

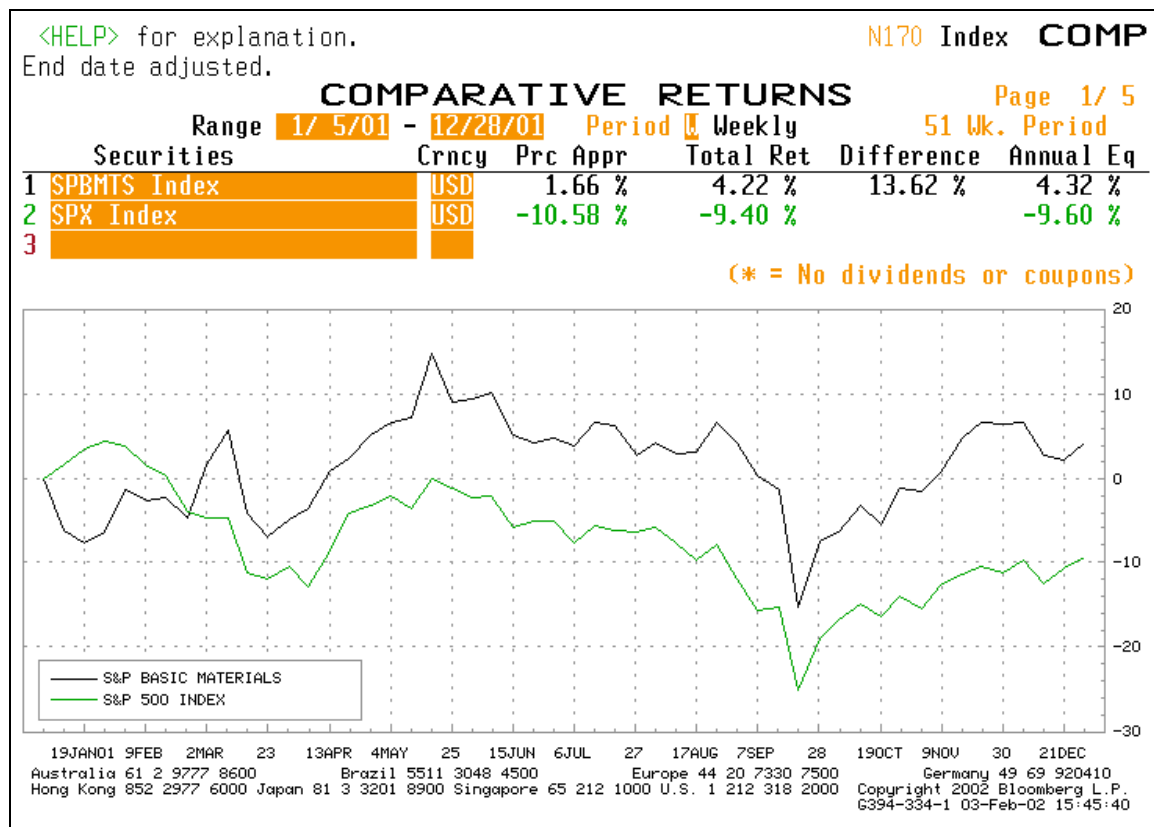
# M.A. Wright Fund

## Materials Industry Update

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February 4, 2002

### Overview

The basic materials sector is comprised of companies that produce the basic building blocks of other value-added products. Companies from the following industries are represented in this segment of the market: Chemicals, Construction Materials, Containers & Packaging, Metals & Mining, and Paper and Forest Products. The following charts compare the returns of the Materials index and four industry group indices for the year 2001.



