

JANUARY 2003 COMMENTS

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and Various Other Longer Time Periods**

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Page 13: **Investment Returns From 2000 to Present, and 1995 to Present**

Note: **Tax Reports for 2002:**

- (1) Form 1099 from Bear Stearns: you should have received these by now.
- (2) Realized Gain/(Loss) Report: will be mailed by us to you this month.

These two reports are all you/your accountant will need from Balis/Bear Stearns for your 2002 taxes regarding dividends, interest, and capital gains and losses.

JANUARY 2003 COMMENTS

During the January period ending Friday, January 31, **STOCK PRICES** declined modestly. While prices for the three major indexes remain 12% or more above their early October lows, the January declines were disappointing, particularly after the strong gains of the first ten days. For the month, the S&P 500 was down 2.7%, the Dow Industrials down 3.5%, and the NASDAQ Composite down 1.1%.

Entering 2003 with three consecutive down years for stocks amidst much continuing gloom and doom, it is worth remembering the history of prior declines (a more extensive discussion of the uses and limits of history appears on page 12). The following chart, which has been presented in previous Comments, sets out the declines and recoveries from the three worst bear markets since 1926, and figures related to the current bear market, from which there has been no significant recovery as yet. The figures show the declining and then recovering value (except for 2000–2002) of a \$1 million stock portfolio, based on an index of Large Cap US stocks (most recently the S&P 500), as reported in Ibbotson Associate's 2002 Year Book: Stocks, Bonds, Bills and Inflation.

<u>Year</u>	<u>% Losses or Gains</u>	<u>Portfolio Value</u>	<u>Year</u>	<u>% Losses or Gains</u>	<u>Portfolio Value</u>	<u>Year</u>	<u>% Losses or Gains</u>	<u>Portfolio Value</u>
1929	-8.42%	915,800	1973	-14.66%	853,400	2000	-9.10%	909,000
1930	-24.90%	687,800	1974	-26.47%	627,500	2001	-11.90%	800,800
1931	-43.34%	389,700	1975	37.20%	860,900	2002	-32.32%	542,000
1932	-8.19%	357,800	1976	23.84%	1,066,200	(at 10/09 Lows)		
1933	53.99%	550,900	1977	-7.18%	989,600	YrEnd		
1934	-1.44%	540,300	1978	6.56%	1,054,500	2002	-23.37%	614,000
1935	47.67%	801,800	1979	18.44%	1,250,000	2003	???	???
1936	33.92%	1,073,800	1980	32.42%	1,654,000			
1937	-35.03%	697,700						
1938	31.12%	914,800						
1939	-0.41%	911,000						
1940	-9.78%	821,900						
1941	-11.59%	726,700						
1942	20.34%	874,500						
1943	25.90%	1,101,000						
1944	19.75%	1,318,400						
1945	36.44%	1,800,000						

BOND RETURNS (price change plus interest) were flat to slightly negative in January, with intermediate term taxable and tax-exempt bonds returning 0.0% and -(0.6)% respectively. During this entire 2000-2002 bear market for stocks, bonds have realized gains in excess of their interest rate yields. This result is due to the significant decline in interest rates, as the Federal Reserve has tried (so far with only mixed success) to stimulate the economy to a faster rate of growth. (The investment results for the January period, for both stocks and bonds, and for the four full years 1999 – 2002, are set out on page 2).

As for the extent of the stock market declines, as measured from the highs of Q1 2000, the following figures chart these results and put them in the context of results since the end of 1994 (see also the figures on page 13). Note that all three indexes have positive average annual returns of 7.2% to 9.6% from the end of 1994 through January 2003. **The long-term investor therefore has a very different view of the stock market's returns than those measuring returns from the highest levels.**

	<u>S&P 500</u>		<u>DOW</u>		<u>NASDAQ</u>	
1st Qtr 2000 High	1,527		11,723		5,048	
Year End 2000	1,320	(13)%	10,785	(8)%	2,470	(51)%
April 2001 Low	1,103	(28)%	9,390	(20)%	1,684	(67)%
Sept 2001 Low	965	(37)%	8,235	(30)%	1,425	(72)%
Year End 2001	1,148	(25)%	10,020	(17)%	1,950	(61)%
Oct 2002 Low	777	(49)%	7,286	(38)%	1,114	(78)%
Year End 2002	880	(42)%	8,342	(29)%	1,336	(73)%
Jan 31, 2003 Close	856	(44)%	8,054	(31)%	1,321	(74)%

