



INVESTMENT STRATEGY UPDATE

January 2, 2003

2003 – THE YEAR AHEAD

The early years of the new century have been brutal for most investors, as the stock market suffered its worst three-year decline since the early 1930s. But what does the future hold? Has the long bear market ended or are we in for a fourth down year in a row? This is a time of major trend changes in our opinion, the primary being a shift from the long-term trend of disinflation to what we believe will be the beginning of a new reflationary period. The implications for our economy and financial markets are substantial.

We are optimistic about the future. Yet over the short term, we find ourselves in a period of above average risk. The U.S. economy is still struggling to gain momentum, and threats of war and terrorism loom. Our vision of the financial future becomes clearer as we look further out in time. Current stock market valuations are generally reasonable. And we know that, over time, stock prices grow in line with corporate earnings which, in turn, grow with GDP. We are confident that the majority of value-oriented investors will earn favorable returns over the next three to four years.

As the time horizon shortens, however, there is more uncertainty. Still, we are expecting positive stock market returns during the coming year. The probabilities favor a continuing trend of economic improvement. Alternative investments such as real estate and bonds seem relatively unattractive at this time. And, with very large cash reserves on the sidelines earning meager returns, there is enormous potential buying power for stocks should investors begin to regain confidence.

Our custom is to start each year with a forecast of the financial markets. It should be noted, however, that predicting the future is difficult, at best. Investment success depends more on one's ability to interpret and adjust to trends and events as new information becomes available. With that in mind, what follows is our outlook for the year ahead.

The Economy and Corporate Profits

The U.S. economy is in the grip of an intense tug of war. On one side are the deflationary pressures borne by the export-based economies of emerging Asia and the aftermath of the bursting of the great technology bubble. On the other is the countervailing reflationary effort of the Federal Reserve Board. The outcome is important because a sustained period of price deflation would have onerous implications for both the economy and the stock

market. And history shows that once deflation actually takes hold, it is very difficult to reverse. However, in recent months, the deflationary risks have gained wider recognition, resulting in increased reflationary efforts. In early November the Fed took a stand, essentially indicating that they will do whatever is necessary to ensure that deflation does not take hold. With the European central banks now following suit, and with the likelihood of additional fiscal stimulus generated by the growing war on terrorism and the new Republican majority in Congress, deflation seems far less probable. There may even be some risk that the reflationary effort will go too far, resulting in an inflationary surprise down the road, but the Fed knows how to respond to inflation should that become an issue.

The risk of a double-dip recession is diminishing in our opinion, and our outlook is for modest economic growth this year, say 3%. Continued consumer spending and reasonable energy costs are the keys to economic health, at least for now. It was consumer spending that kept the last recession from becoming very deep, and now the consumer must hold in there long enough for corporate investment to rebound. A number of pundits have forecast the imminent demise of the consumer, but we don't agree. Housing is the consumer's primary asset, and housing prices are steady. Employment is holding up relatively well. And while the level of consumer debt is historically very high, a large portion of that debt is in well-collateralized mortgages. Furthermore, with interest rates so low, consumer debt-service requirements are not really that far out of line. While consumer spending was weaker than expected this holiday season, we think it will remain strong enough to keep the economy from slipping back.

On the corporate side, pricing remains very weak. The inventory overhang has dissipated, but final demand has only just begun to pick up. The current trend of corporate downsizing combined with increasing implementation of new technologies has led to very strong productivity numbers, but cost cutting can go only so far. We are in need of a new corporate investment cycle, although that is likely to require some additional time and an increase in business confidence.

Corporate profits remained depressed in 2002, even as the economy rebounded. While this may seem an unusual occurrence, one need only look back to the early 1990s to find a prior example. The 1991 recession was relatively mild, yet the decline in corporate profits was severe. The economy recovered in 1992, but it was 1993 before corporate profits rebounded, then rising a hearty 18%. The 2001 recession was similarly mild, but capital spending fell off a cliff and the corporate sector was hard hit. While investment spending has now begun to improve, the weak pricing environment is creating a stiff profits headwind. Nonetheless, corporate profits should work higher this year, buoyed by solid productivity growth, improving sales volumes, and continuing tight cost controls. The bottom line is that we expect reasonable profits growth in 2003, particularly as compared to the very poor results of the prior two years.

The risks in this environment are obvious – a longer than expected Middle Eastern war could lead to a sustained period of very high energy prices. That would weigh heavily on the still nascent economic recovery, spook the consumer, and perhaps even bring on a second leg of recession. Terrorism continues to be an important risk as well, particularly to the short term. The probability of future terrorist acts is very high, but the likelihood of terrorist acts that result in a significant, lasting economic consequence is far lower.

