



INVESTMENT STRATEGY UPDATE

January 2, 2002

2002 - THE YEAR AHEAD

2001 was a year for the history books. Not only was America attacked by terrorists, but we also witnessed an end to the longest economic expansion in U.S. history, wildly gyrating energy markets, and a resounding crash landing of what had been the greatest stock market bubble of all time. By the September lows, technology-dominated stock indices had fallen some 65% from their highs in early 2000. The demise of the technology mania had a major negative impact on the economy, as well as on investors. With far too much money having been thrown at the technology and telecommunication sectors, capacity had been substantially overbuilt. As a result, capital spending came to a screeching halt, inventories were brought down, and corporate profits imploded.

Reacting to the weakening domestic and global economies, the Federal Reserve Board aggressively lowered interest rates. Yet even after seven rate cuts, the economy kept sliding toward recession. Following the events of September 11, the Fed eased still further, injecting substantial amounts of liquidity into the system. As 2001 approached year end, there was evidence that the economy might be stabilizing. Flush with liquidity, investors reacted and the stock market rallied strongly -- particularly the technology sector.

As we look toward the financial year ahead, we find ourselves focused on three primary questions. First, what is the outlook for the U.S. economy and corporate profits in general? Second, what is the probability of future terrorist acts, and what might be their effect on the economy and investor psychology? And third, given current circumstances, what is the appropriate level of stock market valuations?

The Economy

It's official. According to the National Bureau of Economic Research, a U.S. recession began in March. This past year has been one of the more unique periods of economic weakness in our history in that the consumer sector, which accounts for nearly two thirds of Gross Domestic Product, held up relatively well. The downturn was primarily concentrated in the technology and capital goods sectors, as corporate America was hit with the difficult combination of declining sales and substantial overcapacity.

Recent economic statistics have been more encouraging and it appears that a bottom may be near. Monetary and fiscal policy has been extraordinarily stimulative, and the drag of higher energy costs has been substantially diminished. The majority of investors with whom we talk are expecting a V-shaped bottom in the economy, followed by a strong and rapid recovery. That is not our expectation, however. Thus far, this recession has not been very deep. For a sharp rebound to occur, we think a deeper trough would be required. Also, historically, Federal Reserve Board stimulation has been aimed at encouraging a rebound in consumer spending. This time, we believe stimulation was aimed at limiting the economic downturn by *keeping* the consumer spending. So far, so good, but with relatively large current debt loads and rising unemployment, it is probably unrealistic to expect much improvement from the consumer.

The depressed industrial sector, including technology, has begun to stabilize. Costs are being cut and inventories have largely been worked off. As yet, however, there are few signs of a meaningful expansion in order flow. We believe stabilization is the first phase of what will become a three-stage recovery. The second stage will see increasing revenues and some improvement in pricing. Only then will the third stage get underway -- renewed capital spending. We don't expect a meaningful improvement in capital spending until late 2002 at the earliest, and perhaps not until 2003.

Corporate profits should soon show improvement as well, if for no other reason than they will be measured against such miserable prior results. Cost cutting is helping, but pricing pressure remains intense. It is worth noting that corporate America did its part to keep the consumer spending by pricing its products to sell. As we now know, however, such practice was not very helpful for profits.

So the worst is probably over for the recession of 2001/2002 but, in our opinion, consumer spending is still at risk. Since the probability of rising inflation is very low, the Fed is likely to remain quite stimulative. The economy and corporate profits will soon be improving, but we expect the pace of growth to build slowly.

Terrorism – Probability and Consequences

This is perhaps the most difficult of our three questions because there is little comparable history upon which to base our answers. Given the rhetoric of those responsible for the 9/11 attacks, the probability of future terrorism seems high. But who can know, and how can one base investment strategy on such possibilities?

In many parts of the world, terrorism is relatively common -- even expected. Yet we observe that in most nations whose peoples are being constantly challenged with the threat of terrorism, the beat of life goes on. Commerce goes on as well. Shoppers surely go about their daily lives more carefully, but they still step up to the cash register, continuing to purchase both necessities and discretionary items such as televisions, computers, digital cameras, and toys for their children.

We hope and pray that our anti-terrorism efforts will avert the more heinous attempts at destroying our way of life. But either way, we will adjust to our new reality. We are a strong, resilient people, and we will find a way to cope. The American way of life will go on.

Stock Market Valuation

Over time, stock market returns are a function of earnings growth, dividends, and changes in the level of valuation. Earnings growth and dividends are relatively straightforward, but valuation levels are a reflection of investor attitudes about the future. Because it is human nature to extrapolate recent trends and events into the future, current conditions are strongly factored into investor expectations. History shows us that periods of low valuation have usually been associated with either high inflation or strongly depressed economic conditions, such as during the great depression and the years which followed. By contrast, periods of high valuation have traditionally been associated with low inflation, low interest rates, and a general sense of well being. Since 1926, equity valuations, as defined by price/earnings ratios, have ranged from 7 times trailing earnings at the low end, all the way to 35 times earnings during the recent stock market mania. Over the entire period, however, P/Es have averaged close to fifteen.