Context: Prior Five-Year Gains in Bull Market of 1995 - 1999:

End 1994	459	3,834	752
End 1999	<u>1,470</u>	<u>11,500</u>	<u>4,070</u>
Gain	1,011	7,666	3,318
Avg. Annual % Gain, '95-'99	26.2%	24.6%	40.2%
As of 1/31/03	<u>856</u>	<u>8,054</u>	<u>1,321</u>
Gain	397	4,220	569
Avg. Annual % Gain, '95-01/31/03	8.0%	9.6%	7.2%

INDEXED INVESTMENT USED, AND THEIR 2002 INVESTMENT RESULTS

You may recall last month's Comments discussed the various specific indexed investments we use in implementing your asset allocation. Then at the end of January, we provided your 2002 Investment Results, and the 2002 investment results of most of the indexed stock and bond investments we use. The next few pages present these results in an integrated manner.

BONDS – As with all investments, trying to earn higher returns, or higher yields, from bonds means taking on additional risk. We use a number of different bond investments to provide portfolio balance between the yields earned and the risk of price declines. For any bond investment, there is the alternative of taxable or tax-exempt yields; we make that choice based on the tax status of each account for each client.

- (1) The lowest yield and lowest risk come from Short-Term Bond Funds, which invest in high credit quality municipal, corporate, or U.S. Government securities with 1- to 3- year average maturities.

Vanguard Short Term Municipals, 15 month average maturity	(VWSTX)	3.5%
Vanguard Limited Term Municipals, 3 year average maturity	(VMLTX)	6.4%
Strong Short Term Municipals, 3 year average maturity	(STSMX)	5.1%
Vanguard Short Term Bond, 3 year average maturity	(VBISX)	6.2%
Vanguard Short Term Treasuries, 3 year average maturity	(VFITX)	8.1%
Vanguard Short Term Corporate, 3 year average maturity	(VFSTX)	5.2%

- (2) Higher yields, with more risk of price changes, come from Intermediate-Term Bond Funds, which also invest in high credit quality bonds. Intermediate-Term bonds typically have 4- to 7- year maturities. The longer the maturity, the more price sensitive the portfolio will be to changes in interest rates (higher rates cause existing bond prices to fall, while lower rates cause existing bond prices to rise).

Vanguard Intermediate Term Municipals, 6 year avg. maturity	(VWITX)	7.9%
Vanguard Intermediate Corporate, 6 year average maturity	(VFICX)	10.3%
Vanguard Intermediate Bond, 6 year average maturity	(VBIX)	10.9%
Vanguard Total Bond, 7 year average maturity	(VBMFX)	8.2%
Vanguard Inflation Protected, 8 year average maturity	(VIPSX)	16.6%

- (a) Inflation Protected U.S. Treasury Bonds are a relatively new investment, and have had an excellent performance since their inception. Page 7 describes this investment in detail.

(3) Even higher yields, with more risk of price declines, come from Long-Term Bonds, which have maturities longer than seven years. The yields on these funds are somewhat higher than those for shorter-term bond funds, but we do not use them because we believe the risk of price declines outweighs the benefit of only moderately higher yields.

(4) Higher-Yield Securities with Credit Risk. To obtain higher yields as part of a bond portfolio, we use “junk bond” funds, preferred stocks, and funds that invest in commercial mortgages.

(a) Citibank Preferred and Pimco Mortgage are examples of the latter two categories of high yield securities. Both have had favorable results these past few years.

Citigroup Capital V, 7% Preferred	(CPRW)	7.3%
Pimco Commercial Mortgage	(PCM)	9.2%

(b) Most of the “junk bond” funds we use provide taxable yields, and are therefore best suited for tax deferred retirement accounts. Within the “junk bond” category, different funds have different risk profiles. To increase diversification, we use the funds from Vanguard, Strong, Scudder, and T. Rowe Price. Strong Funds have provided the highest yields, with the most price volatility, while Vanguard's high yield bond funds typically offer lower yields and less price volatility. All “junk bond” funds have yields well in excess of the high credit quality bond funds, however.

