

## SUMMARY YTD:

S&P 500	-23.37
Dow Jones	-16.76
NASDAQ	-31.53
Russell 2000 (Small Stocks)	-21.58
EAFE (Foreign Stocks)	-17.52
Bonds (Lehman Brothers Agg.)	10.25

## Investment Review and Outlook

While the fourth quarter was strong for most stocks, it was small consolation in a tough year. The Year 2002 will forever be known as the year where there was nowhere to hide in the stock market. Every single industry sector was in the red and eight of ten sectors experienced a double-digit loss. As we know now, 2002 marked the third consecutive year the stock market has experienced a negative return, the first time this has occurred since The Great Depression in the early 1930's.

It goes without saying that investors are looking for a change of direction in the stock market. If the last three months of 2002 and the first few days of 2003 are signaling an end to this bear market, then some excellent opportunities could lie ahead. It is often in the first few months after a bear market ends that the most money is made. The S&P 500 took only six months to rise 40% from its 1974 low and only three months to advance 40% at the 1982 low.

## Blame the Bubble

Bad bear markets tend to be blamed on a variety of factors, depending on who is doing the blaming. In our opinion there are a number of factors that contributed to the bear market, but without question the biggest was the stock market/tech bubble. Terrorism and war fears didn't help, but these only contributed at the margin to the magnitude and length of the bear market. Corporate scandals also contributed, but were not the driver—it was more of an outgrowth of the environment of bubble-driven greed.

The bubble created three key problems. First, the true value of stocks got way out of line. Second, corporations invested heavily in expanding their businesses as they became overconfident in their growth expectations for the future. Third, investors forgot about risk and were more heavily weighted to the technology sector, and stocks in general, than they had been in any prior bear market. The question we now face is how long will it take for investors to regain their appetite for stocks even in the face of mounting evidence of an economic recovery.

## One-Year Forecasts and the Future

It's almost a tradition for investment professionals and the financial media to issue a forecast at the beginning of each year. Usually these forecasts fall somewhere near the extreme. Some "guru's" will agree with Chicken Little and tell you the sky is falling and stocks will never make you money again. Others will predict that after such a bad market for so long surely we are due for a good 30% return in 2003. But in reality, in any particular year there are many factors that may play out differently than expected, and other potential issues that simply can't be foreseen.

This makes *accurate* forecasting very difficult. *Of greater importance, it makes it dangerous to base any investment strategy on a one-year market forecast.* Take 2003: it's relatively easy to play either side of the fence with respect to the general investment environment.

**Stock Market optimists** will argue that low interest rates and tax cuts are in place to stimulate the economy and build on its slow recovery. The recent economic news is becoming increasingly positive and is being reflected in the market rise in early January. Should this momentum continue, investors who are sitting on the sidelines with a mountain of cash, now have an opportunity to buy stocks at a discount. As for war with Iraq, if a war starts soon investors will begin to look past the uncertainty, and there is a real possibility that there will be no war.

**Stock Market pessimists** respond that investor sentiment has been seriously damaged and therefore investors will not pile back into stocks anytime soon. In the past, stocks were much more undervalued after a serious bear market than they are now. Moreover, falling interest rates have fueled home refinancing and auto purchases, helping to support the economy. But with rates so low it is likely that we've seen the last major wave of refinancing for some time. Then there is the risk of war and the unknown of the ultimate cost of waging the war. On top of that is the terrorism wildcard and increased security costs, which weigh on the economy. Uncertainty leads investors away from the stock market.

**There is truth in both the bullish and the bearish arguments.** From where we sit it is not realistic to expect to be able to accurately assess whether these factors will net out positive, negative or mixed over the next 12 months. As we have pointed out many times in the past, the day-to-day, week-to-week, month-to-month moves in the stock market are based on the collective emotions of investors who are human beings. Trying to profit from determining the emotions of hundreds of millions of people in a short amount of time seems a futile strategy to us. It is not something we would try to do with your hard earned money, especially in a society where Prozac and Viagra are so easily accessible.

### **An Investment Strategy Based on Confidence, Not Hope or Speculation**

This leads us back to our basic philosophy. To achieve long-term investment success we believe it is essential that we base our strategy only on analysis that we are highly confident in. This necessitates a relatively long-term time horizon, since we have a much higher level of confidence in our ability to assess long-term factors but little confidence in our ability to determine how these might play out over the short term. The greatest investment opportunities are created in the worst of times—you just don't know it at the time.

### **The Bond Market**

Bond investors have truly been the only happy campers over the last three years as the Bond Market has outperformed the stock market handsomely. With interest rates now hovering at 40 year lows, we do not believe the Bond Market offers much of an attraction at these levels. With the likelihood of continued economic stimulus, we believe the odds are high that interest rates will be higher, on average, in coming years than they are now. With rates very low, it doesn't take much of a move up in interest rates to wipe out a whole year's worth of interest (about a 1% back-up in rates would do it). It is highly unlikely that the best investment-grade bonds will deliver attractive absolute returns over the next few years unless we fall into a deflationary environment and stay there. The purpose they should serve in a portfolio in this environment is as a hedge against deflation/recession. Investors who can look beyond these risks have less need for investment-grade bonds than do investors who are more sensitive to short-term risk.

Looking out over the next several years, **we continue to believe High-Yield bonds offer a very attractive risk/return potential.** If the economy and financial markets have a strong 2003, high-yield bonds should do quite well, though not as well as stocks. If things deteriorate, they are again likely to hold up much better than stocks. But stretching out our horizon over a few years, we believe high-yield bonds can be competitive with and even do better than stocks.

## **Our Forecast**

As we look out over the next five years, we believe financial markets are likely to deliver decent returns relative to inflation. However, there are two risks that we must mention:

1. Terrorism remains an unknown. We already know there are security costs, which will have a marginally negative impact on productivity. What remains to be seen is the impact of terrorism on economic behavior. This will be determined by whether there are terrorist attacks that alter consumer and business behavior in a lasting way.
2. Inflation and interest rates. We continue to view deflation as a risk. With excess capacity, a very competitive global economy, and lots of debt we are not ready to say that it couldn't happen. But we think the odds of sustained deflation are quite low—lower than a few months ago now that there has been further marginal improvement in the economy and since the Fed has made it clear it will be aggressive in using all its inflationary tools if needed. So the longer-term risk is that there will be some increase in inflation.

In spite of these concerns we are moderately optimistic about the future of the financial markets. Investors are still holding onto lots of cash that should make its way back to the market as some of the uncertainty begins to subside. Unfortunately, for many investors who let their emotions make their decisions, the best gains may be gone before they “feel like” getting in.

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