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Midwest Investment Management

PERSPECTIVE™

Other stories in this issue:

2nd Quarter Economic Review

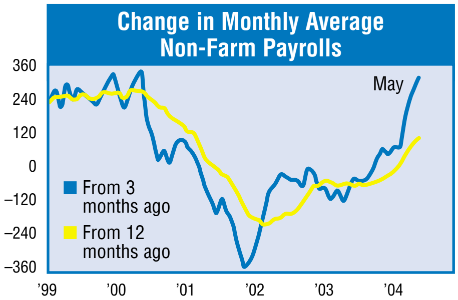
Improving economic results offer bright outlook for equity markets

By Joseph A. Harrison, CFA, Partner

The security markets faced a mixture of very positive economic news, some very worrisome incipient economic trends, and a number of disturbing events in the Middle East during the second quarter.

The equity market was marked by some wide swings and the net result for the quarter was essentially unchanged. Fixed income markets, on the other hand, suffered a significant setback as the yield on 10-year U.S. Treasury Notes increased nearly a full percentage point.

Almost all economic data was positive. We saw strength across all sectors of the economy—from manufacturing to housing to consumer goods. Any lingering doubts about the strength of the recovery should have been removed. The brightest news related to strong gains in employment—a total 1.2 million jobs in the first five months of the year (see chart).



Job growth swelled significantly through the second quarter of 2004.

Source: Bureau of Labor Statistics.

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Best Funds–A Unique Service For Your Family, Your Business

By Al Meszaros, CFA, Partner

Did you know that Midwest Investment Management's *"Best Funds"* program offers an excellent savings or investment option for your family members or your company's 401(k) plan?

How it works

From a carefully selected list of 18 mutual funds in six different categories, we create a portfolio of several funds for people who want professional investment guidance for an investment account — such as a child's college savings, an IRA, or 401(k) — but don't have a high enough balance to qualify for our traditional, individually managed account.

Significant benefits:

- **Independent Advice.** We choose freely from thousands of funds—the only criteria is the well being of our clients. We accept no payments of any kind from these funds and monitor every fund for any adverse changes in managers, performance or philosophy.

  Our only income is the management fee we receive from our clients.

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So...is that all there is?

By Norman F. Klopp, Jr., CFA, Partner

In our last two issues of *"Perspective",* Al Meszaros and I described the critical importance of personal, on-site visits to corporations as a component of our investment management process.

Our answer to the question in the headline is *"No... that's NOT all there is"* to managing our clients' portfolios.

Added insight

Besides our own research, we analyze large amounts of additional and equally important research from *external* sources in order to acquire information about, and gain insight into, specific investment opportunities or developments that could influence the purchase of stocks for client portfolios. For example:

- We also need to know "what the street thinks" about a specific stock or industry. To that end we study comprehensive (and very costly) investment research reports from a number of investment research firms whose collective

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So...is that all there is? (Continued from page 1)

> **"We perform detailed comparative analysis of competing companies..."**

thinking about the earnings outlook or stock price of a particular company provides a "consensus" against which we can judge our conclusions. If my Partners and I believe a company can earn significantly more than that consensus, we might have potential for a real positive surprise versus the "street expectations." *That usually means positive stock performance.*

- We use an Internet-based service that provides instantaneous access to hundreds of additional research reports, along with observations about industries and companies.
- Another critical component of our investment management process is the use of "interactive analytical databases" that provide valuation tools we can use to calculate *our own* estimates of earnings, long-term growth and cash flow. We perform detailed comparative analysis of competing companies and "sensitivity analysis" to determine the impact that factors such as changes in prices, unit growth, interest rates, or capital structure might have on the earnings or cash flow growth rates of a company.
- Perhaps the least recognized, but most valuable, research source is one I have discussed in lectures to college business school students. What is it? A well-filled Rolodex® (or, in this era, a Palm Pilot®).