Vanguard High Yield Municipals	(VWAHX)	7.3%
Strong Short Term, High Yield Municipals	(SSHMX)	4.3%
Vanguard High Yield	(VWEHX)	1.7%
Strong High Yield	(STHYX)	(6.7)%
Strong Short Term, High Yield	(STHBX)	(0.2)%
Scudder High Income Opportunity S	(SHBDX)	(1.2)%
T.Rowe Price High Yield	(PRHYX)	1.9%

Vanguard Inflation Protected Securities Fund (VIPSX)

The Vanguard Inflation Protected Securities Fund owns U.S. Treasuries that provide a current interest rate return, plus an additional return based on current rates of inflation. Since both components are subject to current income taxation, the investment is best owned in retirement accounts, which are typically not taxed until funds are withdrawn.

The investment record of this fund is set out below, and has been quite strong since its inception at the end of June 2000. While it is unlikely the level of returns earned so far can continue into the future, we think the inflation adjustment feature makes this fund an appropriate part of a bond portfolio (see Observations below).

The starting price per share was \$10.00. The closing price per share on 12/31/02 was \$11.84. So in 2 _ years, the price has increased by 18.4%, or an annualized increase of 7.4%. In addition, the following quarterly payments of interest plus inflation adjustment were made, as well as irregular capital gains payments.

All figures are cents per share	<u>2002</u>			<u>2001</u>			<u>2000</u>		
	<u>Interest</u>	<u>Inflation</u>	<u>Total</u>	<u>Interest</u>	<u>Inflation</u>	<u>Total</u>	<u>Interest</u>	<u>Inflation</u>	<u>Total</u>
Q4	8.4	6.6	15.0	7.9	(0.4)	7.5	9.9	7.1	17.0
Q3	6.7	3.3	10.0	6.9	5.1	12.0	5.1	4.9	10.0
Q2	6.9	11.1	18.0	7.2	8.8	16.0			
Q1	<u>7.0</u>	<u>(4.0)</u>	<u>3.0</u>	<u>6.4</u>	<u>2.6</u>	<u>9.0</u>			
TOTAL:	29.0	17.0	46.0	28.4	16.1	44.5	15.0	12.0	27.0
% of \$10.00 price	2.9%	1.7%	4.6%	2.8%	1.6%	4.4%	3.0%	2.4%	5.4%
% of \$12.00 price	2.4%	1.4%	3.8%	2.4%	1.3%	3.7%	2.5%	2.0%	4.5%
							% are annualized; actual result X2		
Capital Gains:	Additional 6.0 per share			Additional 7.0 per share			None		

OBSERVATIONS:

- (1) With 5-year U.S. Treasuries currently yielding 3%, and 10-year U.S. Treasuries currently yielding 4%, the 2002 yield of 3.8% on a \$12.00 fund price is quite attractive, since most of the risk of rising interest rates is covered with the inflation protection feature.
- (2) The quarterly yields are quite erratic. While the interest rate component has ranged between 5¢ (Q3 2002) and 10¢ (Q4 2000), the inflation adjustment has ranged from a low of (negative 4¢) to a high of 11¢. Clearly the inflation adjustment component is (and is likely to continue to be) responsible for much of the total quarterly yield variation.
- (3) The price gain from \$10.00 to \$11.84 is primarily a function of declining interest rates. As with all bonds and bond funds, lower rates mean higher prices. The key difference with this fund is that when interest rates increase, even though the fund price is likely to decline, there is likely to be an offsetting benefit in a higher inflation adjustment payment. This is true because interest rates and inflation rates have a high degree of correlation, that is, they tend to move in the same direction in the same time frame.

STOCKS – The choices with stocks are extremely varied. We use mostly **indexed investments** rather than actively-managed stocks or mutual funds in implementing portfolios. **Indexed investments** are available in no-load mutual funds (from Vanguard, for example) and no-load stocks (referred to as Exchange Traded Funds, or ETFs). **Indexed investments** are available for all the categories of stock choices discussed below. **Indexed investments** seek to equal the results of the market segments in which they invest; actively-managed investments seek to outperform the market segments in which they invest, while running the risk of underperformance.

