

Cedar Fund

3464 Boston Twp. Line Road
Richmond IN 47374-9421

Phone 765-962-3431

Fax 765-962-1991

E-mail: Cedarfund@harfam.org



Cedars of Lebanon • Ezekiel 31
Symbol of majesty and strength

Edward S. Harris
(314) 579-9377
EHarrispc@aearthlink.net

David F. Harper
(765) 966-9306
DHarperCPA@aol.com

Mark W. Harris
(765) 962-3431
Mark@harfam.org

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Dear Cedar Fund Partner:

In another difficult year in which the S & P 500 Index plunged 22.10%, the Cedar Fund fared better with a decrease of 4.63%. In 2002, the value of a fund unit dropped to \$1,654 from \$1,735 the year before. The five-year average (annualized) for the Cedar Fund is up 6.12% compared to a S& P 500 loss of 0.59%.

The good news is that Berkshire Hathaway, the Fund's largest holding, recently announced record profits, the highest in the company's history. "In all respects, 2002 was a banner year," Chairman Warren Buffett said. This marks the turnaround in profits and in the corporate culture of General Re, the giant reinsurer acquired a few years ago. Buffett is unusually enthusiastic about his wholly-owned businesses. One analyst sees growth of 10-12% per year in book value. For the full text of Buffett's 2002 letter to shareholders, see his website: <http://www.berkshirehathaway.com/>. Buffett's annual letters are a must read for learning principles of investing and for discerning the current condition of American business.

Harfam Partners provided a strong base of support with a slight decline of 0.23%. Berkshire Hathaway was down 3.77%. The strongest managers in Harfam, our partnership of money managers, were Semper Vic Partners with a small loss of 0.95% and Ruane Cunniff (Sequoia Fund) with a loss of 2.60%.

Outlook For Stocks

This was the third consecutive negative year for the S& P 500, the first time that has happened since 1939 – 1941. Will there be a fourth? Buffett, commenting on the "Great Bubble" of the 1990s, says, "Unfortunately, the hangover may be proportional to the binge" (2002 Berkshire Hathaway annual report). The extent of the bubble may have been longer and larger than at first realized. Buffett believes that while stock prices have become more reasonable, they are still pricey. He still sees future stock returns in the 6%-7% range over the next ten years. It may take a long period of time to work through the excesses of the Great Bubble.

The Sequoia Fund noted recently that many stocks are overvalued when the inflated earnings are stripped out. In this environment, we feel the most important service we can offer is to identify and retain money managers whose first priority is the high quality of earnings of their investments. We are very comfortable with our managers, especially Berkshire Hathaway which has strong earnings and good upside potential.

Quality of Earnings

What is meant by "quality of earnings"? Deterioration in the quality of company earnings – due to fraud, aggressive accounting tactics and "managed" earnings – contributed to the Great Bubble. In fraud, illegal methods are used to hide expenses and losses from auditors and from being reported in the financial statements. In aggressive accounting, corporate managers take advantage of the interpretative

“gray” areas of accounting to reduce expenses and inflate revenues (e.g. failing to expense stock options and making unrealistic pension assumptions). In managing earnings, corporations try to “smooth” earnings to provide consistent results every quarter to meet Wall Street’s profit estimates (e.g. taking special one-time charges and selling assets to meet profit targets). *All of these tactics distort the true nature of the business and its real earning power.* Every year in his shareholders’ letter, Buffett devotes space to current accounting shenanigans.

These efforts to manipulate earnings are driven by a powerful motivation - greed. Avarice in corporations and their executives serves to fuel unrealistic expectations, and thus greed, among individual investors. Steve Romick, whose FPA Crescent Fund posted a positive 3.7% in 2002, said on the PBS television program “Wall Street Week with Fortune” that greed drove the stock market to excessive levels in the 1990s. Today greed has been replaced by fear as the dominant mood of the market, he notes. Investors are fearful of stocks. Corporations anxiously struggle to meet new governance expectations and to make their accounting more conservative. This sense of real fear seems to have emerged only recently.

Cedar Fund Information

The Cedar Fund continues to be the main focus of our attention. In addition, we can invest money that you have outside the Cedar Fund in a separate account of individual mutual funds. If you are interested, please contact us for more information. We are also compiling a list of recommended mutual funds you can use in your corporate 401(k) plan that has limited investment options. Just a reminder: the Cedar Fund opens every calendar quarter to accept new money. The next opening is April 1.

Enclosed are: (1) 2002 Cedar Fund financial statements audited by CPA firm Williams, Keckler & Ratcliffe, LLC, which list our investments and (2) the year-end value of your investment in Cedar Fund.

On our web site www.cedarfund.harfam.org are: (1) this annual letter, (2) annual CPA audit, (3) historical performance and (4) portfolio holdings of Cedar Fund and Harfam Partners.

Available upon request: (1) Printed copies of any document on the web site and (2) Form ADV, Investment Advisor Registration, which the Indiana Securities Division requires be made available, upon written request, to investors.

We value your confidence in Cedar Fund. We believe your patience and realistic expectations will be rewarded in the future. We welcome any comments or questions you have about the Cedar Fund and its investment philosophy.

HARRIS HARPER COUNSEL, INC., *General Partner*

Edward S. Harris, *President* David F. Harper, *Vice President* Mark W. Harris, *Sec.-Treas.*