

# J. L. BAINBRIDGE & COMPANY, INC.

◆ PROFESSIONAL MONEY MANAGEMENT ◆

## 2005 MID-YEAR REPORT

### INVESTMENT RESULTS

For the first half of 2005 J. L. Bainbridge & Company, Inc. achieved a 1.02% rate of return on all monies managed in its equity investment program. In conjunction with 1994, 1995, 1996, 1997, 1998, 1999, 2000, 2001, 2002, 2003 and 2004 returns of 10.2%, 38.4%, 20.3%, 23.2%, 29.9%, 5.6%, 16.9%, -3.3%, -8.5%, 13.8% and 14.6% respectively, a January 1, 1994 investment of \$250,000 has grown to a June 30, 2005 value of \$1,056,932. This equates to an increase of 323% over the past eleven years and six months or 13.5% compounded annually. These results assume reinvestment of dividends and are after transaction costs and our management fee.

### INVESTMENT REVIEW

While our results for the first half of 2005 were much better than the overall market that declined from -1.7% to -5.7% depending which index is used to measure market results, we expect to do better. The fact is the market over the past three years has appreciated in spurts. For example in mid-October of last year our results were -1.2% for 2004 year to date, but the market rallied strongly and by the end of December our 2004 results were +14.6%. Consequently we do not see

the first half of 2005's results as an indication of what to expect over the second half.

The past five and one half years have been the most challenging in our twenty-four years as investment advisors. This period experienced the devastating end of the almost unimaginable Internet and technology speculative bubble, the September 11, 2001 terrorist attacks, a recession and major accounting scandals such as the bankruptcy of Enron and WorldCom. As a result the market remains well below the levels reached in early 2000. In this environment our program not only preserved clients' assets, but achieved a total return of 36.4% over the past five years and six months. While these results are vastly superior to the market and thereby provide a good degree of satisfaction, they do not meet our 15% annually compounded objective. The pertinent question today is do these results indicate expectations for future returns for our portfolio and should they be reduced to a level below 15% annually? We think not.

### INVESTMENT STRATEGY

Before delving into the reasons for both our optimism and confidence that our objective is attainable, first a look at our assumptions of what the economic and investment environment will be

like over the next several years is in order. Foremost we do not expect utopia. Far from it, we expect growth for both the United States and global economies will be much less than during the 1990s. The reason being Western Europe and Japan, the second and third largest world economies, will continue to experience long-term economic problems with high unemployment and anemic GDP expansion. Because of the economic drag of these regions and the intense competition from developing countries, we also expect low inflation and moderate interest rates. Accordingly, these conditions will likely cause both modest profit growth for most companies and single digit overall stock market returns. Obviously this represents a challenge.

Our strategy for success in this environment is fourfold. First select investments that are benefiting from long-term trends that cause some segments of both the United States and Global economies to expand much faster than their respective overall economies. Second select American companies that are serving those geographic regions of the globe that are growing rapidly. Third purchase these companies only when the current price offers at least 35% appreciation potential over the next year. And lastly avoid catastrophic losses.

As we have stated for many years, the most important long-term trend for investors is the aging of the population that will be a major factor for decades. However this trend has both positive and negative implications. For example, healthcare expenditures will continually increase which is good for healthcare companies, but the burden on government budgets will cause price constraints, which is negative for pharmaceutical companies. Consequently, our approach to mitigating the impact of pricing pressure is to

avoid the major drug firms, and invest in widely diverse healthcare companies. Hence our clients own the following:

- Cardinal Health for drug distribution, medical supplies, drug testing and manufacturing services and hospital automation systems.
- Forest Laboratories a small drug company with a number of new products in development.
- Henry Schein the major distributor of dental products and supplies.
- Johnson & Johnson with its huge consumer, medical device and pharmaceutical divisions, which operate in more than one hundred international markets around the world.
- Medtronic the major producer of cardiovascular, diabetic and spinal products to control chronic life threatening and severe pain conditions.
- Walgreens the largest retail drug store chain that achieves 11% pharmacy and 6% front-end same store growth versus their competitors that achieve 6% and 1% respectively.

While healthcare is the most obvious beneficiary, the aging trend also benefits other industries. For example, our clients own PetSmart and Scotts Miracle Grow because the over fifty age group spends the most on pets and gardening. Our clients also own McGraw-Hill, Nuveen and T Rowe Price in order to participate in the investment management and service industries that are growing rapidly as the wave of baby boomers prepare for retirement. In total half of our portfolio is benefiting today and will benefit even more over the next several years as four million baby boomers reach age fifty every year for the next nine years.

