Client Bulletin
April 2003

<u>Economic & Market Update</u> – It can be tough to keep your chin up with everything that is going on in the world. The war in Iraq, rumblings in North Korea, unrest in Venezuela, record all-time high gasoline prices, manufacturing output down, and consumer confidence down. Economic growth has slowed to a crawl as business capital spending decisions are postponed and consumer spending languishes from the CNN effect, as people stay home and watch the latest war developments. Remember a few short years ago when you couldn't wait to get to the computer to check the prices on your stocks and see how much your portfolio had gone up? It's the flip side today, as very few investors are interested in making any new commitments to stocks as the wounds from the three year old bear market are still painful. Could stocks continue to languish for years? Maybe so, but it's just as likely that the current disdain for equities has provided fertile ground for those brave enough to go against the grain and hold their positions or buy into the weakness. Companies have cut costs to the bone and when business does pick up, a lot of that revenue will hit the bottom line providing strong earnings leverage. We may not see the economy pick up until later this year or next year, but stock prices today reflect not only current events but future expectations. It is that prospect for a brighter future that is beginning to prop up stock prices today. Remember that it can be a mistake to gauge the future by looking in the rear view mirror at recent investment returns.

Our first quarter performance was mixed. The conservative group holding predominantly fixed-income securities once again ruled with a 0.9% net gain for the three months ending 3/31/03. The moderate set was off -0.20%, while the aggressive group finished –0.60%. Check out your portfolio performance review report for your specific returns.

<u>Portfolio Strategy / Asset Allocation</u> – Even though there may be good stock bargains today, many clients simply are not comfortable with the volatility that accompanies a large equity allocation. When deciding how to allocate a portfolio between equities and fixed-income, an easy rule of thumb is to subtract your age from 100. The result is the percentage that you should have in stocks. This simplistic tool ignores relative valuations between asset classes and must be taken with a grain of salt. Benjamin Graham, the pioneer of value investing and author of *The Intelligent Investor*, advised that "an investor should never have less than 25% or more than 75% of his funds in common stocks". These guidelines are a good starting point in determining an appropriate allocation.

We continue to believe that high yield bonds represent one of the most attractive asset classes today. They did not participate in the huge bond rally over the past few years as credit concerns were magnified by accounting scandals and several large profile bankruptcies (Worldcom, Enron, United Airlines, etc.) After reaching historically high levels in 2002, default rates have finally begun to decline and are predicted by the rating agencies to continue their decline. High yield, also called non-investment grade, or “junk bonds” are also seeing strong mutual fund inflows. Remember that their prices are not as heavily influenced by interest rate movements as are treasuries or investment grade corporates. High yield prices respond more to future economic expectations and individual company fundamentals. Although prices have made a nice move off of October lows, there is still gas in the tank as the interest rate spread between treasuries and high yield bonds had reached record levels. We are participating with the **American High Income Trust**, **Metropolitan West High Yield Bond**, and **Vanguard High Yield Corporate**. All three funds are providing generous yields in the 8-9% range through their monthly dividends and the share prices have been stable to higher. Last quarter we also picked some individual bonds issued by **Nextel Communications**. These bonds mature in ’07 and ’09 and carry coupon rates of over 9%.

Preferred Securities continue to provide ballast and nice dividends. New acquisitions last quarter included **AT&T Wireless,** 9.25%, **Tommy Hilfiger USA,** 9%, **Sprint Capital,** 8.12%, and **Valero Energy,** 7.25%. We were also able to pick up some more **Cameco Corp**., 8.75%, as it traded back down to its $25 par value. Many of these securities are “trust preferreds” issued by a special trust and backed by bonds of the parent company. Corporations enjoy favorable tax benefits and investors get exchange-traded liquidity and higher income than straight bonds. Most of these preferreds are issued with five years of call protection, meaning they can be redeemed by the issuer at par (ususally $25/share) five years following their issue date.

