APM Quarterly

4th Quarter

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Much to celebrate

by Catherine Shenoy

Applied Portfolio Management (APM) finished the year with a traditional celebration at Tasso's, and there was a lot to celebrate. One of the guests of honor was the youngest attendee – **Charlie McCarthy**, born on November 22 to **Kent and Missy**. Another young APMer, **Jenna Hekman**, born in October, daughter of **Matt** (APM Fall 02), was also all smiles. Both were probably thrilled with the good portfolio news, as portfolio value kept creeping up.

The party also gave us a chance to wish **Denise Bergin** good-bye. As many of you know, after two years she will be leaving KU and APM, for bigger and better things. I, the students, alums, and friends of APM will all miss her. I would like to thank her for all of the work she has put in these past two years.

We had wonderful speakers during this quarter. **Andrew Hornig** called from London. He made the students global portfolio managers for a few weeks. They got to allocate funds in the global markets. He ran the results for each group and the winner was Group 3 – **Rosalie Ast, Todd Ludgate, Matt Taylor,** and **Cara Lance**.

CEO's **Tim Webster** of American Italian Pasta and **Scott Hartman** of Novastar Financial both revisited class during the fall. Both PLB and NFI have been exceptional performers in the portfolio.

Two APM alum from Kent's first '88 class – **Kent Snodgrass** of Blackthorne Partners and **Dennis Depenbusch** of Whitco Lighting – came to class and made presentations. Kent discussed merger arbs and Stilwell, now Janus (JNS). Dennis discussed financing plans for Catalyst Lighting.

Our speakers seemed to come in pairs. We also had two portfolio managers come to class – **Chris Boyd** of American Century and **Mark Seferovich** of Waddell and Reed. They each discussed their strategies and outlooks for investing.

Our pair of CEOs was a reprise from Fall of '01. **Tim Webster** of American Italian Pasta and **Scott Hartman** of Novastar Financial came during October. Both companies are long-time holdings in the portfolio and have performed well. **Tim Shaftel** and some students in the Italy program came for Tim Webster's presentation. American Italian Pasta has a factory near the Italy campus that many students have visited. As always, Scott Hartman made mortgage-backed securities and the home loan business much easier to understand.

John Dicus, Capital Federal, visited class on Nov 20 with **Neil McKay** and **Kent Townsend**. The class had discussed buying CFFN earlier, but thought it was too expensive. They convinced us otherwise.

For our final class we took a field trip to the Kansas City Board of Trade and the American Century trading room. At the KCBOT we met **Jeremy Glauner** (former APM TA, now with Louis Dreyfus). We also watched **Dan Roemer**, Frontier Futures, execute some of Kent's trades. At American Century, **Gregory Bokach** showed us around and discussed trading strategies. ■

Portfolio Performance

The 4th quarter turned out to be very good for the APM portfolio. Here are the details and a comparison to the market:

Returns	1-Jan-02	1-Oct-02	31-Dec-02	4th Quarter	Annual
NASDAQ	1,965	1,172	1,336	14%	-32%
S&P 500	1,148	815	880	8%	-23%
APM Portfolio	**$ 229,191**	**$ 197,718**	**$ 237,685**	**20%**	**4%**

Some of the high flyers for the quarter were:

Ticker	Q4 Return
SOHU	266%
CNET	174%
WWCA	135%
CHINA	45%
NFI	41%
WMB	35%
VLO	33%
ICM	21%
CHN	19%
RDN	14%
KR	10%

We bought several new holdings over the quarter that have performed well. They are Capital Federal (CFFN), H & R Block (HRB), Garmin, Ltd (GRMN), Beru AG (BRUXF), Crown Pacific Partners (CRO), Guidant (GDT), and Jos A Bank (JOSB). Two of the picks came from this semester's class presentations. Garmin was picked by Group 3. **Matt Taylor** will mentor the stock for the portfolio, and CFO **Kevin Rauckman** is scheduled to visit class this spring. Jos A Bank Clothiers was picked by Group 1, and **Jim MacMurray** will preside over it. Capital Federal was selected by the class after **John Dicus**, COO, **Neil McKay**, CFO, and **Kent Townsend**, Controller, presented on November 20. ■

Fall 02 APM Students

Group 1	Group 3
Matt Hekman	Rosalie Ast
Jim Macmurray	Cara Lance
Mark Ruda	Todd Ludgate
Group 2	Matt Taylor
Steve Andersen	**Group 4**
Deepak Chinaiwala	Ray Andula
Erica Christian	Kathy Bartles
Joan Huber	Kelvin Liebelt

Inside This Issue

SOHU by Kathy Bartles

Sohu.com Inc. (NASDAQ: SOHU) is an Internet portal in China. The company was originally organized in 1996 as Internet Technologies China Inc. (ITC) and launched its original website in January 1997. In February 1998 the company re-launched its website under Sohu.com and in September 1999 renamed the business Sohu.com Inc. Substantially all of the operations are conducted through the wholly owned subsidiary Beijing ITC. Beijing Sohu was also created to bypass the central government's restriction on foreign involvement in the Internet sector. Such restriction has forced Chinese Internet firms hoping to list abroad to adopt a structure in which the listed company provides services to the mainland content provider. The content provider then pays the listed company for those services with revenue earned from operations.