Points in favor of Indexing include:

- (1) Precision: The composition of an indexed portfolio reflects precisely the segments of the market it tracks, and does not vary its focus.
- (2) Difficulty of Active-Management Outperformance: Most individual stock managers and mutual fund managers do not consistently outperform the indexes over time.
- (3) Low Cost: At least 1% lower cost compared to most stock investments. A 1% cost differential on a 10% investment return makes the cost differential 10% of the investment result.
- (4) Tax Efficiency: Many fewer transactions result in significantly reduced tax consequences.

A summary of stock investing alternatives, and the 2002 results of our index choices, follows:

A. By Size of Company: Size refers to market value, which is calculated by multiplying price per share by number of outstanding shares.

(1) Large Cap: Market value over \$5 billion; approximately half the S&P 500 companies meet this Large Cap size criteria. Large Cap companies are typically household names.

S&P 500	(SPY)	(22.8)%
Vanguard S&P 500	(VFINX)	(22.2)%

(2) Mid Cap: \$1-2 to \$5 billion in market value.

S&P 400 Mid Cap	(MDY)	(15.2)%
Vanguard Mid Cap	(VIMSX)	(14.7)%
Vanguard Extended Market; Combines Small and Mid Cap	(VEXMX)	(18.1)%

(3) Small Cap: Market value below the Mid Cap starting level. Historically, Small Cap stocks have had higher investment returns compared to Large Cap, but with significantly greater price volatility. As always, seeking more reward entails taking greater risk.

iShares Russell 2000 Small Cap	(IWM)	(21.3)%
iShares S&P 600 Small Cap	(IJR)	(14.7)%
Vanguard Small Cap	(NAESX)	(20.0)%
Vanguard Small Cap Growth	(VISGX)	(15.4)%
Vanguard Small Cap Value	(VISVX)	(14.2)%

(4) Total Stock Market: Includes Large Cap, Mid Cap, and Small Cap in a single investment, in a % mix that reflects the market value that each size category bears to the overall value of the stock market. Example: 70% S&P 500, 15% Mid Cap, 15% Small Cap.

iShares Dow Jones U.S. Total Stock Market	(IYY)	(23.4)%
iShares Russell 3000 Total Stock Market	(IWV)	(22.9)%
iShares Russell 1000 Large & Mid Cap (no Small Cap)	(IWB)	(23.4)%
Vanguard Total Stock Market	(VTI)	(21.6)%
Vanguard Balanced; 60% Total Stocks/40% Total Bonds	(VBINX)	(9.6)%

B. By Style: Growth Style or Value Style.

(1) Growth investors buy stocks without much regard for the relationship between the current stock price and the underlying earnings, relying instead on the future earnings growth rate to move the stock price higher.

iShares S&P 500 Barra Growth	(IVW)	(24.3)%
Vanguard Growth	(VIGRX)	(23.7)%

(2) Value Investors, by contrast, look closely at the relationship between the current stock price and current earnings, and only buy stocks if that relationship (the P/E ratio) is reasonable. The distinction between Growth and Value also exists for Mid Cap and Small Cap. We have not used the Value style as a separate investment, other than years ago with Small Cap. During certain periods, one style or the other may have better

C. By Sector: Major sectors include Technology, Health Care, Financial, Utilities, Energy, Industrials, and Consumer Products. There are sector index stocks and funds for all these categories and more, and these sector investments may be limited to Large Cap stocks in the sector (e.g., the S&P Sector ETFs), or can include a broader range of Large, Medium, and Small Cap stocks (e.g., the Barclays *iShares* sector ETFs).

S&P 500 Technology	(XLK)	(38.4)%
iShares Dow Jones U.S. Technology	(IYW)	(38.9)%
S&P Financial	(XLF)	(16.3)%
iShares Dow Jones U.S. Financial	(IYF)	(14.6)%
iShares Dow Jones U.S. Healthcare	(IYH)	(21.9)%
S&P 500 Energy	(XLE)	(16.4)%
iShares Dow Jones U.S. Energy	(IYE)	(17.4)%

(1) The NASDAQ 100 index (QQQ) was a sector investment of sorts, since it consisted predominately of technology companies. The composition of QQQ has changed over the past few years, however, based on technology's extreme underperformance.

