



INVESTMENT STRATEGY UPDATE

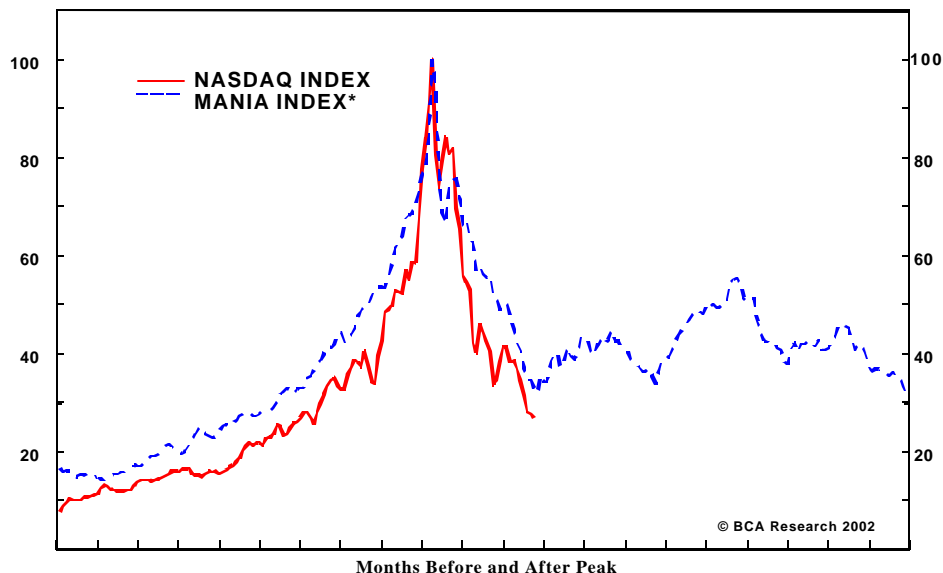
September 26, 2002

AFTER THE BUBBLE

The stock market mania has now come and gone. In its aftermath, the U.S. financial markets are being pulled by two opposing forces. On one side is the deflationary pressure that always seems to follow economic and financial market bubbles. On the other side is the Federal Reserve Board's aggressive reflationary effort.

The stock market rallied nicely off the bear market lows of late July, only to subsequently give it all back. The question now is, will the market hold at these levels or was that but another rally in a continuing bear market? In our Interim Client Update Letter dated July 22, we expressed our opinion that stock market valuations had retrenched to levels that we saw as fair value. Our belief was, and still is, that the most destructive phase of this bear market is largely behind us. But as shown below, post-mania markets typically take time to repair.

After the Bubble: The Long Hangover



*A COMPOSITE INDEX OF PEAKS IN GOLD & SILVER (1973-1986), JAPANESE NIKKEI (1982-1995) AND DOW JONES (1922-1935)
NOTE: BOTH SERIES ARE INDEXED TO 100 AT THEIR RESPECTIVE PEAKS

Source: The Bank Credit Analyst

The Risk of Deflation

A number of financial market pundits have been drawing parallels between our economy and the Japanese deflationary experience that followed their stock market and real estate bubbles of the late 1980s. In fact, asset manias are almost always followed by periods of increased deflationary risk. Among other things, the unrealistic growth forecasts associated with those manias have usually led to rather substantial overcapacity which, in turn, resulted in economic softness and weak pricing. Typically, the lack of corporate pricing power continued even after demand began to recover. The U.S. stock market mania in the late 1920s, and the more recent Japanese mania both resulted in persistent deflation. We all know what happened here in the 1930s. And Japan is still struggling to pull out of its economic malaise, now more than ten-years after their bubble burst.

Yet this time we are not expecting a meaningful deflationary outcome. For one thing, the Federal Reserve Board has extensively studied the previous U.S. and Japanese deflationary experiences and its members are keenly aware of the common policy mistakes that were made. As a result, a massive reflationary effort was undertaken very soon after our stock market bubble burst – almost two full years sooner than did Japan’s central bank, following its mania. Interest rates have been lowered sharply. The Federal Funds Target Rate which was 6 ½% in December 2000 is all the way down to 1 ¾%. And money supply, as measured by the monetary aggregate M2, has grown at a very healthy 8.3% rate over the past two years, which is more than double the rate of increase during the booming 1990s. We believe the Fed’s early response will prove extremely important, because it is much easier to avoid deflation than it is to cure it, once ingrained.

There are other differences as well, between our situation and that of Japan some ten years ago. We have a cultural willingness to recognize bad debt as bad debt; Japan did not. By allowing bankrupt companies to go under, we can cleanse the problems and move on. Also, our banks are in far better shape than were Japan’s. An economy needs access to loans in order to grow. And with the deteriorating condition of Japan’s banks in the early 1990s, their loan growth declined. U.S. loan growth by contrast is still positive, albeit slowing. Furthermore, U.S. corporations are much more free than were Japan’s to restore profitability by downsizing their labor forces.