SOHU currently competes for internet customers in China with Sina, NetEase, and Chinadotcom, although the latter has announced it is leaving the internet portal business to focus on enterprise solution software. In addition, there is a potential new competitor on the horizon in Flying Dragon, a partnership between the Legend Group and AOL, set to debut in 2003.

With over 50 million registered users at the end of September 2002, SOHU has the largest online user base in China. It is a household name among the 300 million people living in urban centers. For the second year in a row the Sinomonitor International survey - the largest Internet Survey in the country- ranked Sohu.com as the most visited portal in China.

SOHU's revenues are based on two strong pillars: a home-market corporate advertising base and a massive, paying user population. On October 23, 2002, SOHU announced that it achieved U.S. GAAP profitability – a full quarter ahead of projection. Non-advertising and advertising revenue contributed to a 51%-49% revenue mix.

Online advertising includes banners, links, logos and buttons placed on its web sites and sponsorship of a particular web site area. Revenues from banner advertising are based on standard charges in terms of cost per thousand impressions (commonly referred to as CPM's). Advertising revenue was split among domestic Chinese companies, which contributed 57% of total advertising revenue, multinational companies, which accounted for 34% of total advertising revenues and dotcom companies which accounted for 9% of total advertising revenue.

For the third quarter of 2002, SOHU's advertising revenues totaled $3.7 million, a 52% year-on-year improvement. Advertising gross revenues reached an unprecedented high of 60%.

Non-advertising revenues are derived from e-commerce services, subscription fees, and e-technology and other services. E-commerce revenues are earned from direct sales of consumer products through Sohu's website. Subscription revenues are generated mainly from short messaging services. E-technology revenues are derived from providing technology services and the sale of hardware to corporate customers. Since China has the largest cell phone industry in the world, the growth in SMS services is expected to be exponential. Users sign up for services such as dating services and alumni clubs. As one user contacts another and they begin messaging each other, both users are contributing to company revenues. Industry analysts estimate that SMS usage will more than triple this year. Cell phone usage in China is almost a necessity because landline phones are unreliable and sometimes unavailable.

For the third quarter of 2002, non-advertising revenues grew 237% year-on-year to $3.8MM and 39% from the prior quarter. Non-advertising gross margins reached a record high of 51%.

After a conference call with **Derek Palaschuk**, Sohu.com CFO and Sr. Vice President, and **Caroline Straathof**, Director of Corporate Communications, the class had a better understanding of the prospects of SOHU. After reaching a low of $1.50 per share this semester on October 9^{th}, the stock has rebounded to $5.95 as of the end of November. This is good news for the portfolio, as SOHU is currently the largest single holding, with 12,400 shares held. Currently growth models developed in the class show that the stock price could appreciate into the $15 to $20 range in the next couple of years if the company hits its targeted growth rates. ■

Sohu is this company, anyway?

By Matt Taylor

The past few months have certainly been exciting ones at Sohu.com. On Monday, October 21^{st}, Sohu announced quarterly results. The company was profitable on a GAAP basis for the first time. The stock shot up as a result, and now the one year chart looks like a fallen over hockey stick. The Chinese Internet sector all shot up on news that Sohu.com, Sina.com, and Netease.com all performed much better than expected. For Sohu, the growth in the non-advertising revenues is what caught our attention. It appears as though the SMS or subscription services are growing at an accelerated rate even to our predictions. Seeing the results come in as compared to our predictions in our pro forma income statements was another "poker card" turned over, as Kent likes to say. We then got an opportunity to speak on the telephone with **Derek Palaschuk**, Sohu.com CFO, who gave us another couple of "cards" to turn over. We have since made changes to our outlooks, and agree the future looks exciting for Sohu.com. ■

Thanks to all our stock mentors!