During recent years, our belief was that higher-than-average equity valuations were warranted. After all, economic and inflationary volatility were low. World trade was growing, and corporations were generating above-trend rates of earnings growth. In addition, there was little inflation, low interest rates, a balanced budget, and favorable demographics as the baby boom generation was saving and investing more for retirement.

Rising valuations helped stock market returns during the 1990s, but where should valuations be currently? Some things have changed, some have not. The positive demographics are still in place, as are the likelihood of continuing low rates of inflation and low interest rates. But, some of the factors influencing valuations have become less favorable. By all appearances, the budget surplus is gone. Also, both world trade and the U.S. economy have slowed substantially, and although we believe that these are cyclical setbacks and do not reflect secular change, the current trends are not positive. In addition, we expect a slower rate of growth, even after the economy recovers, due to the necessary increases in non-productive defense and security spending.

What has also changed, in our opinion, is the overall degree of uncertainty. During the 1990s, stock market valuations were helped by the so-called peace dividend. The world was relatively peaceful and modern day cycles in the economy and the rate of inflation seemed far less volatile than before. Books such as *Dow 36,000* even suggested that the stock market risk premium should be little different from that applied to bonds. However, with the terrorist events of September 11, heightened

conflict in the Middle East, and an uncertain outlook for the U.S. economy, attitudes about the appropriate risk premium for stocks are probably changing. More uncertainty about the future should result in a higher risk premium being applied to stocks, thereby lowering valuations.

Our bottom line is that the appropriate level of stock market valuation is lower than that justified during recent years, but not substantially so. The overall economy is basically healthy and the underlying environment for stocks is still positive, just not as much so as previously.

On a company-by-company basis, current valuations vary widely by quality, sector, and size. While the capitalization-weighted stock market indices are still well above their historic average levels of valuation, many individual stocks are not that expensive. In fact, if the broad array of stocks is measured on an equal-weighted basis, valuations are near their long-term average.

Fixed Income

With the economy nearing a bottom, the environment for fixed-income investments has changed as well, in our opinion. From current levels, we think there is at least as much downside risk to bond and note prices as there is upside potential -- even though yields that have already risen nearly three-quarters of a percent from their early November lows. As the economy strengthens, we expect the yield on the ten-year U.S. Treasury Note will rise to more than 6% from its current 5.1% level. Since fixed-income prices move in the opposite direction of interest rates, there will be a loss of principal value on any bond or note holding that is not very short term.

Therefore, we suggest that fixed-income investors review their return assumptions and the basic reasoning behind their fixed-income allocation. Questions should be asked, such as: Why do I hold fixed income? Is the purpose of bonds in my portfolio to earn a reasonable return, or to limit my exposure to equities or other investment classes? In other words, are bonds or notes held for offensive or defensive purposes? If the answer is defensive, then it probably makes sense to maintain a fixed income allocation, even with the expectation of subpar returns. We think that investors with balanced portfolios should consider the temporary use of fixed-income substitutes with higher yields, such as convertible bonds, REITs, or utilities. The fixed income question is one we intend to include in client discussions.

Conclusions

The U.S economy is nearing a bottom. In anticipation of better times ahead and driven by massive amounts of available liquidity, the stock market has rebounded strongly. But we think that many stocks have already moved too far, in light of their underlying fundamentals. The technology sector seems particularly ahead of itself in that, while

the fundamentals are no longer weakening, a strong cyclical turnaround is still a ways off. Also, in our opinion the likelihood of the previous technology stock mania fully reigniting is close to zero.

For the coming year, we see an improving economy and reasonable stock market returns. But, stock market volatility will continue to be quite high. We believe that the key to a successful investment program in 2002 will be stock market sector and individual stock selection decisions. Well chosen stock portfolios will outperform the capitalization-weighted stock market averages. Also, more importance will be placed on the timing of purchases and sales.

Longer term, the environment for stocks remains positive, but not as much so as before. Corporate earnings growth will be reasonable, but dividend yields are very low and valuations may be under pressure. Therefore, following more than a decade of rising valuations and above-trend stock market returns, our expectation is that returns going forward will be lower than average, eventually regressing to the longer-term mean. Given the performance of the last two years, this process seems to be well underway. We should emphasize, however, that we still expect positive stock market returns over the next several years. We place a single point estimate for the market at close to seven percent per annum which, in our opinion, is likely to be viewed favorably, given the probability of continuing low rates of inflation and as compared to the expected returns of most alternative asset classes.

The past few months have been difficult for America, but we are rising to the occasion. Our current hardships and trials will serve to further build our nation's character. And, it will reinforce our appreciation of how blessed we are to be Americans.

May peace be with you and your family in this new year.