

MAY 2003 COMMENTS

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NOTES: Our new Brochure describing our work is enclosed. We hope you take the time to review it, and feel free to pass it on to (or request additional copies for) others you know who might benefit from our services.

Any recommendation contained in these Comments may not be suitable for all investors. Moreover, although the information contained herein has been obtained from sources believed to be reliable, its accuracy and completeness cannot be guaranteed.

COMMENTS: INDEX RESULTS, period ending May 30, 2003

	<u>YEAR</u>	<u>YEAR</u>	<u>YEAR</u>	<u>YEAR</u>	<u>YTD</u>	<u>CURRENT</u>
<u>STOCKS</u>	<u>1999</u>	<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>MONTH</u>
Total Stock Market				(23.4)%	11.2%	8.5%
S&P 500	19.6%	(10.1)%	(13.0)%	(23.4)%	9.5%	7.3%
S&P 500 Growth	28.8%	(22.2)%	(13.0)%	(23.7)%	9.3%	5.4%
S&P 500 Value	12.6%	6.1%	(12.0)%	(20.9)%	12.0%	10.6%
Dow Jones Industrials	25.2%	(6.2)%	(7.1)%	(16.8)%	6.1%	6.5%
NASDAQ Comp.	85.6%	(39.3)%	(21.0)%	(31.5)%	19.5%	12.1%
MidCap US	25.0%	2.6%	(4.8)%	(16.3)%	10.4%	10.4%
Small Cap US	19.6%	(4.2)%	1.0%	(21.6)%	15.1%	13.7%
Intl, EAFE	25.3%	(15.2)%	(22.6)%	(17.5)%	7.3%	9.2%

BONDS, Intermediate Term (High Yield Taxable; Vanguard; Not an Index Fund):

Taxable	(0.8)%	11.3%	8.3%	8.2%	4.0%	2.1%
Tax-Exempt	(2.9)%	9.2%	5.0%	7.9%	3.5%	2.4%
High Yield Taxable				1.7%	8.4%	1.0%

	<u>1999</u>				<u>2000</u>				<u>2001</u>			
	<u>1Q</u>	<u>2Q</u>	<u>3Q</u>	<u>4Q</u>	<u>1Q</u>	<u>2Q</u>	<u>3Q</u>	<u>4Q</u>	<u>1Q</u>	<u>2Q</u>	<u>3Q</u>	<u>4Q</u>
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

	<u>2002</u>				<u>2003</u>			
	<u>1Q</u>	<u>2Q</u>	<u>3Q</u>	<u>4Q</u>	<u>1Q</u>	<u>2Q</u>	<u>3Q</u>	<u>4Q</u>
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%			

MAY 2003 COMMENTS

During the May period ending Friday, May 30, **STOCK PRICES** showed substantial gains. For the period, the S&P 500 was up 7.3%, and is now up 9.5% year-to-date; the Dow Industrials were up 6.5%, and are up 6.1% year-to-date; and the NASDAQ Composite was up 12.1% for the period, and 19.5% year-to-date.

While these percentage increases are considerable, it should be remembered that after a decline of a certain percentage, the percentage amount of the increase required to regain the amount of the decline is a much higher number. For example, the S&P 500's decline from its year 2000 high of 1,527 to its October 2002 low of 777 was 49%, and requires a gain of 750, or 97%, to return to 1,527. In the case of the NASDAQ Composite, its decline from its year 2000 high of 5,048 to its October 2002 low of 1,114 was 78%, and requires a gain of 3,934, or 353%, to return to 5,048.

The most recent three months, March through May, have now provided a gain of 14% for the S&P 500, its highest three consecutive month return since the 14% gain during the fourth quarter of 1999, and the 11% gain during the fourth quarter of 2001. Note that those two periods of gain occurred just prior to, and in the middle of, the most severe bear market for stocks since 1973-1974. The moral: The future, as always, is an unknown, and whether these current gains continue or not is dependent on future events, not known news, or recent price trends. These uncertain future events include the rate of growth in the general economies of the U.S. and its other major trading partners, the amount and credibility of corporate profits, and geopolitical conditions.