Why? My partners and I have nearly 200 years of collective investment experience. We have built, re-built, and continue to expand lists (Rolodex cards) of hundreds of people in literally every type of business. We talk with them regularly. Our contacts include CEO's and CFO's of many Fortune 500 companies, operating executives, customers, government officials, plus academic and professional experts in a wide spectrum of industries.

This extensive network is very valuable because it provides us with knowledgeable sources of facts and opinions we need when events occur that might impact the future of a company or industry.

My unwavering message to those business students is that the network they build is a powerful asset that can provide a unique perspective on the present and the future.

Revalidation required

At Midwest Investment Management, we continue to believe that successful investing over the long term requires diligence, control of risk, and a comprehensive perspective on a company and its stock. We continuously revalidate our perspective through the use of numerous internal and external research sources...including an overflowing, up-to-date Rolodex!

Best Funds (Continued from page 1)

- **Excellent Performance.** We seek strong results and verify that the manager responsible for that performance is still running the fund and consistently applies a philosophy we understand and agree with.
- **Low Cost.** Because high costs can reduce returns, we insist on funds with low expense ratios, and which do not charge loads (sales fees). For example, one fund we use, "American Funds Washington Mutual" carries a load (sales charge) of 5.75%, but can be purchased by our clients without that sales charge.
- **Superior Service.** Because the *Best Funds* program is operated by Midwest Investment Management, you will receive *superior service that no individual mutual fund family can match.*

For individuals

Every account is tailored to a person's specific investment goals. For example, a portfolio created for someone approaching retirement might emphasize income-oriented funds, whereas an account established for a child's future college expenses might emphasize growth-oriented funds.

For company 401(k) plans

Company 401(k) plans can benefit from the *Best Funds* program because:

- It simplifies the process of selecting quality mutual funds for employees;
- Fund sales fees are eliminated;
- Every participant can have a plan individually tailored to their age, future needs, etc.

If a *"Best Funds"* account could benefit you, a member of your family, or your company, I invite you to contact me at (216) 830-1133 or *elm@mimllc.com*

AIMR introduces name change

By J. Mark Wipper, Managing Partner

The Association for Investment Management and Research (AIMR) changed its name in May to the CFA Institute.

Since 1964, AIMR administered the world-renowned Chartered Financial Analyst program — the most sought-after credential in the investment world.

All three analysts at Midwest Investment Management — Joe Harrison, Norm Klopp, and Al Meszaros — hold this prestigious CFA designation.

Although AIMR's name has changed, its mission as the CFA Institute remains the same:

"*To lead the investment profession globally by setting the highest standards of education, integrity and professional excellence.*"

Those same standards also prevail at Midwest Investment Management. We are proud of our three CFA's, their integrity, and the professional guidance they provide to our clients.

The Analyst's Corner

By Elmer L. (Al) Meszaros, CFA, Partner

Financial stocks still looking good

"Money never disappears, it just finds a new parking space—so own as many parking spaces as possible."

That pithy advice was offered by Dick Kovacevich, CEO of Wells Fargo & Company, to a meeting of professional investors in Cleveland.

His suggestion was also a simple, yet effective rationale for incorporating financial service company stocks into our clients' managed portfolios. Financial services companies—including banks, insurance, investment, mortgage, and real estate firms—are the "gatekeepers" of American commerce. They derive fees whenever money changes hands and represent nearly 22% of the U.S. economy.

"They derive fees whenever money changes hands..."

Legendary "Pony Express"

Many financial service companies have long histories of profitable operations and stability. Some of our holdings, such as National City, Fifth Third Bank, and U.S. Bancorp, were founded more than 150 years ago. Wells Fargo was founded in 1852 and used the legendary "Pony Express." Many prospered from the Agricultural Age to the Civil War era, through the Industrial Age into the Information Age.

Their growth continued through wars, depressions, booms and busts. Despite significant bank failures in the 1930's, most survived.

Today, many well-run financial service companies are growing slightly faster than the economy. In fact, financial service companies currently represent 21% of the value of the S&P 500 and 36% of the Barra Value Index.

Midwest Investment Management currently invests a significant portion of our clients' assets in financial service stocks because we like their ability to deliver steady growth in earnings and dividends, despite fluctuations in interest rates.