NASDAQ 100	(QQQ)	(37.4)%
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(2) Biotech and Real Estate Investment Trusts (REITs) are two other sectors we use.

HLDRS Biotech	(BBH)	(35.9)%
iShares NASDAQ Biotech	(IBB)	(45.8)%
Vanguard REIT Index	(VGSIX)	3.9%
iShares Cohen & Steers Realty	(ICF)	(3.3)%
iShares Dow Jones U.S. Real Estate	(IYR)	(3.1)%

D. By Geography – This is the distinction between U.S.-based companies and companies based outside the U.S., either in more developed parts of the world (e.g., Europe and Japan, with Royal Dutch, Unilever, Sony, and Honda as examples of non-U.S. companies), or the so-called “emerging markets” (e.g., Indonesia, Mexico, Russia (?)). We rarely use International investments, because we believe (a) large U.S. based companies have significant international business activities; (b) the U.S. is the world's dominant economic power; and (c) currency fluctuations add an additional element of portfolio volatility.

iShares MSCI EFA International	(EFA)	(17.0)%
Vanguard Total International	(VGTSX)	(15.2)%
Vanguard Pacific	(VPACX)	(9.3)%
Vanguard Europe	(VEURX)	(18.1)%

We hope this discussion helps you to better understand the many choices we employ in managing your investment portfolios. **Note that no one knows in advance which parts of the stock or bonds markets will do better than others in any given time frame, and so we use a variety of these investments to provide the benefits of diversification.**

IMPORTANT INVESTMENT CONCEPT: CAUSATION

CAUSATION is a key issue for investors to understand clearly. Every day the media, TV, radio, newspapers, and magazines, tell us not only what happened, but also try to enlighten us as to why what happened happened. It is in the “whys” that we must be particularly discerning.

For example, if stock market declines are attributed to Iraq, or the weak economy, or P/E's that are still too high (to cite a few of the most frequently cited current villains), what are we to make of the days when prices increase? Surely these problems have not gone away. On those “up” days the media might tell us of “bargain hunters”, or focus on a piece of good news. But the explanations are all after the fact, with no predictive value whatsoever. And if all the currently cited problems are known already, why isn't it reasonable to conclude that the then current level of stock prices has already priced in all these known problems? In other words, how long can known problems be cited as reasons for future stock price movements (e.g. the risk of impending war with Iraq)?

Nicholas Taleb, in his book “Fooled by Randomness”, cited in prior Comments, gives us food for thought on this subject. “Causality can be very complex. It is very difficult to isolate a single cause when there are plenty around” (pg. 165). To determine appropriate causality, there is the “need to look at all the factors, their historical effect both in isolation and jointly, the stability of the influence, and then...isolate the factor if it is possible to do so.” (pg. 166).

Here is a current, pertinent example of the difficulties of causation. During the last week in January, the Federal Reserve left the interest rates it influences unchanged from the rates in November. The Wall Street Journal (WSJ) reported that the Fed “affirmed a belief that the risk of war with Iraq is all that stands in the way of a sustained [economic] recovery” (WSJ, pg. 2, January 29, 2003). Yet the same article points out that “Some Fed officials suspect that more than Iraq is weighing on business confidence. Stocks have fallen not just because of Iraq, but because of lackluster sales and profits ... and Fed officials think President Bush's proposed ... tax cuts will provide little boost in the first half of 2003.” Note the article talks about falling stock prices, but does not refer to a time frame. Actually, since their October lows, the stock market (S&P 500) is up more than 10%, even as the same problems have been repeated and repeated.

The lesson here is to be highly skeptical of the barrage of conflicting reasons given for stock price changes. The important corollary is that there is no telling when, and from what price level, the stock market will begin a meaningful recovery, even in the face of all the known problems, as well as those yet to arise.