We are mindful of the risks deflation poses to both the economy and our investment expectations. We continue to closely monitor the actions of the Federal Reserve Board, as well as those of the central banks of our major trading partners. The objective is clear: avoid deflation by aggressively reflating now. Any unintended inflationary consequence can be dealt with later.

What about Valuation?

Two and a half years have now passed since the bull market peaked in early 2000, and stock prices have fallen a very long way. Have stocks finally reached attractive levels of

valuation? The answer depends on the valuation metric and basic assumptions utilized. For instance, if we consider the so-called Fed stock valuation model, which discounts expected earnings by the interest rate on the ten-year Treasury Note, stocks are now quite undervalued because interest rates are very low. Yet by other valuation measures such as price-to-dividend yield, price-to-book value, and price-to-replacement cost value, stocks are still not cheap.

The valuation question is not easily resolved, even when considering the most traditional of all stock valuation methods, price/earnings ratios. When looked at on an overall basis, stocks are still priced well over their long-term, average mid-teens P/E ratio. However, in low inflation/low interest rate environments, such as we have currently, stocks have historically been priced toward the higher end of valuations. Steven Leuthold, in his monthly publication *Perceptions*, utilizes normalized earnings to calculate P/E ratios. By his measurement, the current P/E on the Standard & Poor's 500 Stock Average is about 19 times, while the median P/E ratio during periods of low inflation is 18.3 times – not that far from current levels.

In the years following previous stock market manias, price/earnings ratios eventually retrenched to the lower end of valuations. But to some extent, that P/E decline was because the stock market went through rather prolonged periods of little net progress (flat P), while earnings continued to grow (rising E). Also, if we consider those previous busted bubbles, each one resulted in a very difficult economic outcome, combined with either persistent deflation or, as occurred during the 1970s, rapidly rising inflation. In each of those instances, very low valuations were warranted. Going forward, we expect slower than normal economic growth, but neither persistent deflation nor rapidly rising inflation.

Can the stock market still overreact to the downside, even in the absence of fundamental reason? Sure, but we think to much lesser extremes. A recent Morgan Stanley study showed the range of trailing P/E ratios since 1956, under varying inflation environments. With the inflation rate at 3% or less, the lowest recorded P/E ratio was 13.7.

So here we are, currently not that far from fair value in our opinion, given the high probability of a continuing environment of low inflation and low interest rates. The momentum of the bear market may carry valuations still lower, but not, we think, to the extremes that followed previous stock market manias. That is, of course, so long as we are able to successfully manage the economic outcome and avoid deflation. We think we can.

Expectations

At this point, we expect neither bull market nor bear market, but rather a broad trading range. Investors have been through a terrible wrenching, and we think it will be a while before the love affair with equities resumes. On the other hand, the economic and productivity benefits of the technology revolution are real, and the baby-boom generation will continue putting money away for retirement. We also note that there are few attractive alternatives to stocks. The return on cash and cash equivalents is a

little over 1%. And, when the economy inevitably does recover, interest rates will rise, thereby driving bond prices lower. Also, we think that it is rather late in this cycle to play real estate.

Stocks are not that cheap, but by our analysis they are not that expensive either. And, from these cyclically depressed levels, earnings should improve by some six percent or so, annually. Add to that a small dividend yield, and one can reasonably expect the stock market to provide investors with seven or eight percent annualized returns over the next few years, which is not that bad in a low inflation environment.

Are we at the final bear market bottom? We're not sure. The economy is showing evidence of weakening again and may even temporarily slip back into recession, although in that circumstance we would expect the Fed to respond quickly and decisively. There is also the continuing risk of unexpected events. At the July lows, we saw mild evidence of an investor capitulation, which typically signals an end to a bear market phase, but it was not convincing. In any event, we would not expect a penetration of the July lows to result in a substantial further decline.

The bottom line is that we are anticipating a volatile, sideways market over the next few years, with a slight upward tilt. Valuations may decline further, but not meaningfully so. We think the simple buy-and-hold environment of the 1990s is gone. Rather, we anticipate markets similar to those of the second half of the 1970s, when it was more important to utilize the swings by periodically varying asset allocation and sector weightings. We believe that BTR's investment style is ideally suited for that environment, and we expect to be able to provide our clients with favorable risk-adjusted returns going forward.

ADDITIONAL INFORMATION IS AVAILABLE UPON REQUEST. The information contained herein is based on sources which we believe reliable but is not guaranteed by us and is not to be construed as an offer or the solicitation of an offer to sell or buy the securities herein mentioned. Opinions expressed herein are subject to change without notice. This firm and/or its individuals and/or members of their families may have a position in the securities mentioned and may make purchases and/or sales of these securities from time to time in the open market or otherwise.