Symbol	Stock	Mentor	Symbol	Stock	Mentor
LTD	*The Limited*	*Brendan Woodbury*	*DUSA*	*Pharmaceuticals, Inc.*	*Betsy Rowe*
SPCT	*Spectrian Corp.*	*Greg Greenberg*	*JNS*	*Stillwell Financial, Inc.*	*Mark Hirschey*
WMB	*Williams Communications*	*Mark Hirschey*	*FST*	*Forest Oil*	*Brett Young*
GRMN	*Garmin Ind*	*Matt Taylor*	*TGT*	*Target*	*Jessica Reuss*
APC	*Anadarko Petroleum*	*Todd Ludgate*	*RDN*	*Radian*	*Brian Murray*
GDT	*Guidant*	*Paul Koch*	*VLO*	*Valero Energy*	*Robert Tracy*

Valero – risk of war

Perhaps no other company within the APM portfolio would be immediately affected as much as Valero, should any kind of war but a brief one occur with Iraq. Valero Energy Corporation is a United States refining company that operates in two business segments: refining and retail. Valero is engaged in the production, transportation and marketing of environmentally clean fuels and products. One of the company's strengths is its ability to refine sour crude. Unfortunately, a key supplier of sour crude oil in the past has been Iraq.

Two aspects of Valero are key to its future growth. The first would be the competitive advantage gained by having technology in place to refine sour instead of sweet crude. Should the supply of sour crude remain weak, Valero will continue to lose some of its competitive advantage. A bright spot for Valero is its marketing of environmentally clean fuels. It is expected that California will pass legislation that will mandate cleaner burning fuels. Valero stands to benefit greatly from the move towards cleaner fuels. It is this technology that should propel Valero forward.

Over the past 52 weeks, Valero has traded as low as $23.15. Currently, the stock is trading in the $30 range. The 2003 EPS projections of $4.80 would suggest that Valero will be trading in the $50 range within the next year. Two factors weigh heavily into this appreciation. First would be a normal winter for the United States. Second would be a limited disruption in oil production caused by war. Should a mild winter occur and a prolonged war with Iraq, we would expect to see a flat or slightly dropping stock price for Valero. Its competitive advantages with sour crude production and cleaner burning fuels will, however, remain in place. War could easily delay the appreciation in price, but overall Valero is poised for some strong appreciation in the near future. ■

VALERO ENERGY CORPORATION

Kroger – the exaggerated demise of supermarkets

Frank Remar, CFO for Dillon's, joined the class in early October to discuss future prospects for the company. Much has been made of the competitive nature within the grocery store business. Target and Wal-Mart are each making a push into this area, as well as various warehouse clubs. All in all, it has led to a perception that the future of companies like Kroger may be somewhat troubled.

For most of the year, Kroger traded in the $20 range. Through the second half of the year, the stock dropped as low as $11 and has since rebounded into the $15 range. As the stock dropped, the focus turned towards whether a company like Kroger could still compete in what is perceived to be a tough marketplace.

The title of Mr. Remar's presentation was "Supermarkets: The Demise has been Greatly Exaggerated." The focus was simply that Wal-Mart, Target, and wholesale clubs are not true competition for Kroger and other supermarkets. Wal-Mart will always be the low price provider in everything that they do. Kroger will not and should not compete on that stage. Target's high margins on grocery items suggest that it is not looking to compete heavily in this arena. Sure these supercenters will take some sales away from supermarkets like Kroger, but their focus is very different than Kroger's target.

Positive spin from an insider? Likely not. Kroger is well positioned within its footprint to compete. It is moving the route of adding fuel stations (highly profitable) to as many locations as possible. Valuations would suggest that the stock should trade back into the $20 range. The recent drop can be attributed to the company's restatement of future growth initiatives. Sure new competition will play a role in how Kroger will move forward, but at a price of $11 and even $15, Kroger appears to be a good buy. ■

Kroger

Novastar Financial

Novastar Financial Inc. (NYSE:NFI) is an investor in mortgage assets with a focus on non-conforming mortgage loans. The Company also originates single-family non-conforming loans through NovaStar Mortgage, Inc. (NovaStar Mortgage), its subsidiary.

During the semester the stock price fluctuated considerably from a high of $29.50 early, a low of $18.82 at mid-semester and wound up about $24.00. With a moderate price to book of 1.5 and a rich yield of 16.7%, this REIT is an excellent choice for a tax-free or tax-deferred account. Novastar's success going forward will largely hinge upon how well it manages its credit risk. ■

Williams Companies

Williams Companies, Inc. (NYSE:WMB) is engaged in the transportation and sale of natural gas and petroleum products and other energy related activities. The firm is attempting to work itself through a liquidity crisis that has smashed its investors' sentiment (trading at only 30% of book value). Significant asset sales were made in the second half of 2002 to provide liquidity for approximately $4.4B in debt maturing 2003 through 2005. A significant cloud will reside over WMB until any legal and/or regulatory issues regarding the California Energy Crisis and WMB's energy trading operations are resolved. A favorable resolution could go a long way towards unlocking significant value at WMB. ■