Individual Municipal Bonds have been good for us as investor interest in tax-free income has remained steady. We get good offerings primarily of California paper in the secondary market from our specialist with First Albany in New York. These bonds pay interest semi-annually which is received free of federal and state income tax. Yields have collapsed as money flooded into this area pushing prices to premiums. We sold some Escondido zeros last quarter to nail down a profit. Remember that your principal value will fluctuate prior to maturity. If market interest rates head higher and you are forced to sell, you would likely have a capital loss. By holding bonds to maturity, you eventually eliminate that risk when your principal is returned at maturity. This assumes that the issuer is solvent and financially able to pay off the debt. Look for insured issues for extra security. Always check to see if your bond is callable. This enables the issuer to pay back your principal prior to maturity. We’ve built some nice ladders with staggered maturities for many of you. Please keep us posted on any upcoming cash needs you may have.

Stocks – Here are some interesting numbers courtesy Ibbotson Associates looking at stock returns during the bear market of 1973-74 and the three years following the big decline.

	1972-74	1975	1974-76	1974-77
S&P 500	-37.2	37.2	69.9	57.7
Dow Jones Industrial Average	-39.6	38.3	63.0	34.9

The returns are cumulative, net of dividends, and provide a glimpse of what can happen following large declines. After a 39% drop, you need a 66% return to get back to even. Think about a dollar losing 50 cents. After a 50% loss, we need a 100% return to get back where we started. The 1970's were a tough decade for U.S. stocks and after good returns in the 80's and 90's, the 00's will be challenging. Stockholders are owners, not lenders, and over time (10-20 years) the owners have made the most money. But it requires patience, discipline, and a long-term time horizon to ride out the dips. Not getting caught up in the mania and buying at a good price also helps.
We continue to like the core funds U.S. stock funds mentioned last quarter. We have concentrated our foreign stock exposure in **First Eagle Overseas** for counterbalance. Large investments in Europe and Japan, along with a 5% gold component offer good diversification from the typical U.S. fund. The managers are bargain hunters that focus on per share net worth with significant holdings in nautural resource companies. For the venturesome, check out the bombed out **NASDAQ 100 Trust**. This is an exchange traded fund giving us exposure to the 100 largest companies traded on the NASDAQ stock exchange. Another aggressive play is the closed-end **China Fund**. With a large trade surplus and a new frontier mentality, China's 7%+ GDP growth rate is the highest in the world. The SARS illness is a new development that we are watching closely for impacts on this holding.

Mortgage Refinancing – Hopefully you had good timing and refinanced your mortgage toward the end of last year or in early March when rates touched record lows. If you can swing the higher payment, go for a 15-year loan to get the lower interest rate and greater income tax deduction. Since the early payments of a loan are comprised mainly of interest, and home mortgage interest is tax deductible, your taxes will be lower with the higher mortgage payment. Making extra principal payments on 30-year note will shorten the life of the loan. But those payments are not deductible. So if you can swing the higher payment, go for the 15-year loan. I recently switched to a 15-year and went with E-Trade Mortgage after checking the rates in the Sunday Business section. Eloan.com on the internet is good for comparison purposes, or a mortgage broker that you trust. Don't forget to ask your bank too. E-Trade Mortgage offered a no points, no fee option that I chose and got a 5 3/8% fixed rate on a jumbo loan. Even though mortgage interest rates have ticketed back up a bit, you can call 1-800-470-0999 to get a current quote. Better yet, if it won't pinch you, pay it off and don't worry about the payment.

Long-Term Care Insurance – No one likes to spend money on insurance premiums, but the best investment plans can go awry without proper risk management, which includes insurance. If your portfolio is worth several million, self-insuring the risk is a viable option. Otherwise, we suggest clients age 60 and over look into this coverage. An insurance professional we know that specializes in this area tells us that the current national average cost for skilled care is $55,000 per year. Within 30 years this expense is expected to reach $241,000 per year. Baby boomers have started to obtain this insurance as a result of their own experience of caring for their parents. Let us know if you would like to be referred to a specialist to assess your needs in this area.

We appreciate your continued patronage and are here for you to discuss any financial, tax or estate planning need or question you may have.

Scott Walker
April 3, 2003