Alley Company Commentary
Principles of Compounding: Part 1 in a Series

Picking the Right Compounding Vehicle

The principle of compounding is one of the most powerful, yet least appreciated forces in stock market investing. Compounding, in simple terms, is earning future returns on earlier returns (unrealized gains, interest, or dividends) over a period of time. The higher the growth rate in annual returns, and the longer the time period that one realizes this growth, the more favorably the formula works for investors.

Investing in stocks of United States corporations has historically been among the best compounding vehicles available to investors. The challenge for equity investors is in selecting stocks that have consistent growth characteristics that can be counted on for long periods of time. **This is important because stock price performance in the long run is closely linked to earnings performance.** It is not easy to accomplish emotionally because market forces such as interest rate concerns, fear of recession, global instability, etc. cause investors to lose conviction in the long term stability of proven companies. We believe that selecting a portfolio of proven growth stocks coupled with the discipline of maintaining a long time horizon will yield superior investment results due to the benefits of compounding.

To illustrate, consider the merits of investing in the common stocks of **Walgreens** vs. **General Motors**. On a valuation basis, Walgreens appears to be a more expensive stock than General Motors. However, when examining the profitability, the consistency of profitability and the track record of growth over the past ten years, one may come to a different conclusion.

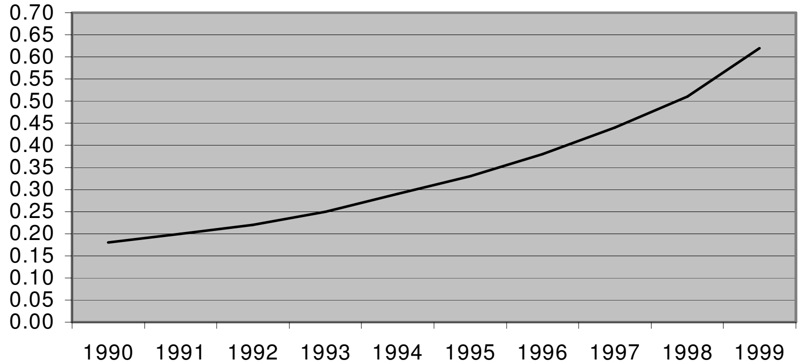
In examining Walgreens' ten year history, as illustrated below, we find that the company has **consistently** grown its earnings 15% and has achieved a return on capital (no debt) of about 18% annually. The company generates remarkable consistency of results which is why at $31 per share it commands a premium P/E of 25x on year 2000 earnings estimates.

Walgreens Return on Capital

1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
16.6%	16.7%	18.3%	18.0%	17.8%	17.8%	18.1%	18.4%	18.0%	18.0%

Alley Company LLC
585 Bank Lane, Suite 2400
Lake Forest, IL 60045
Phone 847-482-0938
Fax 847-482-1237
www.alleycompanyllc.com

Walgreens Earnings Per Share



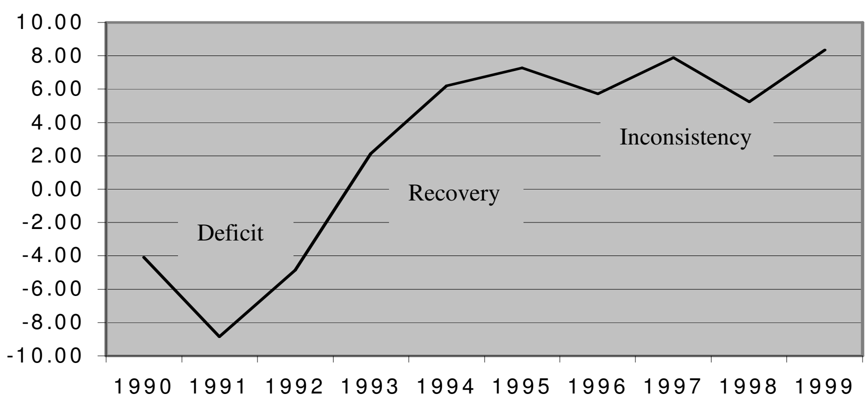
Over the next ten years Walgreens plans to double its store base in the United States and will likely continue its strong same store sales growth of 10% + driven by the powerful demographics of its pharmacy business. We believe Walgreens will continue to grow earnings at a 15% -16% clip over the next ten years from a base of $.80 per share in the year 2000. At this rate Walgreens will earn $3.53 per share in the year 2009. If Walgreens generates the numbers we project over the next ten years, the compound earnings growth will drive the stock significantly higher irrespective of its seemingly full P/E ratio.

Turning to General Motors, as illustrated below, the company has grown its earnings 3% annually and has achieved a return on capital, on average, of less than 8% a year (debt is 77% of the capital structure). GM has delivered inconsistent results, with deficit as well as positive earnings during the period.

GM Return on Capital

1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
0 %	0%	0%	9.7%	14.0%	13.9%	9.9%	13.0%	7.8%	9.9%

General Motors Earnings Per Share



Over the next ten years GM is likely to generate the same inconsistent pattern of earnings that on average provides low relative profitability. While GM is a stalwart in the auto industry, the inherent cyclical nature of the global automotive business is the cause for its unpredictable earnings prospects. It is very difficult to forecast what GM may earn ten years from now off of a base of $8.50 per share projected in the year 2000. With earnings likely to be volatile, it is just as probable that the company will earn $8.50 per share in the year 2009 as it will earn $5.00 or $12.00 per share. Therefore, given the inability to forecast compound earnings growth for GM, it is impossible to predict whether the stock will be up or down in ten years.

The point of this comparison is not to forecast with any degree of certainty where these stocks will be trading ten years from now, but to provide a framework for comparing the relative predictability of the two companies earnings prospects. Clearly, the analysis points to Walgreens as being the superior compounding vehicle in the long run because of its far superior rate and consistency of earnings growth. Ironically, it may be the best value over the long run as well, given the high degree of confidence in the company's earnings prospects. General Motors, on the other hand, is a stock that one would have to trade in and out of a number of times over the time period in order to make money because of the inherent inconsistency of its earnings prospects.

We are committed to owning companies that have superior compounding characteristics, i.e. **consistent earnings growth**, and monitoring them to make sure our judgement is correct. As stated earlier, stock price performance in the long run is closely linked to earnings performance (see graphs below). Periodically, some of our holdings fall out of favor due to market dynamics that make it difficult to maintain conviction. This is where discipline and analysis becomes crucial as we strive to stay with our philosophy and allow the power of compounding to prevail.

<u>10 Year Historical Stock Price</u>

<u>Walgreens</u>

<u>GM</u>

December, 1999