Target Up 15% QTD

Target (TGT) reported 3Q EPS of $0.30, up 20% from 3Q01 and $.02 ahead of consensus. It is the #2 Discount and Department Store Retailer (after Wal-Mart) and is completing its plans to expand square footage by 12% in 2002 as well as add distribution facilities. **Jessica Reuss**, our APM mentor, has been advocating BUY on Target all semester. TGT's P/E is 19.07 vs WMT at 30.69 and its growth forecast is 14.8% vs. WMT at 13.6%. Jessica states, "We believe that TGT, with its Target division, has one of the most powerful concepts in the retailing sector. It continues to successfully differentiate itself from WMT on the merchandising front, yet emulates WMT by spending more on systems and distribution infrastructure." Target share price is up 15% quarter-to-date ($33.96 on 12-6; $29.52 on 9-30). TGT constitutes 1.33% of the APM portfolio, with our average cost of $43.07. ■

CNET

CNET Networks, Inc. (CNET) is a global media company that is a source of technology and commerce-related services, primarily for the technology industry. Based in San Francisco, CA, it produces a branded Internet network, technology information via online, radio and in print publications, shopping services, and a licensed database and e-business technology marketplace.

Media consumption is shifting to the Internet, and the Internet and CNET have gained market share of the media advertising dollar. CNET is the leading player in the technology information space. Following its merger with ZDNet, CNET became the clear leading source for technology news and information, and it also is the #11 US website overall based on unique visitors.

As was the case with many information technology-related stocks, CNET's share price suffered significantly during the middle quarters of 2002. At the same time, CNET's operating income was becoming increasingly less negative. Early in the semester APM increased its position in CNET at low prices, so that by November when the technology sector sparked to life with an upturn, the aggregate position had grown to ~11% of the total portfolio. APM booked some profits, bringing the position down to about a 9% level in the portfolio. Management's discussion accompanying 3rd quarter results gave guidance that the company expects to be operating income positive (before Q&A) in the fourth quarter, and in all of 2003, so APM feels positive about this holding going forward. ■

Good news for LSB!

Only shortly before the end of its fiscal year, LSB completed the sale of Slurry Explosive Corporation ('Slurry') and Universal Tech Corporation ('UTEC') to a private bidder. Shareholders have waited patiently for this sale to be completed, as the letter of intent to sell these businesses was announced in October. This much anticipated event is characteristic of the entire year for shareholders of LSB: much expectation about the actions and opportunities for the company have abounded.

In other news

The explosives products manufacturing facility in Hallowell, KS, owned by Slurry and later sold to UTEC in May 2002, had its license revoked in February 2002 for alleged violations relating to explosives storage. That license was reinstated on September 30th.

On November 14th, the Board of Directors decided not to declare the cash dividend on its outstanding shares of $3.25 Convertible Exchangeable Class C Preferred Stock, Series 2. The APM portfolio holds Preferred Stock, so the APM class can anticipate receiving this dividend in future semesters.

Operating results reported by the company for the three months ending September 30th included losses of 27 cents per share (for 12 million shares outstanding).

Despite the up and down moments of the last quarter, the preferred stock price has ranged between $20 and $25 for most of the semester, while the common stock price has ranged between $3.50 and $2.50, and has only recently dropped below $2.50.

And although the Fall '02 class believes that better (and simpler) profit can be made in other companies that the portfolio holds, Kent still believes that this stock is a potential home run. Only time will tell, and future APM classes will have the opportunity to conduct their own research and make up their own minds on the future profitability of this company. ■

Fund Raising Highlights

Thanks to the following APM friends and alumni for their contributions in 03 2002.

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Christopher J. Klausner
Jeremy D. Glauner
Steve Lane
Dirk E. Richter
Marie Schumacher McCarthy
Charles D. McCarthy
Scott F. Jones
Carol A. D'Souza
Robynn Hart Drueger
Yum! Brands Foundation Inc.
Deloitte Foundation
BP Foundation
Frederick N. Coulson

Kent McCarthy is still matching alumni gifts 2 for 1, so now is a great time to make a donation. Contact Patrick Mikesic, 1-800-444-4201 ext. 461, or PMikesic @KUEndowment.org, for more information. ■

Thank you for your contributions!

If you would like to contribute to the portfolio, please mail your donation to:

KU Endowment Association
McCarthy Fund
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Lawrence, Kansas 66045-7585

or contact Patrick Mikesic at:

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