The other major trend is the use of high technology to reduce costs and improve customer service. While high technology is available to all companies, some are much better at effectively incorporating technology into their business processes than the majority. Accordingly, our clients own American Express and First Data that use technology to cost effectively process millions of transactions daily. McGraw-Hill utilizes the latest digital printing to produce educational material in book form as well as electronically over the Internet. And as a final example, Wal-Mart's computer controlled distribution system results in products delivered to their stores on a just in time schedule. As a result Wal-Mart sells more than half of the goods in the store before the goods are paid for. Thus the cash that would otherwise be stuck in inventory is available to fund store expansion and share repurchases.

The second part of our strategy is to invest in American companies serving the fastest growing international markets. Globalization is increasing the standard of living in many poor countries causing increased competition for high cost nations. Hence Asia, particularly China and India, Eastern Europe and Russia are growing more than twice as fast as the world economy while Japan and Western Europe are growing at less than one-half the world economy. The companies leading the charge are Avon Products, First Data, Johnson & Johnson, McGraw-Hill, Proctor & Gamble and Wal-Mart. Notable examples are Avon Products that has surpassed \$1 billion in sales in Eastern Europe, is expanding rapidly in India and is already profitable in China where it is the only foreign company with government approval to employ representatives to sell directly to consumers. Another is First Data, which has contracts in both China and India to deploy Western Union in more than forty-five thousand

post offices. First Data also has deployed Western Union throughout the remainder of Southeast Asia as well as Eastern Europe and Russia. Another is McGraw-Hill that is opening offices all around the globe to provide Standard & Poor's debt rating and market indices in virtually every major country worldwide. And lastly Wal-Mart is rapidly expanding both Supercenters and Sam's Clubs in China. Who could have imagined an American company would have the opportunity to freely operate giant retail outlets in the world's most populated country that not many years ago was a closed communist society?

The third, purchase only when the appreciation potential over the next twelve months is at least 35%, and fourth, avoid catastrophic losses. Parts of our strategy are closely related in that one cause of catastrophic losses is due to over paying for a companies stock. For example, Intel and Microsoft remain leaders in their industries, but investors that purchased their stock at the lofty prices that prevailed five years ago are currently experiencing a loss of almost 60%. The discipline of refusing to pay exorbitant prices that are being hyped by analysts and the media is difficult, but it is essential for good long-term investment results. The same discipline is utilized to establish prices when one of our investments reaches full value and should be sold.

Avoiding catastrophic losses is also based on possessing a thorough understanding of the businesses of companies considered for investment. This includes a complete analysis of their financial condition and cash flow and equally important an understanding of the economic trends that have driven past revenue and earnings growth and the sustainability of these trends to drive future growth. The movie, "Enron: The Smartest Guys in the Room," provides a fascinating view of how an

escalating stock price causes investors to blindly jump on board a ship destined to sink. Consider all seventeen analysts following Enron rated the stock a strong buy just before the company went downhill like a roller coaster. We did not invest in Enron, not because we are the smartest investors, but because we did not understand how the profits were being generated. Supposedly they were coming from astute trading of energy. However, as history has taught many times, trading profits are easy to come by when prices are rising but evaporate when prices are flat or declining. Accordingly, we could not see any long-term viability to their business model. Enron's investors lost billions of dollars by throwing caution to the wind and assuming their stock's appreciation was sufficient proof that this was a great company. Be assured we will never invest in a company we do not understand.

## CONCLUSION

As we have stated several times before most investors have incurred losses over the past five years and are pessimistic about the future. Logically the past five years have resulted in much

lower evaluations, which enhance the potential for future returns. Specifically our portfolio is more reasonably valued than anytime in the past decade, and based on our analysis has the potential to produce returns of 52% and 164% over the next one-year and five-years respectively. Another approach to evaluating the potential for future returns is to compare growth companies with the ten-year treasury, which currently yields 4%. As a comparison Johnson & Johnson's dividend currently yields 2%. But while the interest on the ten-year note will remain constant over the next ten years, assuming J&J increases their dividend at 18% annually as they have over the past ten years the yield would be 4.6% and 10.4% in five and ten years respectively. Hence even without any capital appreciation, J&J is clearly the superior investment. Lastly as most companies in an environment of low inflation and intense competition will likely achieve at best single digit earnings growth, companies growing at a double-digit rate should be evaluated at a premium, as was the case in the late 1960s and early 1970s. This is the basis of our confidence we are on the threshold of several years of returns of at least 15% compounded annually.

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

Managing over \$350 million for more than 900 clients nationwide.

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1582 MAIN STREET  
SARASOTA, FLORIDA 34236  
(941) 365-3435/(800) 899-5171