BOND RETURNS (price change plus interest) were also higher for the five-week period, which marked the first time since December 2000 and January 2001, when both stock and bond prices were higher for two consecutive periods. For the May period, intermediate-term taxable and tax-exempt bonds gained 2.1% and 2.4%, respectively. Year-to-date, these same bond returns are positive 4.0% and 3.5%, respectively.

Stock and bond investment results for the May period, for 2003 year-to-date, and for the four full years 1999 – 2002 are set out on page 2.

While the March – May stock gains for the S&P 500 have now reached 14%, and the increase from the 2002 low is 24%, it is still premature to conclude that the three-year bear market for stocks is over. As the chart below indicates, the rally from September 2001 to year end 2001 turned into the rout of 2002, so it will take more than a three month recovery to declare an end to this bear market.

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 13). Note that all three indexes have positive average annual returns of 9.2% to 10.4% from the end of 1994 through May 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)%
May 30, 2003 Close	964	(37)%	8,850	(25)%	1,596	(68)%

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 5/30/03	<u>964</u>	<u>8,850</u>	<u>1,596</u>
Gain	505	5,016	844
Avg. Annual % Gain, '95-5/30/03	9.2%	10.4%	9.3%

IMPORTANT ECONOMIC CONCEPTS CURRENTLY IN THE NEWS

The following discussion covers a number of important economic concepts currently in the news. Since each of these subjects is complex, and has filled many books, our discussion is only intended to highlight a few of the key ideas related to each concept, and to indicate how each concept affects the liquid investments about which we provide advice. The concepts are:

- I. Inflation and Deflation
- II. Currency Exchange Values,
Particularly the Recent Decline in the Exchange Value of the Dollar
- III. Recent Changes in the Income Tax Laws
- IV. Employment Levels, and Their Impact on the Economy and Corporate Profits

I. Inflation and Deflation

A. Introduction - Ever since Federal Reserve Chairman Allan Greenspan mentioned the possibility, albeit remote, of deflation in the U.S. economy (WSJ articles, pg. 1, 5/7/03 and pg. A3, 5/22/03; WSJ cites are to Wall Street Journal), the subjects of inflation and deflation have become increasingly prominent in the media.

B. Definitions

- 1) **Inflation** refers to the rise of general price levels in an economy. When general price levels are rising, the purchasing power of a fixed amount of money (e.g. U.S. dollars) declines. The key point is the rate at which prices are rising; over the past decade, annual inflation averaging less than 3% has been welcomed; during the late 1970s and early 1980s, when inflation rates rose to and briefly above 10%, the Federal Reserve took aggressive steps to reduce what it believed was an excessive rate of inflation.
 - a) Rising prices in certain sectors of an economy --e.g. in the U.S., education and plumbing services-- do not constitute inflation. Inflation refers to a time when almost all prices are rising.
 - b) Also, price increases due to real or perceived improvements in products and services would not constitute inflation.

- 2) **Deflation** presents the reverse situation, and would describe a period in which the general level of prices in an economy is declining. In such a circumstance, the purchasing power of a fixed amount of money would rise. Again the rate would be a crucial point, but the U.S. economy has not experienced significant deflation (above 3%) since the early 1930s, during the "Great Depression".
 - a) As with inflation, falling prices in certain sectors of an economy --e.g. in the U.S., electronic items and clothing-- do not constitute deflation. Deflation refers to a time when almost all prices are declining.
 - b) Also, price decreases due to real or perceived reductions in the quality of products and services would not constitute deflation.