"A well-run financial company is an annuity-like business..."

On average, the dividends of financial service companies have grown substantially faster than the S&P 500 Index in recent years (see chart below).

Dividend Growth
Through Dec. 31, 2003

	5 Years	8 Years
Banks	+58%	+125%
Financial Service Companies	+55%	+114%
Insurance (Property & Casualty)	+27%	+ 70%
S&P 500	+ 7%	+ 26%

Source: Baseline. The S&P 500 Index is a broad market-weighted average of U.S. blue-chip companies. This index is unmanaged and investors cannot actually make investments in this index.

This superior growth in earnings and dividends has been reflected in superior shareholder returns, as shown below.

Annual Total Shareholder Returns
Through Dec. 31, 2003

	5 Years	15 Years
Financial Service Companies	+9.7%	+21.6%
Banks	+2.6%	+16.5%
S&P 500	+0.5%	+12.2%

Source: Wells Fargo & Co. 2003 annual report. The S&P 500 Index is a broad market-weighted average of U.S. blue-chip companies. This index is unmanaged and investors cannot actually make investments in this index.

Any risks?

Not all financial service companies are good investments, however. In fact, dozens of poorly managed financial companies have disappeared over the years. Risks can result from:

1. Excessive debt leverage;
2. Excessive exposure to interest rate changes;
3. Poor asset quality;
4. Poor execution.

Currently, some people believe that rising interest rates will produce a negative effect on financial service stocks. We hold a different view. We believe the stocks of many bank and insurance companies could actually benefit from rising interest rates because it would improve their asset yields, offsetting the burden of rising interest rates.

How we judge financial stocks

Strategies are usually not unique, so execution defines the winners. First, we look for asset quality. This means the company should own a diversified portfolio of good quality loans and investments. Revenue growth—the ability to grow the business—is indispensable. Expense control is a necessity. The ability to consistently expand revenues faster than expenses is the mark of a potential winner. Skill in integrating acquisitions is important. Last, but not least, we look for quality management reflected by solid execution of growing revenues, earnings, and dividends.

Springboard for growth

A well-run financial company is an annuity-like business with 80% to 90% of revenues from existing customers fairly predictable at the beginning of each year. This stability provides an advantageous springboard for growth. Thus, a company like Wells Fargo that can grow its earnings 10% to 12% annually with a 3% dividend yield produces compounded growth of invested value at 13% to 15% per year.

This means you could double your money every five or six years—not bad!

How To Reach Us.

You may contact the partners or staff members at Midwest Investment Management by phone or e-mail. Here is a complete listing for your convenience.

PARTNERS:

JOE HARRISON
216.830.1131 *or*
jah@mimllc.com

NORM KLOPP
216.830.1135 *or*
nfk@mimllc.com

AL MESZAROS
216.830.1133 *or*
elm@mimllc.com

CHUCK NYE
216.830.1127 *or*
cen@mimllc.com

MARK WIPPER
216.830.1125 *or*
jmw@mimllc.com

BOB YAROMA
216.830.1129 *or*
rjy@mimllc.com

STAFF:

MEG HALLORAN
216.830.1139 *or*
meh@mimllc.com

JACK NAKEL
216.830.1142 *or*
jwn@mimllc.com

CAROL PRUSAK
216.830.1140 *or*
cap@mimllc.com

MARY SALZER
216.830.1110 *or*
mrs@mimllc.com

The Tower at Erieview
1301 East 9th Street
Suite 1110
Cleveland, Ohio 44114

Phone: 216.830.1110
877.945.9900
Fax: 216.830.1159

e-mail: invest@mimllc.com
web: www.mimllc.com

Midwest Investment Management

2nd Quarter Economic Review *(Continued from page 1)*

Factories hiring

The employment increase was broad-based across 75% of all industries, with the largest gains in the higher paying sectors. Factory hiring was up for the fourth consecutive month after 42 months of losses. Average hourly earnings are increasing at a 3.1% annual rate. The average factory workweek rose to 41.1 hours, the highest since October 2000, and average overtime rose to 4.7 hours, the highest rate since July 2000.

