Vic's Home Office Phone: 212-588-0015
Vic's Home Office Fax: 212-588-9032
Nick's Office Phone: 510-601-6662

MARCH 2003 COMMENTS

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COMMENTS: INDEX RESULTS, period ending March 28, 2003

STOCKS	YEAR 1999	YEAR 2000	YEAR 2001	YEAR 2002	YTD 2003	CURRENT MONTH
Total Stock Market				(23.4)%	(1.5)%	2.7%
S&P 500	19.6%	(10.1)%	(13.0)%	(23.4)%	(1.8)%	2.7%
S&P 500 Growth	28.8%	(22.2)%	(13.0)%	(23.7)%	0.8%	3.7%
S&P 500 Value	12.6%	6.1%	(12.0)%	(20.9)%	(3.8)%	1.7%
Dow Jones	25.2%	(6.2)%	(7.1)%	(16.8)%	(2.4)%	3.2%
NASDAQ Comp.	85.6%	(39.3)%	(21.0)%	(31.5)%	2.5%	2.5%
MidCap US	25.0%	2.6%	(4.8)%	(16.3)%	(3.3)%	2.0%
Small Cap US	19.6%	(4.2)%	1.0%	(21.6)%	(3.4)%	2.3%
Intl, EAFE	25.3%	(15.2)%	(22.6)%	(17.5)%	(6.1)%	0.0%
BONDS, Intermediate Term (High Yield Taxable; Vanguard; Not an Index Fund):						
Taxable	(0.8)%	11.3%	8.3%	8.2%	0.9%	(0.5)%
Tax-Exempt	(2.9)%	9.2%	5.0%	7.9%	0.2%	(0.2)%
High Yield Taxable				1.7%	4.1%	1.3%

	1999				2000				2001			
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q
S&P 500	4.1	7.6	(7.7)	15.6	2.0	(3.0)	(1.3)	(7.8)	(12.1)	4.8	(13.8)	8.1
NASDAQ COMP	14.6	10.0	0.0	61.0	12.4	(14.8)	(7.2)	(29.6)	(25.5)	12.9	(26.7)	18.3
BONDS Interm. Taxable	0.0	(0.5)	0.4	(0.7)	2.4	1.5	3.1	4.3	3.2	0.8	4.3	0.0

	2002				2003			
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q
S&P 500	0.0	(13.8)	(14.1)	4.5	(1.8)%			
NASDAQ COMP	(5.5)	(19.5)	(13.5)	7.0	2.5%			
BONDS Interm. Taxable	0.0	2.8	3.6	1.8	0.9%			

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MARCH 2003 COMMENTS

During the March period ending Friday, March 28, **STOCK PRICES** increased for the first month since October 2002. For the month, the S&P 500 was up 2.7%, but still down (1.8)% year-to-date; the Dow Industrials were up 3.2%, but still down (2.4)% year-to-date; and the NASDAQ Composite was up 2.5% for the month and year-to-date.

The month's results had three distinct periods: through March 12th stocks had declined about 10% from their 2002 closing levels; then followed a sharp eight-day rally that coincided with the beginning of the invasion of Iraq and raised stock prices to a small gain for the year; but then stocks declined again during the final week. Conventional wisdom assumes that the stock market's movements are tied to the war, but, as time passes, the issue of whether the general economy is or is not going to improve is likely to emerge as the major factor for near-term stock price changes.

BOND RETURNS (price change plus interest) were modestly negative in March, with intermediate term taxable and tax-exempt bonds declining (0.5)% and (0.2)%, respectively. Year-to-date, these same bond returns are still modestly positive, at 0.9% and 0.2%, respectively.

As has been the case for the past few years, during periods when stock prices advance bond prices decline, which also means an increase in interest rates.

The investment results for the March period, for both stocks and bonds and for 2003 year to date, and for the four full years 1999 – 2002, are set out on page 2. An in-depth discussion of Bonds begins on page 5 of this month's Comments.