C. Problems Associated with Inflation

- 1) People on fixed incomes, and those whose incomes do not keep pace with rising price levels, are unable to maintain their standards of living. Since by definition their dollars cannot purchase the same quantity of goods and services, their lifestyles are diminished.
- 2) Consumers and businesses accelerate their current purchases of goods and services, on the premise that any delay will cause them to pay higher prices in the future. When this thinking becomes prevalent, economic distortions arise, as current demand becomes excessive. Again, the rate of inflation is crucial here; modest increases in general price levels are easily absorbed with few dislocations, but a high rate of inflation feeds on itself, and tends to create additional dislocations and additional inflation.
- 3) Corporate profits can be artificially inflated, since goods sold and equipment needed will require replacement at higher costs than the previous goods sold or equipment purchased.
- 4) Holders of debt demand higher interest rates to compensate them for the loss of purchasing power of the dollars owed to them at a later date; the longer the maturities of the debt, the greater will be the interest rate demanded. When interest rates increase, the value of all existing debt declines, and, depending on the rates involved, the declines can be substantial.

D. Problems Associated with Deflation – Although at first blush, declining prices seem like good news, there are real problems associated with deflation.

- 1) Wages are likely to decline, as businesses are faced with receiving fewer dollars for their goods and services.
- 2) Investment income is likely to decline as interest rates decline.
- 3) Less available income makes all debt repayment more onerous, since the debt is denominated in fixed dollars.
- 4) Economic demand falls, as consumers and businesses anticipate future prices to be lower than current prices.
- 5) Profits fall if businesses receive fewer dollars for their goods and services and are unable to reduce costs as much as the declining prices.
- 6) If all the above takes place, overall economic activity is likely to decline, leading to further cutbacks in employment, production, and purchases, which in turn trigger additional declines in economic activity.

E. How Inflation and Deflation Impact the Prices of Liquid Investments;
Also, How Government Acts to Overcome the Problems Discussed Above.

- 1) Bonds and Inflation – There is a high degree of correlation between inflation rates and interest rates. The reason is that as inflation increases, the value of the dollars to be returned to the bond investor at maturity declines, and the interest payments on the bonds are the only way for the investor to be compensated for the loss of purchasing power. So as inflation rises, interest rates rise; and as interest rates rise, the price of existing bonds declines.
 - a) Conversely, as inflation rates decline, interest rates decline and bond prices rise.
 - b) The relationship between inflation rates and interest rates is clearest with bonds that have little or no credit risk (e.g. U.S. Treasuries, other U.S. Government securities, and high credit quality municipals and corporate bonds). However, high yield, a/k/a “junk”, bonds react more to the economic conditions of the issuer and the general economy, and their prices are not as directly related to the movement of interest rates.
 - c) During times when inflation rates are high and threaten to create the problems discussed on page 6, the Federal Reserve often acts to raise interest rates even higher, in an effort to slow down the economy, which eventually tends to reduce the inflationary cycle. Other governmental actions that tend to reduce inflation include raising taxes and/or reducing governmental spending. These actions would reduce the amount of private spending available in the economy.

- 2) Bonds and Deflation - Deflation would have the effect of lowering interest rates, since lenders would be receiving dollars that have not lost purchasing power. There is a limit to this effect, however, since interest rates cannot go below zero. As interest rates decline, the prices of high credit quality bonds increase.
 - a) Junk Bond prices could be an exception, however. In a weak economy, the issuers are more likely to default, so interest rates on these bonds would rise to compensate for this higher risk.
 - b) To combat deflation, government would attempt to stimulate the economy back to growth. Measures might include maintaining low interest rates, reducing taxes (see Section III on pages 10 and 11), and/or increasing government spending (more than likely deficit spending, as tax revenues would shrink in a deflating economic environment).