Interest Rates and The Bond Market

Interest rates have trended lower for most of the last twenty years. Over that time, investors have been provided with wonderful fixed-income returns. But we believe that a major turning point has been reached. As a result, bond market investors are at risk, particularly those holding longer-maturity positions in the highest quality issues. At current levels, the threat of deflation and fears of further stock market weakness have been fully factored into bond prices. The Federal Reserve Board has adopted a strong reflationary stance and central bankers around the world have begun to follow suit. On the fiscal side, the patterns of deficit spending have resumed at both the federal and state levels, and further stimulus seems likely. Barring the ravages of a true deflationary-debt spiral or a severe double-dip recession, interest rates on quality bonds have fallen to the lowest levels likely to be seen for many years to come.

We believe the Federal Reserve Board will maintain a stimulative posture until it gains some comfort that the deflationary risk has passed. Therefore, short-term interest rates are likely to stay very low, for a while longer. But once investors become convinced that the economic rebound has taken hold, longer-term interest rates will begin to rise, particularly in the overvalued U.S. Treasury bond sector. We think interest rates on the ten-year U.S. Treasury note, currently close to 4%, will rise to the 5 1/2 to 6% level over the next 12 to 18 months.

So what's a bond investor to do? That's a difficult question. Interest rates are so low currently, there is little cushion against capital erosion from falling bond prices. Maintaining a short-term maturity schedule is one way to stay out of trouble, but at current levels quality short-term paper provides little in the way of real returns (adjusted for inflation). Corporate bonds are attractive relative to treasury bonds, in our opinion, particularly in the higher-yield sector. Interest-rate spreads seem far too wide currently, considering the improving economic outlook and declining default risk. Nonetheless, investors should recognize the need for a diversified approach to lower quality debt issues, as they are quite equity-like in their risk profile.

Municipal bond spreads seem historically high as well, but we worry about the poor current condition of state and municipal finances. As such, we are not inclined to own tax-exempt bond positions in anything but the highest quality issues. We further note our experience that municipal bonds are much easier for investors to buy at reasonable prices than they are to sell, if and when such sales become necessary.

Our belief is that the search for attractive income will lead increasing numbers of investors away from bonds and toward dividend-paying stocks. For select companies, dividend yields are comparable to bond yields and the risks may be equivalent or less, given our bond market outlook. Furthermore, dividend payments generally grow over time. There could be an additional bonus as well, if the Republican Party follows through on its promises to provide investors with some relief from the double taxation of dividends.

The Stock Market

The terrible bear market of the last three years is likely over, in our opinion. But so too is the twenty-year bull market that began in the early 1980s. We expect the market will experience a series of cyclical bull and bear moves over the next few years, the net result of which may be

only a moderate gain in the overall stock market indices. As mentioned earlier, we anticipate a healthy increase in corporate earnings from these depressed levels, but we also believe that the overall level of valuations is likely to work lower. With low interest rates and little inflationary pressure, current stock market valuations seem reasonable. But we think that the bursting of the speculative bubble, combined with last year's bombshell exposures of corporate malfeasance, could lead to a period of investor disenchantment with stocks.

We view the current stock market outlook as being much like that which marked the middle 1970s, following the devastating 1973/74 bear market. We note that the cyclical bull market phases of that time period yielded meaningful investor returns, but it was not like the simple buy-and-hold environment of the 1990s. The outline for success during those years was to utilize the periodic strength and weakness to adjust asset allocation and sector weightings. Many successfully did so. We see that past as prologue.

Conclusion

The bear market has ended in our opinion, and while another test of the lows is certainly possible, it seems likely that we have entered a new cyclical bull market phase for stocks. As such, increased equity exposure is warranted. Nonetheless, the economy continues to muddle and corporations are seeing little in the way of top line growth. Given the risks of this environment, we are choosing a more cautious stance than might otherwise seem appropriate. In other words, we are bullish on the coming year, but also mindful of what could go wrong. Our strategy is to remain somewhat defensive, utilizing periods of stock market weakness or testing to add to equity holdings, and periods of strength to pare our more expensive positions. As for the bond market, we are very cautious – particularly in the overvalued, highest-quality government sector. An improving economy will inevitably lead to higher interest rates.

Looking longer term, our outlook is buoyed by the enormous technological advances of recent years. We are in the midst of an amazing technological revolution, and the pace of advances in the information technologies, genetics, biotechnology, and even space exploration shows no sign of slowing. Thus far, the advances are not paying off for the companies that produce or enable those technologies, but the productivity enhancements for the users of technology seem a huge economic positive, longer-term. As students of history, we are reminded of the far reaching economic benefits that accompanied the advent of railroads, the automobile, and electricity. Our future is bright and enormously exciting.

We wish you and yours a healthy, happy, and prosperous new year.

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