Client Bulletin
July 2003

<u>Economic & Market Update</u> – Finally, sunshine. The clouds have lifted and the warm weather has arrived, and the markets have warmed up too. It doesn't get much better than the last three months, as all client accounts moved significantly higher. Security prices now need some time to consolidate to let business fundamentals catch up to the recent price gains. Both stocks and bonds rallied following our successful military endeavor in Iraq. There are still threats in the world, so our philosophy for all but the most adventuresome is to maintain a balanced portfolio with a moderate dose of fixed-income securities. Economic signals continue to be mixed. Companies have shed jobs and slashed capital spending budgets. The unemployment rate has jumped to a nine year high of 6.4%. Consumer spending has provided the fuel to keep the economy moving with fresh cash from the mortgage refinancing craze. Imports continue to flood into the U.S. and we keep buying. Is there a looming consumer debt problem in the U.S.? Not as long as we have jobs and income to service the debt, but the trend in manufacturing moving to China is a bit disturbing. However, consumer sentiment is optimistic as stocks continue to trend higher based on favorable earnings expectations for later this year and into 2004. Assuming the dollar continues to be weak against other currencies, large U.S. companies stand to benefit, as U.S. goods become more competitive in foreign markets.

<u>Fed Policy</u> – The monetary authorities at the Fed and other central banks around the world have won the war against inflation and through coordinated interest rate cuts are pursuing accommodative monetary policies to stoke economic growth. Even though the short-term fed funds rate was recently cut to 1%, the Fed has no control over long-term interest rates. Paradoxically, long-term rates have recently turned higher. Considering we've been in a 20-year bull market for bonds and yields touched 45 year lows in late June, remember that trees don't grow to the sky. It's not a good sign that the herd has flocked to high-grade bond funds just as their prices have gone through the roof. This pattern is eerily familiar to the mass buying of technology funds in late 1999 and early 2000 near the stock market peak. We have been trimming back bond fund exposure at the current high prices. By reducing interest rates to reduce the risk of deflation, Mr. Greenspan has created a bubble in the U.S. Treasury bond market and a mini bubble in residential real estate in certain areas.

The U.S. is dealing with federal and state budget deficits. More bonds will be issued to cover the shortfalls, so this increased supply could easily result in lower prices and higher yields for bonds. The U.S. continues to run a trade deficit with the rest of the world. This deficit has been financed through foreign buying of U.S. Treasury securities. If these foreign holders of U.S. Treasuries decide to cut back on their holdings, it would not be favorable for bond prices.

<u>Equity Investments</u> – Many have postulated that given the outsized stock returns of the 1990's that a reversion to the mean is necessary and that investors will need to adjust their expectations downward for future stock market performance. What is a reasonable rate of return to expect moving forward? From 1926 through 2000, the S&P 500 produced an average annual return of 10.7%. The decline over the past two years has dropped that average to 10.2%. Data from Ibbotson Associates shows that 4.6% of the 10.7% return surprisingly came from dividends. Another 3.1% of equity market gains can be attributed to inflation, which is captured in corporate profits to the benefit of shareholders. The other 3% represents real earnings growth.

Stocks racked up much of their historical performance edge over bonds in periods when inflation was high. The best 20-year period for stocks over bonds came in 1941-61, during which equities returned 16.9% a year, versus 1.9% for Treasuries, while inflation was above the long-term average. Also helping equities then: they began 1941 with a 7% yield, compared to 2.1% on government bonds, and a P/E of 8.8. In a previous post-bubble decade, 1928—38, stocks started at 15.9 times earnings and a 4.1% yield to bonds' 3.3%. Back then, deflation reigned and stocks fell almost 1% a year while bonds returned 4.6%.

So where do we stand today? The current dividend yield on the S&P 500 is 1.7%, less than half its average for most of the 20^{th} century. The inflation story is similar, as excess global manufacturing capacity has fostered deflation. Will inflation return to the 3% historical average? Maybe so, but it will take awhile. So, we have 1.8% from dividends, plus a generous 3% for inflation, plus 3% from real earnings growth, totaling 7.8% as the expected return for stocks based on the broad S&P 500 market index. That's a decent return given that 10-year Treasury bonds finished the quarter yielding 3 ½%. Our job is to find superior actively managed funds and individual securities that will beat these averages.

Even after the brutal bear market, it's hard to argue the market is cheap. The price multiple of the previous year's earnings reflected in stock prices was 10.2 in 1926 and averaged about 15 for the 75-year span. Based on reported earnings from *Barron's*, the S&P 500 now trades at 32 times earnings. Despite the recent resurgence of growth stock funds and technology stocks, we continue to favor value stock funds, domestically and overseas, that focus on stocks trading at a substantial discount to the intrinsic value of the business. Many of these companies also pay dividends that will be taxed at a reduced rate (maximum 15%) under the new tax law.

<u>Fixed-Income Investments</u> – A recent poll of consumer's showed that 70% did not understand the relationship between interest rates and bond prices. As interest rates have declined in recent years, bondholders have prospered as the higher coupons on older bonds have lead to price gains.

But when interest rates turn higher, prices on many existing bonds will decline. There are several ways to combat this risk. One may simply hold individual bonds to maturity when the par value is returned. We have built "bond ladders" for many clients with bonds maturing in different years. Shortening your maturity structure will help, as short maturity debt instruments are not as prone to price fluctuation as longer maturity issues. High yield, or "junk" bond prices are not as sensitive to interest rate changes as Treasuries or investment grade corporate bonds. That's because investors will see a rise in interest rates as a sign of economic strength. Economic health boosts corporate earnings and balance sheets. That in turn lifts corporate credit ratings and investor confidence in junk bonds. This virtuous circle has been playing out now for the past eight months. Money has recently been flooding into junk bond funds, which prompted Vanguard to close their High Yield Corporate fund to prevent hot money from disrupting their investment process. We have started to reduce our exposure to this area following the recent gains and have been buying the **ProFunds Rising Rate Opportunity** fund. Unlike standard bond funds, this fund is designed to move higher in price if interest rates rise.

Preferred securities have been an excellent asset class for us with dividend yields in the 6 – 8% range and low price volatility. As long-term Treasury prices have declined in recent days, preferred prices have held firm. Preferreds do carry call risk, as most are callable by the issuing company five years after they are issued. During June, our holdings in Bank United, Equity Residential, and Equity Office were called at "par", or $25/share. Purchase candidates for reinvestment include **JP Morgan Chase** (JPM+K, $25, 5.875%), **El Paso Corp.** (PJJ, $23, 8.3%), **UnumProvident** (PJR, $24.40, 7.5%), **Dillards Capital** (DDT, $22.25, 8.4%) and convertible issues from the Dallas, Texas utility **TXU Corp.** (TXU+D, $34, 11.9%), and **Baxter International** (BAX+, $48, 7.25%).

New Tax Law – President Bush recently signed tax legislation into law with reduced tax rates for capital gains, dividends, and income brackets. We will be sending out a summary of the key points for investors later this quarter.

We appreciate the opportunity to serve your financial advisory and investment management needs. If you have any questions or comments, please let us know. Enjoy the summer!

Scott Walker
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