- 3) Stocks and Inflation – Stocks are most impacted by corporate profits and general economic conditions, so that the relationship between stock prices and inflation is by no means direct. Stable price levels are typically best for stock prices, and, historically, periods of modest inflation have resulted in stock gains (WSJ article, page C1, 5/16/03). Significant rates of inflation have set the stage for significant stock price declines (1973-1974, late 1970s). High inflation and the resulting high interest rates create serious competition for investment dollars, which tends to draw money out of the stock market.
 - a) However, low inflation and low interest rates do not necessarily mean higher stock prices. The current three-year bear market of 2000 – 2003 provides ample proof of the absence of this relationship.
 - b) The question of how inflation has impacted the actual historical results of stock market returns is addressed in Appendix A.

- 4) Stocks and Deflation – Declining general price levels also show a mixed record with regard to their impact on stock prices, even with the likelihood of slower economic conditions and lower corporate profits resulting from lower sales dollars that could not be totally offset by lower costs.
 - a) The Depression years of the 1930s provides evidence of the relationship between lower stock prices and deflation. During 1949 – 1950, however, when prices fell at a modest rate of just under 1% per year, stock prices realized average annual gains of 16% (WSJ editorial, 5/29/03).
 - b) The previously cited WSJ article, 5/16/03, pg. C1, discusses the relationship of deflation to stock prices: Mild deflation (up to 2.4%) has been favorable for stock prices, while more severe deflation has been related to declining stock prices.

II. Currency Exchange Values, Particularly the Recent Decline in the Exchange Value of the Dollar

A. Introduction - During this past year, the exchange value of the dollar relative to the euro has declined substantially. This occurrence has put the exchange value of the dollar in the news.

B. Definitions

- 1) The value of a currency is related to its exchange value with other currencies, e.g. how many dollars are needed to receive a given amount of euros, or yen.
- 2) As a corollary, the value of the dollar in the U.S., where dollars are the currency, does not fluctuate; one dollar purchases one dollar's worth of goods and services. What does change within a country is the purchasing power of the currency, which is the subject of inflation and deflation previously discussed.
- 3) Why Does the Exchange Value of a Currency Decline?
 - a) Economic growth prospects are weaker than in other countries.
 - b) Differences in interest rates: Higher rates tend to attract investments to a country, whereas lower rates tend to cause investments to be made elsewhere.
 - c) Loss of confidence in the political stability of a country.

C. Problems Associated with a Declining Currency

- 1) Goods imported from other countries should cost more; under certain economic conditions, this can lead to more inflation within the importing country.
- 2) Capital inflows and investments can decline if investors believe the value of their investments are likely to decline because of a decline in exchange rates.

D. Advantages of a Declining Currency

- 1) Goods exported to other countries are less costly to the purchasers, which stimulates economic activity in the exporting country.

E. How a Declining Currency Exchange Rate Affects Liquid Investments

- 1) The impact on international investments is clear in one respect; when the U.S. dollar is declining, investments denominated in currencies rising against the dollar will be benefited, since it takes fewer amounts of those currencies to acquire a given amount of dollars. However, if the economic performance of the companies in those countries with appreciating currencies is weak, the overall investment result can be worse than the U.S. result even after factoring in the currency impact. This is the situation in 2003, with the U.S. Stock Market outperforming an index of international investments (discussed in WSJ article, pg. C1, dated 5/30/03).
- 2) There is no clear relationship between the specific factor of a declining currency and the investment results of either the stock or bond markets in the country whose currency exchange rates are declining.

III. Recent Changes in Income Tax Laws

A. Introduction – President Bush has been seeking a reduction in income taxes, in part to help stimulate the economy. The final tax bill recently passed by Congress has important changes related to investments.

B. The Key Changes

- 1) Dividends paid by businesses that pay taxes on their income will be taxed at a rate of 15%; previously, dividends were taxed at the recipient's highest marginal tax bracket, which could range from 27% to 38.6%.
 - a) Dividends paid by REITS will not receive this tax benefit because REITs do not pay income taxes.
 - b) Interest on bonds subject to taxation will not receive this tax benefit, since interest is already deductible by businesses. There is also no change in the taxation of interest paid by governments.
- 2) Long Term Capital Gains (assets held more than one year) will be taxed at 15%, down from 20%.

