

# INVESTOR EXPRESS

A semi-annual newsletter for our shareholders.

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## Investors Value Low Expense Ratio More in Down Markets

*"It's only when the tide goes out that you learn who's been swimming naked."* —WARREN BUFFETT

The legendary investor Warren Buffett was referring to investment strategy when he observed how bear markets illuminate issues in the portfolio that might otherwise go unnoticed. But he might just as well have been referring to rising investment expenses. *The Wall Street Journal* recently reported that expense ratios have been edging up in the declining markets of the past several years. According to Lipper Analytical Services, the average expense ratio for a domestic equity mutual fund rose to 1.64% last year, up from 1.45% in 2001. When times are good, few investors pay close attention to fund expenses and sales charges. Give them a sustained bear market, however, and investors learn that many fund expenses, customer service charges and portfolio management fees are eating into their returns.

Are mutual funds increasing their expenses just when investors are feeling the pain of declining asset values? Not necessarily. It may be a matter of simple division, as the following example illustrates: Let's assume an investor paid \$100 in fund expenses or 1.0% on a \$10,000 investment. When the value of a \$10,000 investment drops to \$9,000, the same \$100 of expenses increases from 1.0% to 1.11%. Because there is a smaller asset base across which to allocate expenses, the expense ratio goes up even though the expenses stay the same.

Compare the average domestic equity mutual fund's expense ratio to the expense ratios of Adams Express and its sister fund, Petroleum & Resources in 2002. With an expense ratio of .34%, Adams Express shareholders benefited from the lowest expense ratio of any closed-end fund in the industry, according to industry analysts. Similarly,



the expense ratio for Petroleum & Resources last year was .49%, or less than one-third of the industry average. While up marginally from 2001, these expense ratios were within close range of their five-year averages.

As demonstrated by their low expense ratios, expense control is a highly valued principle at Adams Express and Petroleum & Resources. Expenses are kept low through structural and organizational discipline. The funds are internally managed, so that, unlike funds that pay external advisors to provide investment management for the funds, Adams Express and Petroleum portfolios are managed by full-time employees. Only 19 employees handle research and investment management, client service, accounting, and administrative duties. And the funds' buy and hold approach results in low portfolio turnover, keeping transaction costs low. It is a point of pride that the funds' expense ratios are not much more than those charged by the typical passively-managed index fund, while providing our shareholders the benefit of our experienced professional management of the portfolios.

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**DAVID SCHIMINGER**

David R. Schiminger joined The Adams Express Company in 2002 as a research analyst covering the healthcare sector.

Dave is optimistic about the opportunities in this historically defensive sector. "Demographic trends should continue to drive strong demand for healthcare products and services," he said. At the same time, advances in drug discovery technologies and a recently appointed pro-business FDA commissioner are likely to speed the time to market for new products.

Diversification remains an important hallmark of Adams Express's healthcare holdings. "Our portfolio holdings offer exposure across the healthcare continuum, from pharmaceutical and biotechnology companies to clinical laboratory and hospital operators," according to Dave.

Prior to joining the Company, Dave was a vice president at Mercantile-Safe Deposit and Trust, where he covered the healthcare sector. He began his career as an equity analyst at Croft-Leominster. After graduating with honors from Washington and Lee University, Dave received an MBA degree from the Darden Graduate School of Business Administration at the University of Virginia. He is a Chartered Financial Analyst and a member of the Baltimore Security Analysts Society.

### Forward-Looking Statements

To the extent that any statement made in this newsletter contains information that is not historical, such statement is essentially forward looking in nature and is subject to risks and uncertainties, and actual results could differ materially from those contemplated by the forward-looking statement. Several factors that could materially affect the Companies' actual results are the conditions in the U.S. and international economies and financial markets, the performance of the portfolios of stocks held by the Funds, the prices at which shares of the Funds will trade in the public markets, and other factors discussed in the Companies' periodic filings with the Securities and Exchange Commission.

# Equity Investors Should Watch for Signals of a Market Recovery

Investors through the first quarter of 2003 were preoccupied with the prospect of war in Iraq. The military and political buildup cast a long shadow occluding any rational view of the equity markets. While turmoil and uncertainty may be with us for some time, there are factors investors can watch for that could lead to more robust market performance.

Four of these factors are 1) the relative attractiveness of stocks compared to bonds; 2) debt levels, both in U.S. households and corporate boardrooms; 3) corporate earnings; and 4) levels of corporate capital investment. Sharing their context in the current economic environment, these factors are closely interrelated.

**1) Attractiveness of stocks.** Long term, stocks have been America's best performing asset class in each 10-year period since 1900. Short term, stocks compete with debt securities, commodities and cash for investors' attention.

Stocks moved paradoxically in 2002 when corporate earnings rose in the low 20% range, yet the S&P 500 nonetheless fell by about 22%. Of course, much of stocks' poor performance last year can be attributed to corrections of over-inflated values and specific (hopefully one-time) events involving corporate malfeasance and bankruptcy.

Over the last three years, stocks have gained back some luster compared to bonds, both in terms of price attractiveness and yield. 10-year Treasury bonds yielded 6.2% in March 2000 compared to 3.63% at one point in March 2003. While bond yields declined, stock dividend yields improved: the S&P dividend yield climbed from 1.06% to 1.91% during the same three-year period. Meanwhile, the S&P 500 price/earnings ratio retreated from the hyper-inflated value of 27 times earnings in 2000 to about 16 at the end of last year, close to the long-term average S&P 500 p/e ratio of 14.

In theory, these trends argue that stocks are approaching levels of attractiveness relative to investing in bonds, which could be a harbinger of better times ahead for equity investors.

**2) Managing debt.** The investment bubble of the late 1990's and downward pressure on interest rates have combined for an absolute debt binge for U.S. households, corporations and government

jurisdictions. Total debt zoomed up from about \$4 trillion in 1980 to \$31 trillion late in 2002, according to Federal Reserve flow-of-funds data.

Debt is a concern around the kitchen table as well as the boardroom table. Soaring mortgage debt and declining stock prices have put a crimp in the net worth of U.S. households, a situation that could worsen if housing prices decline as well.

If we see improvement in the household savings rate to the 5% or 6% level, and reduction in corporate debt-equity ratios from nearly 100% now to about 85%, that could signal a return to a healthier investment climate.

**3) Building corporate earnings.** Earnings are the greatest determinant of stock value. Most of the sins of past excesses and current stock market sluggishness would be set right by a bevy of rising earnings reports. Warren Buffett, whose quote we used above, told Fortune readers in March 2003 that he'll keep his checkbook closed at least until he sees pretax corporate earnings returns in the 10% range.

**4) Resuming capital investment.** Which comes first, capital investment or earnings? No matter, a healthy economy needs both. But in order to place those new orders for plant and equipment, corporations must pay less for debt service and grow their return-on-equity to the 6% range.

If anything popped the stock market bubble in 2000, it was the growth in overcapacity of corporate production that occurred in the late 1990s. At that time, business investment peaked at about 30% of U.S. GDP growth, far exceeding the usual 10% of GDP growth. The capacity utilization of all U. S. industries started dropping in September 2000 and fell to 75% of capacity in December 2001. Economists have concluded that when capacity utilization climbs to 80%, we will see business investment begin to grow again, which would be a sign of an improving market for stocks.

While economic conditions improve, investors are advised to maintain portfolio diversification with professional management, avoid high costs of transactions or fund charges, and follow the tactic of dollar-cost-averaging to build portfolios at the lowest possible share cost.