BANYAN CAPITAL MANAGEMENT

February 2002

Dear Client:

Last year saw the stock market in turmoil the likes of which has not been seen since the big crash of 1987. The recession, previously confined to the industrial and capital equipment sectors, officially engulfed the economy as a whole. As unemployment crept up, corporate profits declined. The events of September 11 made a bad situation even worse; such that in the third quarter the stock market posted the biggest quarterly decline since The Great Depression.

Our equity composite for the year was down 7.9% (Explanation of how composite was compiled). We take no pride in the S&P 500 being down an even greater 11.9%. This marks the second year in a row of a decline in the market averages – the first such two-year decline since 1973-74. Due to an outstanding year in 2000, Banyan's two-year return showed an increase of 9.1% per year versus a decline of 10.5% per year for the S&P 500. We are proud to have preserved and even built capital over this challenging period. The enclosed reports show the returns for your specific portfolio.

So much for the past - what does the future hold for equity investors? While divining the answer is quite problematic over the period of the next several months or even the next year, a much clearer picture emerges when the next 5-10 years are considered. This question is addressed in detail in an essay in the December 10 issue of Fortune prepared by Carol Loomis from a speech given by Warren Buffett last July. It is an insightful analysis that we will summarize for you now.

One can determine an appropriate value for any business by predicting the future cash flows from that business, and discounting that stream of cash to its present value. There is, of course, much difficulty in accurately forecasting those cash flows and discounting them at an appropriate rate. It is axiomatic, however, that the lower your interest rate assumption, the higher the value ascribed to the same stream of cash and, therefore, a higher business valuation. Indeed as Buffett points out, "In economics, interest rates act as gravity behaves in the physical world. At all times, in all markets, in all parts of the world, the tiniest change in rates changes the value of every financial asset. You see that clearly in the fluctuating prices of bonds. But the same rule applies as well to farmland, oil reserves, stocks, and every other financial asset. And the effects can be huge on values. If interest rates are, say, 13%, the present value of a dollar that you're going to receive in the future from an investment is not nearly as high as the present value of a dollar if rates are 4%."

To see how this affects our prediction for the stock market, we must first travel back to the fall of 1981. At that time the U. S. Treasury had to pay a whopping 15.75% in order to issue new 30-year

BANYAN CAPITAL MANAGEMENT, INC.
2100 RIVEREDGE PARKWAY, SUITE 1030, ATLANTA, GEORGIA 30328
PHONE 770-951-2129 FAX 770-951-8277
www.banyancapital.com

bonds. Today that same bond yields 5.4% and short-term rates are at 2%. In other words, the stock market has had the wind at its back for about twenty years in the form of generally declining interest rates in order to support ever-higher valuations. Since it is unlikely that rates will go to zero, one powerful catalyst for increasing stock prices has been taken away. The fact that interest rates will no longer be declining is by far the single most important factor affecting equity returns over the next several years – more important than accounting scandals, the occasional corporate fraud or the garden variety recession we are currently experiencing. Over the next 5-10 years only increased earnings will move stocks to higher levels. Buffett estimates the market will advance 7-8% on average. At Banyan, as we continue to improve on our skills at controlling risk, our goal is to generate 9-10% on average. By the way, there is nothing wrong with compounding at these rates. It is only when compared with the aberrant returns of the past decade that these returns seem diminished. It is unrealistic to expect our portfolios to keep pace with the 16% returns we have enjoyed over the past ten years. In fact, if we compound at a double-digit rate over the next several years I'll dance on my desk for you at our occasional meetings.

This sort of market environment will produce an ever-declining population of stockbrokers and investment advisors. There will be increasing consolidation in the mutual fund industry and many do-it-yourself investors will either leave the playing field altogether or seek professional advice. Since making money in the stock market will not be easy, it will not be the hot subject of conversation at cocktail parties. At some point investors may begin to look more closely at the astonishingly high expense element of their investment approach. At Banyan we have been thinking about this for years. For example, our annual brokerage expense has averaged a very low .09% of average assets and we will continue to make every effort to ensure that these costs remain low or decline even further. In addition, other typical investment expenses such as custodian fees, distribution charges, termination charges and asset management fees have been eliminated or reduced to acceptable levels in our portfolios.

Banyan has experienced solid growth in assets under management over the past two years as more investors turn away from speculation and seek methods that are more tested and true. In order to better serve you and allow for further growth, we are currently exploring new office space possibilities. Look for us to add administrative support during the year and a second investment professional further down the road.

Whatever the future brings, you have our pledge to do our utmost to continue to provide you with the best in customer service. We continue to be energized by the challenge of the investment process and we look forward to meeting your investment objectives for many years to come.

Sincerely,

Gary L. Watkins
President