The implications of this data is very important. Wage income constitutes over 70% of national income. The large number of new jobs at higher pay and overtime for hourly workers will produce far more than sufficient income to cover higher gasoline prices and interest rates. In addition, the overtime and workweek figures suggest additional new jobs will be created in the months ahead. Strong consumer demand should be sustained for many months to come. Rising personal income is a powerful ingredient to a healthy economic expansion. A further benefit is a lower federal budget deficit than had been forecast.

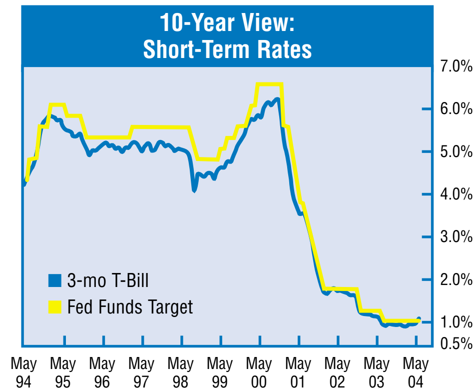
Capital spending

Two other forces for a healthy economy are inventory and capital spending. To a great extent, the lag in inventory spending is testimony to the productive effects of technology investment. Thus, it is not surprising that capital spending, especially on technology, is showing larger gains than spending on inventories.

While additional good news is likely, some worrisome signs have emerged on the horizon that must temper any inclination to “irrational exuberance.” With a weaker dollar and strong economic growth, wholesale and consumer prices have started to accelerate from the very moderate pace of the past few years. The price of oil is the most visible culprit, due to terrorism in Saudi Arabia and tight refining capacity in the U.S. The recent decision by OPEC to increase production should provide some relief in coming months, but many other materials and goods will still provide upward pricing pressure. Metal prices have also risen sharply. Imported consumer goods, lodging, healthcare and homeowners equivalent rent have all shown strong increases in recent months.

Federal Reserve

Although increased productivity should have a moderating influence on inflationary pressures, increasing employment costs (wages and healthcare) will dampen recent strong gains in productivity. Recent action by the Federal Reserve Bank to increase interest rates should also help. With rates so very low, however, this rate increase is only a small step to return short-term rates to a more normal 3% level (see chart below). Even several 1/4% or 1/2% increases should not be cause for concern if the recent upward move in the rate of inflation can be moderated.



Short-term rates are still very low, according to historical averages.
Source: Laffer Associates.

On a longer term basis, higher energy prices can be reined in by increased production and a shift in consumption attitudes. OPEC has agreed to increase production rates and several countries have initiated programs to renew exploration and development of new oil fields. Also, one well-known and respected auto manufacturer has announced plans to extend its hybrid vehicle offerings to include SUV’s.

Sustained earnings growth

The spectacular growth in corporate profits has largely been the result of moderate sales growth and enormous productivity gains over the past three years. We expect that technology will produce further gains in productivity. Yet, the benefit of declining unit labor costs will no longer be supportive of the substantial gains in profitability. Nevertheless, we believe that many companies will be able to sustain their earnings growth.

While it is still too early to predict this year’s Presidential election or the ultimate success of returning control of Iraq to its people, the strong pace of economic growth, personal incomes, and corporate profits provide ample opportunity for reasonable returns in the equity markets. Somewhat higher interest rates suggest caution with respect to fixed income markets, but a 5% to 5.5% rate on a 10-year U.S. Treasury issue might provide an opportunity to extend maturities in the months ahead.

We hope you enjoy reading our quarterly newsletter, which contains news about our firm, its investment philosophy, the economy and market trends. We suggest you retain these newsletters for future reference.

Perspective is published quarterly by Midwest Investment Management LLC, Cleveland, Ohio for its clients, friends and members of the business community. All information contained herein reflects the opinions of the authors and does not necessarily constitute investment advice. Past results are no guarantee of future performance.