

# Exclusive Outlook

WEST COAST ASSET MANAGEMENT, INC.

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## Eyes Believe What They See, Ears Believe Others

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In 1992 the New York Times reported that President George Bush was “amazed” by supermarket scanner technology, suggesting that the president was out of touch with the American people, belonging to a caste of people for whom others did the shopping. Although the story turned out to be apocryphal, evidence suggests there really is an elite group of Americans who haven’t done much grocery shopping in recent years: the analysts and institutional investors of Wall Street.

Supermarket chains such as Krogers, Albertsons and Safeway are in trouble. The competitive landscape shifted dramatically when retailing giants Wal-Mart and Costco expanded their merchandise lines to include groceries. The trouble has been brewing for years, but Wall Street has just noticed. We think this situation illustrates the arrogance of over-education; investment professionals studied financial statements and annual reports, but didn’t notice the Costco, Trader Joe’s, Whole Foods, and Wal-Mart grocery bags being unloaded from their neighbors’ SUVs.

Customers seem to know well in advance when a company is in trouble, but Wall Street notices after the damage is done, then severely punishes the stock.

### BACKYARD BARBECUES PREDICTED SUPERMARKET SECTOR DECLINE

Education without experience is knowledge without wisdom. Or, as a fortune cookie opened by Paul so eloquently put it: “Your eyes believe what they see. Your ears believe others.” We think anyone could have seen this crisis in the supermarket business coming. 30 years ago, if you went to a multi-family barbeque, the host bought the meat at a butcher’s shop. 10 years ago, the host bought the meat, and the drinks and paper

goods, at the supermarket. For the last five years, the host has bought the meat, the drinks, the paper goods, the lawn furniture, potted plants, outdoor speakers and the barbeque itself at Costco or Wal-Mart.

What goes great with a giant SUV and a Sub-Zero brand freezer? A huge cargo of dry goods and frozen meats: It’s all part of the super-sizing of America. Our huge middle class does not have the cash-flow worries of thirty years ago; they are better able to realize economies of scale by shopping “club” style and buying in bulk. Of course, few top-floor Manhattan restaurants host multi-family barbecues, so analysts missed this trend until it was too big to miss.

### KODAK FAILS TO FOCUS ON DIGITAL PHOTOGRAPHY

Long-term investors must distinguish trends from fads. Large companies are, by definition, long-term investors in themselves, but many seem to miss trends that the average person and the competition clearly identify. Kodak, for example, recently announced that they would cease research and development of film products. We cannot say that Kodak missed the fact that large numbers of people quickly embraced digital photography, for Kodak was an early entrant into the market. Offering low-priced, feature-poor cameras and very expensive, high end cameras, they misallocated resources for the last ten years, utterly missing the mass-market feature set and price points. Worse, they seem to have missed the market for digital media such as compact flash cards, the products that will actually replace film in the short term.

The company will insist that they were listening to customers, and we believe them. At least, we believe they were listening to marketing focus groups. Perhaps they failed to watch customer



behavior. A colleague who rhapsodizes about the quality of his 35mm Nikon bodies and lenses leaves the 20-pound camera bag at home and takes his tiny digital camera everywhere he goes. It's what people do every day that really counts.

### WATER, WATER EVERYWHERE

Coca-Cola once dominated the nonalcoholic beverage market. But over the past few years, we have seen shelf space give way to bottled water and supplemented specialty drinks. Was it not obvious that nearly every parent on the sidelines at youth soccer games was drinking bottled water? Comparatively low start-up costs allow water bottlers to create localized brands at competitive price points. How much brand loyalty can one expect for a bottle of water?

### YOUNG ADULTS HERALD THE WIRELESS FUTURE

Visit any college community to see the future of telecommunications. School-year renters no longer bother with landline phone service; everyone has cell phones. In these same communities, DirectTV and digital cable systems now deliver television programming and high-speed internet access. Landline phone companies, such as AT&T, and dial-up Internet services like AOL seem dumb-founded as their customers flee en masse for the obvious benefits of wireless telephony and high speed DSL or cable Internet access.

