Client Bulletin
January 2003

<u>Economic & Market Update</u> – While the 4th quarter rally was nice to see, it was not enough to overcome the damage inflicted during the first nine months of the year. All but our most conservative accounts were down in 2002, as it marked the third year in a row that stocks finished lower, a feat unmatched since 1939- '41. Will the market finally make a turn in 2003? We're cautiously optimistic, but casting a wary eye as storm clouds still loom overhead. The ongoing geopolitical tensions with Iraq and North Korea are a continuing concern. A war could conceivably be around the corner as the saber rattling intensifies. Depending upon the duration of the conflict, the economy and stocks could recover quickly or continue to struggle. Stock rallies typically start when pessimism is highest. Many investors have thrown in the towel as evidenced by stock mutual funds showing net outflows for the first time in fourteen years. Conversely, investors poured a record amount ($77 billion thru 11/30) into taxable bond funds. Selling stocks after a 3 year decline and buying bonds after a 3 year rally is the sell low / buy high mistake that many often make. While there are selected opportunities in corporate and municipal bonds, they are not in the over priced long-term Treasury area where much of the recent buying has occurred.

Warren Buffet said that investors make the most money during bear markets, they just don't know it at the time. It's likely that a few years from now we'll look back at this as a great time to have been buying stock mutual funds at bargain prices.

We look for a pick up in business spending in 2003 following almost two years of declines. New capital investment in the technology area will help support battered stock prices. Tech stocks positive performance in the 4th quarter is an indicator of these upbeat prospects. Stock prices typically move 6-9 months ahead of future earnings, so even though the economy may not pick up until the 2nd half of 2003, the stock market may rally before the data confirms a recovery. The Bureau of Economic Analysis reported that business investment in software and tech equipment increased in the third quarter for the first time since early 2001. On the fiscal policy front, President Bush has pledged to strengthen the economy by proposing numerous tax breaks. Hopefully, Congress will concur with the measures and enact favorable legislation.

<u>Interest Rates / Fixed-Income Securities</u> – Looks like rates finally hit bottom about the same time the stock market did in early October. The key 10-year Treasury note yield bottomed at 3.5% in October. Short-term rates were goosed at the Nov. 6th Federal Reserve meeting where Greenspan & Co. cut the federal funds rate by 50 basis points to 1.25%. While this is good for corporate borrowers, investors with money market and CD accounts are withering on the vine as rates descend to levels not seen in 40 years. Bondholders have been smiling. Bonds had another good year of positive returns bolstered by the tailwind of declining interest rates. As we've outlined before, most bond prices move inversely to interest rates. If interest rates continue moving higher, most bond prices will decline, but some bonds will be less affected than others.

Funds focused on riskier debt, such as high yield "junk" bonds and emerging market bonds are doing well. We own the **American Funds High Income Trust** and the **Vanguard High Yield Corporate** funds. Stable to higher share prices and monthly dividends producing 9.5% and 8.4% yields do the job. **Global High Income (GHI)** has performed well for us in the emerging market debt area. We've stuck with our team at **Metropolitan West** and were rewarded with a 4%+ pop in the last quarter. **Loomis Sayles Bond Fund** sprang to life as its convertible bonds blossomed as the year wound down.

Due to the high demand for tax-free income, most municipal bonds are holding their value. We have be buying **Nuveen CA Value (NCA)** at the low end of its 52 week price range. This represents a 6% discount from the recent $10.25 net asset value of this closed-end bond fund traded on the NYSE. Monthly dividends from a portfolio of older bonds give us a 5.4% double tax-free yield.

<u>Preferred Securities</u> have continued to shine. **Price Legacy**, **Bank United, Commercial Net Lease**, and many others have now appreciated beyond par value while paying good quarterly dividends. Newer buys include: **Cameco Corp**., 8.75%; **Stilwell Financial**, 7.875%; and **Ford Motor Co**., 6.5% convertible preferred. The 6.5% dividend yield on the Ford security is based its $50 par value. We buy it on the secondary market where it currently trades at $43/share producing a current yield of 7.5%. Each preferred share is convertible at any time into 2.8 shares of Ford common. The preferred matures 1/15/32, but can be sold at any time and is redeemable at the issuer's option on or after 1/15/07 @ the $50 par value. With the conversion feature, the price of the preferred will track Ford common stock giving us a hedge against rising interest rates as the economy recovers.