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Despite the modest gains in March, the bear market for stocks continues. As for the extent of the stock market declines 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 10). Note that all three indexes have positive average annual returns of 7.5% to 9.5% from the end of 1994 through March 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.**

	S&P 500		DOW		NASDAQ	
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)%
Mar 28, 2003 Close	864	(43)%	8,146	(31)%	1,370	(72)%

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

End 1994	459	3,834	752
End 1999	1,470	11,500	4,070
Gain	1,011	7,666	3,318
Avg. Annual % Gain, '95-'99	26.2%	24.6%	40.2%
As of 3/28/03	864	8,146	1,370
Gain	405	4,312	618
Avg. Annual % Gain, '95-3/28/03	8.0%	9.5%	7.5%

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KEY IDEAS TO UNDERSTANDING BONDS

Over the most recent three years, investment returns for Bonds have greatly exceeded the negative returns for Stocks as well as outperformed the long-term average returns for Bonds. Investor interest in Bonds has in turn grown dramatically. Accordingly, we would like to set out the key ideas for understanding this asset class. While we have spent a fair amount of time in prior Comments discussing Bonds, this section is intended to provide a more in-depth look at the subject. The attached WSJ article by Jonathan Clements (page 9), dated 3/12/2003 and discussing some of the pitfalls of bond investing, should also prove helpful in understanding bonds.

Before discussing the key variables affecting bond prices, some definitions will be useful:

1) A bond is a promise from the borrower to repay the money borrowed from the lender at a particular time (maturity), and to pay the lender a return in the form of interest while the loan is outstanding.

2) Borrowers are more formally referred to as Issuers of bonds. Issuers can be public entities, such as the U.S., state, or local governments, or private companies.

3) Lenders are those who invest in bonds. Investors expect both to have their money returned to them as promised and to receive periodic interest payments as promised.

The key variables affecting Bond prices are few in number (a detailed discussion of each variable accompanies the following list):

1) Current interest rate levels, and the anticipated direction of interest rates in the near future.

2) The maturity of the bonds, which refers to the time when issuers repay investors' original principal investment.

3) The quality of the bonds, which refers to the likelihood investors will receive their principal at maturity as well as periodic interest payments.

4) Tax characteristics: Is the interest paid taxable or tax-exempt?

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1) Interest Rate Levels, Current and Future. Newly-issued Bonds pay interest at rates that are sufficient to attract investors, no more, no less. For example, if the U.S. Government can get investors to buy its bonds by paying 3% for bonds due in 5 years, it will do so. (The current interest rate for a 5-Year U.S. Treasury Bond is in fact 3%). How does this fact affect changes in bond prices?

   a) Investors who bought 5-Year U.S. Treasuries two years ago when they paid a 5% interest rate have seen the price of their bonds increase. Why? Because they are entitled to 5% interest for three more years, compared to current bond investors who can only get 3%.

   b) Investors who bought the 5-Year U.S. Treasury two years ago have a choice; they can hold the bond to maturity and collect 5% for three more years, or sell the bond at a price higher than their purchase price. If they sell, they are left with money to reinvest. If they then want another 5-Year U.S. Treasury, their interest rate will be 3%. The amount of the price increase will be approximately the equivalent of three more years of interest payments 2% higher than the current rates.

   c) Investors who buy the current 5-Year U.S. Treasury with a 3% interest rate could very well see the price of their bonds decline over the five-year period, since 3% is a very low interest rate in historical terms. For example, if, two years from now, interest rates for newly-issued 5-Year U.S. Treasuries are back at 5%, the owners of the 3% bonds will see their prices decline by approximately the amount represented by 3 years at 2% per year. Yes, the bonds will mature and be paid at the initial price at issue, but holding the 3% bond when interest rates return to 5% means the bond owner must accept 2% less interest for the next three years compared to the buyers of the 5% bonds. See also the Jonathan Clements article (page 9), which addresses this idea of bond price risk in the context of historically-low interest rates.

   d) Key Point to Remember: As interest rates rise, the price of existing bonds decline; as interest rates fall, the price of existing bonds rise. The extent of the price change is a function of the next two key variables, maturities and quality.

2) Maturities. The longer the time until a bond matures, the more volatile will be the price change of the bond based on changes in interest rates.

   a) The example used in the Interest Rate discussion above used a 5-year maturity, with a 2% change in interest rates over a two year period, which left 3 years until maturity.

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b) If the maturity of this bond were 10 years instead of 5 years, there would be eight more years to wait and receive 3%, rather than 5%, interest. Therefore, the price of the 10-Year bond would decline more than that of the 5-year bond, because of the additional five years of lower interest rates. By the same logic, the buyers of the 5% bond two years ago would have higher prices if the maturity was 10 years compared to 5 years, because there would be eight years to receive higher interest rates compared to three years.

c) If the maturity of the bond purchased were two years, the price change would be much smaller, since the bond would be paid off after two years and any interest rate advantage or disadvantage would be rendered meaningless by the fact the bond was maturing.

d) Certain bond-like investments have maturities that are so short, measured in months rather than years, that there are essentially no price changes. The tradeoff for such price stability is very low interest rates. Money Market Funds and U.S. Treasury Bills are examples of investments with essentially no risk of price change. The real risk for investors who choose these low interest rate investments is **INFLATION,** because the investment return can be less than the rate at which inflation erodes the purchasing power of the original principal plus interest.

e) Key Point to Remember: Longer maturities mean more price volatility for any given change in interest rates. Shorter maturities mean less price volatility.