### TELEVISION LOSES ITS REASON FOR EXISTENCE

People don't like to acknowledge this, but television news and entertainment are mere subsidiaries of the advertising industry. What will happen as more consumers gain the power to avoid commercials through time shifting digital recorders like Tivo? The advertising industry is currently reacting with more in-program product placement, which has drawn regulator and consumer advocate attention, but not much revenue.

What is the future of the advertising industry if people have the power to avoid ads? When will the ripples hit content and

distribution companies like Viacom, Disney, and GE (NBC), whose products are paid for by advertising revenue?

### GROCERS LOSE TOUCH, AND THEIR IDENTITY

Wal-Mart revolutionized retailing through technological mastery of their supply chain. Their expertise ensures that the most popular items are always in stock, and always at the lowest prices. With their remarkable distribution and information technology systems in place, conquering grocery retailing seems a simple matter. In fact, in 2001 Wal-Mart surpassed industry lead Kroger with an estimated \$65.3 billion in food sales.

Small competitors position themselves to make traditional supermarket shopping seem like drudgery. People talk about a trip to Trader Joe's as an EVENT. A quirky alternative for those who love to experiment with an ever-changing inventory, Trader

Joe's offers gourmet fare at discount prices, and does so with humor and personality. Whole Foods and Wild Oats position themselves as morally superior alternatives for healthy, environmentally friendly, and socially conscious shopping. Each uses its unique identity as its competitive advantage.

When Wall Street misses a major trend, investors pay dearly. Wal-Mart, Costco, and specialty retailers like Whole Foods

and Trader Joe's are expanding and taking market share from Albertsons, Safeway and Kroger. The declining stock prices of these large supermarket chains reflect Wall Street's reaction to the customer exodus.

### FRONTLINE COWORKERS & CUSTOMERS

Although Yogi Berra's famous remark that a certain restaurant was "so popular that no one goes there anymore" is an amusing oxymoron, it may have been accurate. Customers know when the wait is too long, and word gets around. Customers complained for years about the inconvenience of 35mm film; the mystery, waiting and expense. When decent digital cameras broke the \$500 price point, customers bought them.

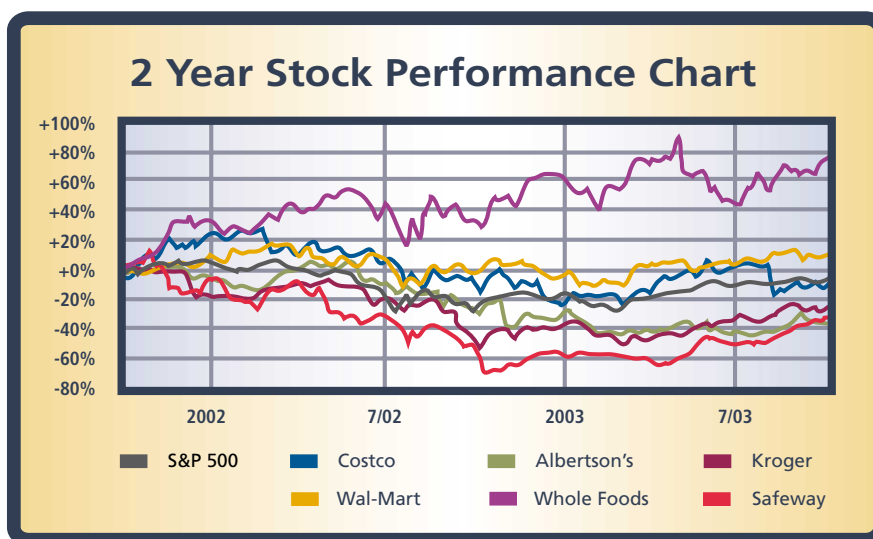


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Was it not clear that as soon as wireless matched the quality of landline telephones, the latter would be redundant? Was it not apparent that everyone using high-speed Internet access at the office would clamor for high-speed access at home?