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N170 Index COMP

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### COMPARATIVE RETURNS

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Range 1/ 5/01 - 12/28/01 Period Weekly

51 Wk. Period

Securities	Crcncy	Prc Appr	Total Ret	Difference	Annual Eq
1 BUSFRST Index	USD	-0.07 %	2.44 %	-0.45 %	2.49 %
2 BUSCHEM Index	USD	-0.10 %	2.89 %		2.96 %
3 SPX Index	USD	-10.58 %	-9.40 %	-12.29 %	-9.60 %

(\* = No dividends or coupons)



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### COMPARATIVE RETURNS

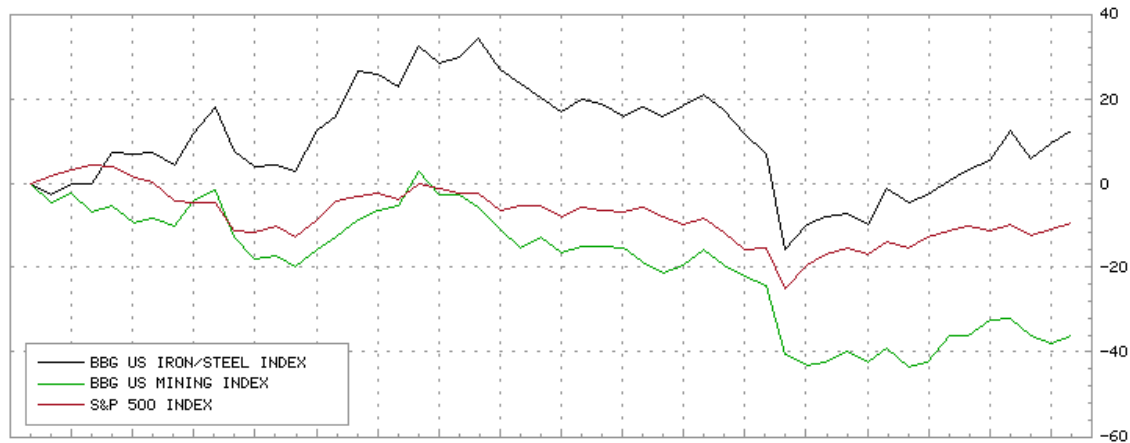
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Range 1/ 5/01 - 12/28/01 Period Weekly

51 Wk. Period

Securities	Crcncy	Prc Appr	Total Ret	Difference	Annual Eq
1 BUSIRON Index	USD	9.96 %	12.37 %	48.01 %	12.67 %
2 BUSMING Index	USD	-36.43 %	-35.64 %		-36.27 %
3 SPX Index	USD	-10.58 %	-9.40 %	26.24 %	-9.60 %

(\* = No dividends or coupons)



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The Materials sector outperformed the S&P by a considerable margin in 2001—as the first chart above shows, materials returned 4.22% while the S&P 500 lost 9.4%. This trend has continued into 2002, with the materials sector gaining 1.26% so far this year versus -2.25% for the S&P 500. As mentioned in the last sector report, materials companies are very dependent on the state of economy in general. The consolidation trend continues in packaging and construction areas. Increasing global competition and the strength of the U. S. dollar also hurt the well being of the sector.

### **Sector Drivers**

The fundamental and most important driver in this sector is global economic health. As a result, many investors are turning a blind eye to these companies while the weakness in the US and other economies works itself out.

The second big driver is manufacturing activity. Firms producing durable goods require raw materials supplied by most of the companies in this sector.

Other drivers include industry capacity, supply, and demand. The first two are inter-related, and the only hope in this environment is that producers demonstrate restraint by operating below capacity, so as to avoid a situation of excess supply. On the demand side, we come back to the question of economic activity. Consumer spending on durable goods, business investment, and government works projects underpin demand. It will require a significant upturn in these areas for excessive demand of basic materials to return.