<u>Real Estate Investment Trusts (REITs)</u> have also made money for us with **Equity Residential Properties (EQR)** being our newest position. EQR is the largest owner of apartment complexes in the U.S. With home prices skyrocketing, many are now priced out of the market so we see a steady demand for quality apartments. Locally, the company owns properties in Irvine, Laguna Niguel, Laguna Hills, and Mission Viejo. The dividend has been increased each year since 1993 and currently produces a 6.7% yield. This asset class may be vulnerable to an exclusion from the favorable dividend treatment in the Bush package. We'll closely monitor any developments.

<u>Equities</u> – Valuations have still not contracted to lows reached during the past two bear markets in the U.S. On 2003 estimates, the S&P 500 stock index is currently priced at 24 times the projected $38/share in earnings. In the 1990-91 recession, the S&P traded at a 14 multiple, and in the 1973-74 bear market it was 7. Using the more generous "operating earnings" which adds back in depreciation, interest, taxes, and special charges, we get and '03 estimate of $58/share, which gives us a P/E of 16. This is more reasonable but still not a screaming bargain. Following the '73-74 bear, value stocks dominated as tech stocks languished. Will it be different this time? We have a value bias, but continue to own both value and growth positions, domestically and overseas with managers that have demonstrated an ability to pick good stocks in their particular niche. As long as Bill Nygren continues to manage the **Oakmark Fund** and **Oakmark Select**, they will continue to be our largest positions. **First Eagle SoGen Overseas**, **Tweedy Browne Global Value**, and **Janus Overseas** give us exposure to opportunities outside the U.S. **Wasatch Small Cap Value** provides an avenue to under-followed smaller companies. **Vanguard Capital Opportunity** and **TCW Galileo Value Opportunity** will lead the pack when growth stocks return to favor. We have also added to our position in the **Vanguard Health Care Fund**. The sector came under pressure last year for several reasons: Large pharmaceutical companies have had several products go off patent, concern is growing over the government's increasing involvement in pharmaceutical pricing, and FDA approval for new products is much more difficult to obtain. We believe the constant and growing demand for health care products and services will overcome these issues and lead to continued profitability for the sector. The Vanguard Fund is tops in its category, with an experienced manager in Ed Owens who has been at the helm since the fund's inception in 1984. The fund's largest holdings are Pharmacia, Schering-Plough, Eli Lilly, Astrazeneca PLC, and Pfizer.

Retirement Planning – Don't let the stock market swoon deter you from contributing as much as possible to your IRA, or other retirement plan account. There are plenty of other investment alternatives if you are not comfortable placing new money in stocks. Since deposits are made with pre-tax dollars, this is one of the few areas where you get guaranteed tax savings simply by making the contribution. New higher annual limits are effective in 2003, such as $12,000 for 401k, 403b, and 457 plans. Those age 50 and over may contribute an additional $2,000 in 2003. Self-employed now have the ability to shelter more income with a SEP-IRA, and contributions for 2002 may be made up until your tax filing deadline. IRA contributions remain at $3,000 this year with an extra $500 for those 50 and over. You must have earned income to take advantage of these plans.

Education Funding – If you have children or grandchildren who plan on attending college, don't let the new 529 plans pass you by. Not only do these plans offer tax-deferred growth, they also provide tax-free withdrawals as long as the money is used for qualified higher education expenses. Another benefit is greater control versus the old UGMA or UTMA (Uniform Gift/Transfer to Minors Acts) accounts. Money deposited into a 529 plan will not automatically transfer to the beneficiary when he or she reaches the age of majority. Instead, you retain control as the account owner. Feel free to contact us for additional information.

It's been a very challenging time and we all appreciate your loyalty and value your business. If you have any questions or if we can improve your experience in any way, please let us know. We are looking forward to a good year ahead.

Scott Walker
January 7, 2003