C. How These Changes Affect Investment Portfolios

1) Stocks owned in taxable (i.e., non-retirement) accounts are clearly more attractive, but how much more is the key question.

- a) Dividends: A \$1 million stock portfolio earning the average dividend yield of the S&P 500 would earn approximately \$20,000 in dividends. If the taxpayer were in the highest marginal tax bracket, the income tax would be approximately \$7,700. Now the income tax will be \$3,000, a savings of \$4,700 on a \$1 million portfolio, or less than _ of 1%.

Even if the investor sought stocks paying higher dividends, so that the dividends doubled to \$40,000, the tax savings would amount to \$9,400, still less than 1% of the portfolio. Since stocks are owned primarily for growth, how much impact is this additional 1% after-tax return going to make on investors' collective decisions?

- b) Capital Gains: The lower tax rate on capital gains is an outright gift to taxpayers, since the previous capital gain tax rate of 20% was highly advantageous to begin with, and 15% is that much better. Whether this reduction will motivate investors to shift to higher capital gain opportunities as compared to dividend producing investments, or as compared to what investors were already doing with their money, is open to question. This issue can be summarized with the question of whether risk-averse investors seeking to protect principal after the 2000 – 2003 bear market are likely to make significant changes in their asset allocations based on these tax law changes.

2) Stocks owned in retirement accounts, or tax deferred accounts such as annuities, become relatively less advantageous, since all gains and dividends earned in these accounts are eventually taxed at the higher ordinary income marginal tax brackets at the time of distribution. (In retirement accounts that provide income tax deductions for contributions, all distributions are taxed as ordinary income).

IV. Employment Levels

- A. Introduction – As the economy weakened in 2001 and 2002, employment declined and the unemployment rate increased. But even now, in mid-2003, with hopes of an economic recovery spreading, employment levels remain well below what they have been and what economists think they should be in a robust economy. In its first page article from 5/29/03, the WSJ discusses this situation in some depth, stating: “In short, the U.S. is experiencing the most protracted job-market downturn since the Great Depression. It has left behind a remarkably broad swath of workers – from young to old, and from high school dropouts to the highly educated – even as the economy has started growing again.”

B. Why is This Happening? What Are the Consequences?

- 1) Employers try to keep costs down; among other things, employees are a major cost of doing business. This is especially true in a low growth, low inflation environment, in which businesses have little ability to raise prices.
- 2) According to the WSJ... "Intensifying competition from abroad, slow growth at home, and a relentless push for productivity are driving this change."
- 3) When employment is slack, less income is earned, which reduces overall demand in the economy. Therefore, the very actions that make sense for individual businesses to keep costs down adversely affect the overall economy by keeping incomes and demand down.
- 4) Productivity, which is a measure of the amount of output obtained from a unit of labor input, has been growing since the 1990s. This is good news for the overall economy, but not for workers. As the WSJ article puts it: "Productivity growth... is creating a short run problem. Worker productivity has been growing faster than the overall economy... allowing executives to meet small increases in demand while still eliminating jobs."

C. Impacts on Investment Portfolios

1) On Bond Prices

Typically, during periods of slack employment the overall economy grows slowly if at all. Interest rates in such an environment tend to go lower, and this in turn raises bond prices.

2) On Stock Prices

The relationship between slack employment and stock prices is much harder to identify. During the early periods of an economic downturn, stock prices are likely to decline. The stock market tends to be a forward-looking pricing mechanism, however, and may anticipate economic recovery well before actual employment levels turn up.

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)%
May 30, 2003	964	(34.4)%	8,850	(23.0)%	1,596	(60.8)%

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%
May 30, 2003	<u>964</u>		<u>8,850</u>		<u>1,596</u>	
8.42 Year Gain; Annualized %	505	9.2%	5,016	10.4%	844	9.3%



Victor Levinson



Nicholas Levinson