### **Industry Trends and Outlook**

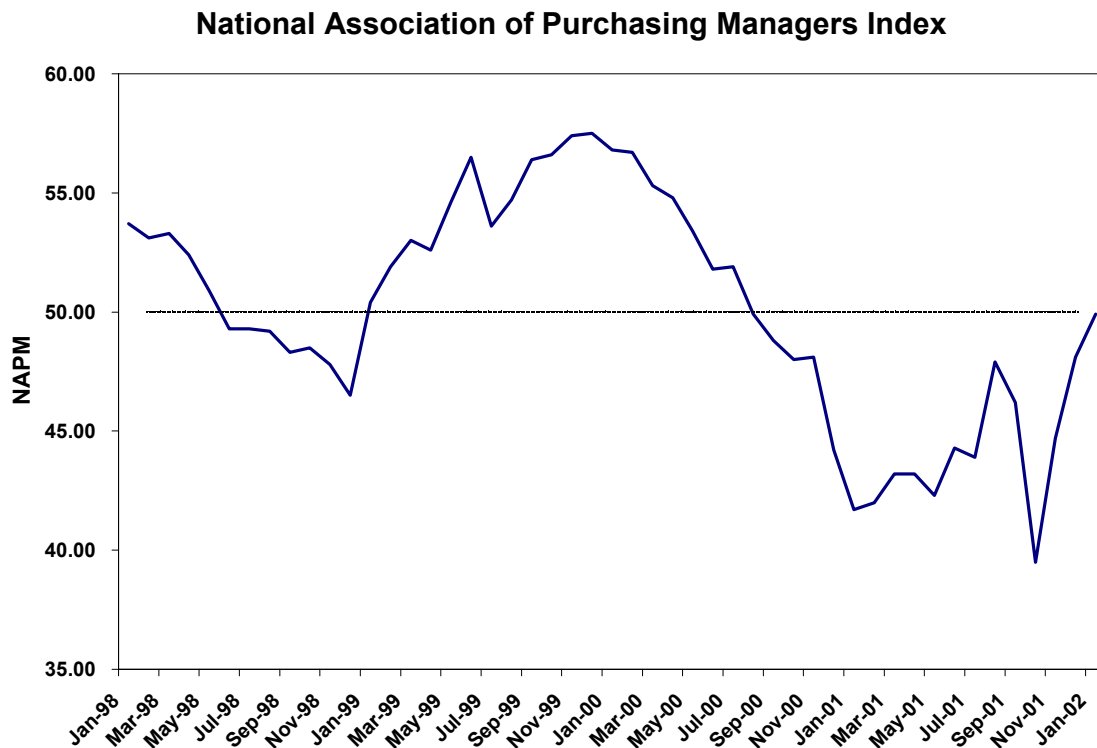
Although materials stocks have performed well over the past twelve months, we feel there is additional upside potential for the sector as a whole. Due to the “old economy” nature of most of these companies, they tend to be overlooked. Contrarians might find the current environment an opportune time to quietly add to stock positions in this sector.

Broadly speaking, most of the companies covered in this sector will require an economic upturn in order for genuinely good times to return, but such is the nature of cyclical businesses. The best time to establish positions in cyclical companies is precisely when they are out of favor. For investors with a long time horizon, therefore, we would argue that the materials sector is an entirely appropriate sector to be evaluating.

At the moment, a common trend in the sector is one of cost cutting, which is natural given the environment at hand. Phelps Dodge and Alcoa are two companies in the metals and mining group to recently announce new or more vigorous cost reduction programs. Firms in other groups, too, have placed an increased emphasis on controlling expenses. The end result is a positive for the sector, because when the cycle turns, the companies to have made the most progress on this front will be those that enjoy the strongest upswings.

Regarding an outlook for the sector, we think the National Association of Purchasing Managers Index (NAPM) is worth watching. Over the past few months it has moved solidly higher, indicating the beginning of a recovery in the manufacturing sector (see chart below). A reading above fifty indicates growing manufacturing activity, while a reading below fifty spells a contraction. Since manufacturing activity is a significant profit driver for materials companies, this trend bodes well for the sector. We feel that if the emerging recovery is real, and can be sustained, the US economy will improve.

Overall, we feel the materials sector is not one to be avoided. Instead, we take a contrarian's point of view and suggest that perhaps materials companies offer a good place for the long-term investor to turn for a reasonable risk / reward proposition.