3) Quality. Bond quality refers to the likelihood of timely payments of principal and interest as promised. High quality bond issuers are expected to make such timely payments. Low quality bonds have a higher likelihood of some kind of default in the payment of principal and interest. To compensate for the higher risk of default, low quality bonds must pay higher interest rates than high quality bonds in order to induce investors to buy the bonds. Low quality bonds are referred to as "high yield", or "Junk Bonds".

a) Hierarchy of Quality

i. U.S. Government is highest quality, with no chance of default.

ii. Municipal Bonds vary in quality; investors need to know the identity of the issuing entity to determine quality.

iii. Corporate Bonds of large, successful companies are viewed as high quality, but their quality can change (see recent examples such as Lucent, ATT, Worldcom, Ford Motor, and various Airlines).

iv. Corporate Bonds of struggling companies known to be poor credit risks start out as junk bonds, and pay high interest.

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b) There are various bond rating services, including Moody's and Standard & Poors, that rate bonds for quality. The problem with ratings is that the services are often very late in identifying problems that adversely affect the ability of companies to pay their bond obligations.

c) Key Point to Remember: High quality means lower interest rates, or yields; low quality means more risk, and therefore higher yields.

4) Tax Characteristics. Interest on bonds can be taxable or tax exempt. Municipal bonds ("munis") issued by state and local governments are exempt from federal taxes. U.S. Government bonds are taxable at the federal level, but not at the state and local level. Corporate bonds are taxable at the federal, state, and local levels. Muni bond interest rates are typically lower than rates on taxable bonds, since the tax savings are factored in.

a) Retirement accounts in which investors do not pay taxes on investment income are best suited to own taxable bonds.

a) Whether to own taxable or tax-exempt/muni bonds in a taxable account is a function of marginal tax brackets. If, for example, each additional dollar of taxable income is taxed at 33%, then a muni bond paying more than 67% of the interest of a taxable bond of comparable maturity and quality is advantageous to the investor. But remember, in comparing a taxable bond paying 4%, with a tax-exempt bond paying 3%, it is a **fallacy** to think the muni bond is paying the equivalent of 4.5%. The reality is the taxable bond is paying 2.7% after-tax compared to the tax-exempt 3%. You cannot spend the so-called "taxable equivalent" of muni bond interest; you can only spend the actual interest earned on the muni bond, or the actual after-tax interest of the taxable bond.

Other Points Worth Knowing:

1) Bonds can be purchased individually or in mutual funds that own substantial numbers of individual bonds. Mutual funds are professionally managed, and can be purchased with specific characteristics as to maturity, quality, and taxability of interest. We prefer to own bonds in low-cost index funds. Managing the maturities of individual bonds is more difficult than having the mutual fund manager do so. While bond mutual funds do not have specific maturities, the bonds owned by the funds do have specific maturities. So long as the fund manager reinvests the proceeds of maturing bonds in a manner consistent with the characteristics desired by the investor, this "lack of maturity" should not adversely affect the investor.

2) Preferred stocks that pay high interest raise the same basic issues as bond investments with regard to maturities and quality. Furthermore, certain recently created closed-end preferred stock funds that sell for prices higher than their net asset value carry an additional loss potential for investors focused solely on current yields.

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Vic's Home Office Fax: 212-588-9032
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	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 Low	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 Low	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)%
Mar. 28, 2003	864	(41.2)%	8,146	(29.2)%	1,370	(66.3)%
II. Figures From Period Starting 1995 (% Figures Are Gains From 1/01/95)						
Start of 1995	459		3,834		752	
End of 1999	1,470		11,500		4,070	
5 Year Gain; Annualized %	1,011	26.1%	7,666	24.6%	3,318	40.2%
End of 2001	1,148		10,020		1,950	
7 Year Gain; Annualized %	689	14.0%	6,186	14.7%	1,198	14.6%
End of 2002	880		8,342		1,336	
8 Year Gain; Annualized %	421	8.5%	4,508	10.2%	584	7.5%
Mar. 28, 2003	864		8,146		1,370	
8.25 Year Gain; Annualized %	405	8.0%	4,312	9.5%	618	7.5%

Victor Levinson

Nicholas Levinson