Did some of the largest companies in America watch their customers, or did they listen to marketing consultants, accountants, stock analysts, and other experts? Did they even listen to their own frontline employees, those firsthand witnesses of customer behavior?

In Ernest Hemingway's *A Farewell To Arms*, a recuperating World War I soldier visits an Italian pawnshop to replace his lost pistol before returning to the front. The elderly proprietor tries to sell the young man a sword. He calmly explains, "I have no need of a sword. I'm going to the front." He has seen the new face of war, the mechanized, 20th century war. He has seen for himself what things are like on the front lines, and he knows what he needs to compete there.

THE SMARTEST MAN IN THE ROOM?

Arrogant and aloof companies lose ground to new competitors with new products. They try to sell buggy whips after the invention of the car. They even offer new colors and packaging for their buggy whips. "Selling buggy whips" used to imply an unwillingness to accept new technology. Closer to the truth, these companies cannot even see their customers' desire for new product benefits.

F. Scott Fitzgerald once said that a good writer isn't the smartest man in the room, just the most observant. Likewise, a

good investor doesn't have to know everything in the world about investing, but ought to know what's going on in the world. We think that Wall Street brokers and analysts talk to each other more than they watch consumer behavior. It's interesting to hear how other people invest money, but it's more profitable to watch how consumers spend their money. ▲

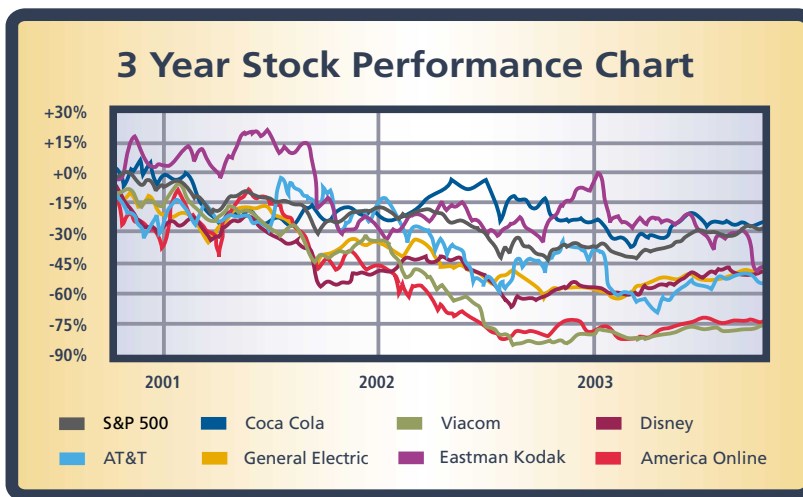


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REPORT CARD—PERFORMANCE OF STOCKS HIGHLIGHTED

Profiled	Stock	Recommend?	Stock Gain or Loss	Stock Gain or Loss vs. S&P 500	Opinion Changed?
3/31/01	Johnson & Johnson	Yes	13.82%	24.73%	
5/31/01	Ford	No	-52.77%	-35.09%	
6/30/01	Northrop Grumman	Yes	14.11%	47.35%	*02/13/03
7/31/01	Guitar Center	No	114.58%	129.23%	
8/31/01	Crescent REIT	Yes	-23.52%	-25.71%	*12/07/01
9/30/01	General Electric	No	-18.82%	-18.13%	
10/31/01	Wrigley	Yes	11.95%	14.40%	
1/31/02	Kellogg	No	9.98%	18.51%	
5/31/02	Magnum Hunter	Yes	16.39%	19.52%	
10/31/02	Tootsie Roll	Yes	-4.06%	-13.24%	*08/06/03
1/31/03	Microsoft	Yes	3.83%	-9.17%	*06/02/03
Stocks Recommended			4.65%	8.27%	

Performance as of 10/8/03. \*Performance is calculated based on the date recommended through the date opinion changed.