## Chemical Industry

The overall outlook for chemical companies is neutral, but slightly positive for specialty chemicals producers. The utilization rate was the lowest in many years at 73.4% as of October 2001. Excess existing capacity and new capacity will keep margins relatively low for commodity chemicals and reduce the probability of quick industry-wide recovery. Specialty chemical producers are generally less affected by the recession because the margins and demand are relatively stable.

## **The Packaging Industry**

The outlook for this group is slightly positive. The industry has experienced low demand since September 11. In the aftermath, firms in this group reacted intelligently by increasing plant downtime, thus alleviating the pressure on price. With the success of the war effort, we see demand bouncing back over the next few months.

Additionally, the industry has been consolidating. The formation of Smurfit-Stone Container, the world's largest paper-based packaging firm, helped reduce capacity by 5% since late 1998. In May 2000, Smurfit acquired St. Laurent Paperboard, and the company currently has 19% U.S. market share. This will increase the pressure on competitors and likely will induce further consolidation within the industry.

## **Agricultural Products**

This group performed well in 2001 as investors escaped technology stocks and invested in "safe havens." However, the industry performance outlook is weak for the next six to twelve months due to recession-induced weak demand for most crops. The commodity prices are expected to be low due to oversupply and weak worldwide demand. The long-term outlook is favorable due to increasing worldwide population, especially from Latin American and Asian countries.

## **Paper & Forest Products**

A problem facing this group is oversupply. Canadian and other foreign imports have been a drag on US players for years, and the pattern shows no signs of abating anytime soon. The situation is hazy at the moment due to an import duty imposed on lumber by the Commerce Department in August. However many expect a compromise to be reached soon, which would likely dilute any mileage the US producers might have gained in terms of a pricing advantage.

Given the question of industry capacity, and the uncertain future of the long-running homebuilding / home improvement expansion, we remain cautious toward this group.

## **Construction - Cement & Aggregates**

The outlook for this industry is neutral. The stocks in this industry have enjoyed healthy gains in the final three months of 2001. However, the weak economic environment will likely hinder demand. Government highway spending is likely to increase, thus offsetting some of the weakness in demand.

The industry has also experienced some rapid consolidation recently. Furthermore, several companies have completed capital spending programs to upgrade facilities, which reduces capital spending and free cash available for other uses. The \$160 billion federal highway spending act will expire at the end of this year, so the future of highway

spending remains cloudy. If Congress makes any changes to spending in this arena, pricing and demand could be significantly affected in regional markets.

## Metals and Mining

Makers of metal were hit in 2001 with a simultaneous drop in demand and an overhang of supply. Prices on the London Metals Exchange (LME) dropped significantly, particularly in copper and aluminum, which led to reduced earnings, and even losses, for a number of producers.

Many firms in this group took last year as an opportunity to clean house. Many restructurings have resulted, and most firms now are focused on reducing costs so they can remain competitive while they wait out the slow economic environment.

The outlook for these firms depends primarily on LME prices. From a reversion-to-the-mean perspective, metal prices may well be poised to rally this year, after spending most of last year in negative territory. Should this be the case, mining stocks will benefit nicely.

## Correlation Matrix

Given there is only one holding from our sector in the Wright Fund currently, i.e. Praxair (PX) the correlation matrix is simply the following:

	<i>PX</i>	<i>SPX</i>
<i>PX</i>	1	
<i>SPX</i>	0.457409	1

## Summary

On balance, we feel now is an opportune time to consider buying into shares of materials companies. Our outlook is slightly positive, particularly in light of continuing signs of economic recovery. We recommend looking within the sector for inexpensive companies with adequate interest coverage ratios and conservative capital structures.

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**Sources:** Bloomberg  
Yahoo! Finance  
Bear Stearns Phelps Dodge report dated January 31, 2002  
Industry Surveys – Monthly Investment Review, January 2002  
Value Line – Investment Survey, January 11, 2002