INVESTMENT REVIEW

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While the prevailing view is returns over the next several years are expected to be in the single digits, we remain committed to our 15% objective and are pleased that during a year marked by considerable stock market turbulence, we came extremely close to a 15% return. Once again the wisdom of staying with high quality investments when the media is full of gloom and doom was validated last summer and autumn when the market was in decline and

investor expectations were low. In an unusual year more than half of our return was achieved in the last ten weeks of the year and had we sold our holdings as the “experts” were recommending in October, our return for the year would have been less than 6%.

One unusual aspect of 2004 is the relatively wide variation of returns among clients. While there are always variations between clients, last year this was more pronounced because the returns achieved by each of our investments ranged from a negative five percent for Cardinal Health and flat for Wal-Mart to a gain of almost fifty percent for Nuveen and PETSMART and over thirty percent for McGraw-Hill and Target. Hence clients with a larger position in certain investments either fared better or worse than our composite return. While this can be disconcerting for those clients that experienced a lower return, returns even out over the years and based on our experience in the past, clients with a lower return last year will likely fare much better this year.

### INVESTMENT STRATEGY

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Last year the market remained highly volatile, and we see no reason to expect the volatility to lessen

over the next several years because most investors are focused solely on short-term events. This volatility rears its ugly head in the overall market as evidenced by the market decline last summer and early autumn prior to the presidential election as well as in individual stocks such as Cardinal Health's sharp decline prior to its recovery late in the year.

Many clients questioned our resolve to hold Cardinal Health during this period. Be assured our decision was not based on stubbornness or the inability to realize a mistake. In all cases where our analysis indicates an investment's prospects or risk characteristics change, we react decisively as was the case in year 2001 when we sold Merck at \$82, which resulted in a loss of as much as 12% for some clients. We sold because future prospects diminished when the sales growth of their new drugs slowed unexpectedly. On the other hand we sold Pfizer in 2003 due to the risk of safety side effects of Lipitor.

Cardinal's decline was painful and the media hype caused many investors to sell. One client called in October to make us aware that an "expert" on CNBC stated that Cardinal was a junk company and should be sold immediately. Obviously this "expert" had neither any knowledge of Cardinal's business prospects nor a good analysis of their cash flow. This client asked, "How can we be so confident Cardinal will not experience the same fate as Enron and WorldCom?" Our confidence was based on two factors. First a thorough understanding of their pharmaceutical distribution, medical supply manufacturing and distribution, hospital automation and biotechnology drug manufacturing businesses and how well these businesses are positioned to grow as the demand for healthcare accelerates as the population ages. Secondly a detailed cash flow

analysis revealed no indication of accounting fraud and showed a close correlation of cash flow growth and earnings growth. This is important because one can inflate sales and/or capitalize expenses and fraudulently increase net income but because phony sales do not produce any dollars and because dollars are spent to pay for the misclassified expenses, cash flow is not affected. The situation with Cardinal was further influenced by an accounting review, which dragged on for months. However when this review was concluded with no impact on cash flow, no impact on sales other than minor reclassifications and less than a one percent reduction in net income, Cardinal's stock soared twenty percent in a single day and at year end recovered most of its decline. With double digit growth expected to resume in the second half of this year upon the completion of the transition of their pharmacy distribution business to a fee for service contract, our expectation is Cardinal will be one of our best investments this year as well as over the next several years.

The fact Cardinal last year and Avon five years ago, declined for no good reason is a fact of an investor's life and future individual stock declines will surely occur. To mitigate the impact of such declines in the future we decided to increase the number of companies in our investment portfolio which reduces the size of each holding. Hence if an individual stock declines the impact on the total portfolio will be greatly reduced. We now have twenty-three companies, and new client accounts, which are large enough to fully diversify, have no more than six percent in a single stock. Our goal over the next two to three years is to diversify existing clients' portfolios by selling a portion of large positions as they near full value and reinvest the proceeds in new stocks. In fact we have begun this process via our recent sale of part of McGraw-Hill in clients' accounts where this investment has

grown to make-up a large percentage of the total. We did not make this sale because of lower expectations of their future business prospects. The thirty percent appreciation in McGraw-Hill's stock last year provided an opportunity to sell a portion at a good price and achieve greater diversification. Our intent is to follow the same procedure going forward as large positions become fully valued. The strategy to reduce the size of each holding will reduce the impact of an individual stock decline, and because we have not deviated from our long standing discipline of owning only companies with proven earnings growth and exceptional finances, the overall quality of the portfolio has not been compromised.

Consequently we have reduced individual stock risk while retaining the protection against market risk. We cannot over emphasize the importance, which was demonstrated again last year; of carefully selecting quality companies and holding on to them during emotional market declines. Investors that join the panic and sell when the market is low, incur permanent loss of capital and poor investment returns. We have been fully invested throughout the past eleven years, and a client that invested \$250,000 eleven years ago now has \$1,046,230 and a secure retirement. This could not have been realized either by selling during any of the panic declines that occurred during this period or by misjudgments that result in selecting poor companies for investment. Be assured we will never deviate from the philosophy of owning only the highest quality companies, buying them only when the price is reasonable and holding for the long term to reap the benefits of their earnings growth.

## CONCLUSION

As stated at the beginning of this report, in the face of investor sentiment that modest single digit

returns should be all one should expect over the next several years, we are fully committed to achieving our 15% annually compounded objective. It is nothing short of amazing that the same "experts" that are cautious today were overly optimistic five year ago when the market valuation was much higher. Logic says that when the market is high expectations should be low and when the market is low expectations should be high.

For the past three years we have stated that because the stock prices of our investments are reasonable, the opportunity to achieve returns above 15% is a reality. In fact because our return in 2004 was actually slightly less than the composite earnings and dividend growth of our portfolio, the portfolio is valued somewhat lower than a year ago and is substantially lower than five years ago. This together with firm conviction that the companies carefully selected for investment are highly ethical and will continue to produce strong double digit growth, is the basis of our confidence that we will continue to meet our clients' needs for many years to come.

It should not be assumed that past results will be achieved in the future or that a loss could not be incurred. Furthermore it should not be assumed that a 15% compounded return will be achieved or that future results will exceed market indexes.

In accordance with SEC regulation, a current copy of our SEC registration from ADV Part II is available upon request free of charge.

PRIVACY POLICY: J.L. Bainbridge & Company, Inc. policy is client information is private and is not shared with any individual, organization or firm.

# ENHANCING CLIENTS' LIVES

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At J.L. Bainbridge & Company, Inc. our business is dedicated to “enhancing clients’ lives” by providing long term professional money management service totally focused on helping clients finance their children’s education, build and preserve the resources for an enhanced retirement and achieve a meaningful higher standard of living.

The foundation of J.L. Bainbridge & Company, Inc.’s business philosophy is based on the full understanding that our future and success is completely dependent on client satisfaction and delivering to clients a consistent long term investment service of the highest level of quality, competence and integrity.

Our commitment to “enhancing clients’ lives” is a guiding light that governs our professional daily activities and demands every decision and action be assessed as to exposure to investment risk as well as the long term benefit to clients.

## J.L. BAINBRIDGE & COMPANY, INC.

Managing more than \$290 million for over 800 clients nationwide.

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