IMPORTANT INVESTMENT CONCEPT: USES OF HISTORY

Using **HISTORY** to draw theories about the future from past events is another important investment issue discussed in Taleb's book. The problem as he sees it is that the combination of past events being used "might have arisen from randomness" (pg. 48). Taleb continues (pg. 50), "But somehow, overall, history is potent enough to deliver, on time, in the medium to long run, most of the possible scenarios...." So, on the one hand, events that make up the history we know may well have been random. This means there are many alternative scenarios that can occur, as opposed to the repeating of the pattern of events we know about from our knowledge of history. But after acknowledging this point, Taleb still concludes that history is "potent enough to deliver... most of the possible scenarios" over periods of time.

The real practical issue for investors is the period of time needed for the historical patterns to repeat. We know from the history of 1926 – 2000 that stock market declines have been followed by recoveries. Even the 1929 – 1932 stock market crash, which occurred during financial and economic conditions far worse than the current period, registered a recovery all the way back to even, over the years 1933 – 1936 (see chart on page 3). And during the entire 75-year period, annual stock market returns averaged 10 – 12%, compared to 5 – 6% for bonds.

But within this long history of 1926 – 2000, there was one lengthy time period, 1929 – 1943, when a broad-based stock portfolio had no positive return; and a more recent period, 1966 – 1982, during which there were no price gains and the only returns came from dividends. So even the history we know indicates at least some likelihood of poor stock returns over substantial periods of time. Note, however, that during both of those lengthy periods, there were sharp stock price recoveries that at least eliminated the declines.

We have now experienced three years of sharply declining stock prices (2002 essentially doubled the extent of the 2000 – 2001 declines; see figures on pages 2 and 13). History does suggest, at a minimum, that recoveries from these levels are likely to occur over some period of time. While it can be argued that all the bad news surrounding current markets (including the economic and geopolitical issues listed at length on page 9 of December's Comments) can reverse the history, it is also true that the prior recoveries occurred in the context of news at least as bad as current events (e.g., other wars, worse economic conditions).

Unfortunately, there is no absolute certainty that the history of recoveries following periods of decline will repeat. Taleb writes that even after seeing 1,000 white swans you cannot say with certainty all swans are white; but the appearance of even one black swan is definitive that all swans are not white. Similarly, history can only provide likelihoods, not certainties.

While we continue to rely on the favorable history of stock price recoveries for clients with many years until they are likely to need to use their money, we also continue to stress the importance of all clients having appropriate allocations to stocks consistent with their particular time frames and emotional willingness to live with risk.

S&P 500

Dow

NASDAQ

I. Figures From Period Starting 2000 (% Figures Are Cumulative Declines From 1/01/00)

Start of 2000	1,470		11,500		4,070	
End of 2000	1,320	(10.1)%	10,785	(6.2)%	2,470	(39.3)%
Sept. 21, 2001 <u>Low</u>	965	(34.3)%	8,235	(28.4)%	1,425	(65.0)%
End of 2001	1,148	(21.9)%	10,020	(12.9)%	1,950	(52.0)%
Oct. 9, 2002 <u>Low</u>	777	(47.1)%	7,286	(36.6)%	1,114	(72.6)%
End of 2002	880	(40.1)%	8,342	(27.5)%	1,336	(67.2)%
January 31, 2003	856	(41.8)%	8,054	(30.0)%	1,321	(67.5)%

II. Figures From Period Starting 1995 (% Figures Are Gains From 1/01/95)

Start of 1995	459		3,834		752	
End of 1999	<u>1,470</u>		<u>11,500</u>		<u>4,070</u>	
5 Year Gain; Annualized %	1,011	26.1%	7,666	24.6%	3,318	40.2%
End of 2001	<u>1,148</u>		<u>10,020</u>		<u>1,950</u>	
7 Year Gain; Annualized %	689	14.0%	6,186	14.7%	1,198	14.6%
End of 2002	<u>880</u>		<u>8,342</u>		<u>1,336</u>	
8 Year Gain; Annualized %	421	8.5%	4,508	10.2%	584	7.5%
Jan. 31, 2003	<u>856</u>		<u>8,054</u>		<u>1,321</u>	
8.1 Year Gain; Annualized %	397	8.0%	4,220	9.6%	569	7.2%



Victor Levinson



Nicholas Levinson