



# Park Piedmont Advisors LLC

Registered Investment Advisor

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## JUNE 2004 COMMENTS

### IMPORTANT NOTES:

#### **E-MAIL INFORMATION and TRANSMISSION**

We will continue E-MAILING the Comments, instead of mailing them, to everyone for whom we have e-mail addresses. If you prefer receiving the Comments by regular mail, please advise Lynette at her email address, [lynettec@parkpiedmont.com](mailto:lynettec@parkpiedmont.com). Alternatively, if we do not have your e-mail address, and you would like to receive the Comments by e-mail, please provide your e-mail address to Lynette.

#### **TAX COST BASIS INFORMATION on MONTHLY STATEMENTS**

Your LaSalle Street/National Financial Services' (LSS/NFS) statements for taxable accounts have a column for cost basis information (cost basis is not relevant for IRA and other retirement accounts). We have begun the process of providing you with spreadsheets containing cost basis information for your approval, after which the cost basis information will be added to your monthly statements. Each of you will get a letter specific to your information. We expect all clients to have this information by year-end 2004.

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*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 JUNE 30, 2004**

	<u>YEAR</u>	<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>2004</u>	<u>MONTH</u>
Vanguard Total Stock Market Index Fund (1)	23.8%	(10.6)%	(11.0)%	(21.0)%	28.4%	3.9%	2.1%
S&P 500 Index (2)	19.6%	(10.1)%	(13.0)%	(23.4)%	26.4%	2.6%	1.8%
Vanguard S&P 500 Growth Index Fund (1)	28.8%	(22.2)%	(13.0)%	(23.7)%	25.9%	3.0%	1.1%
Vanguard S&P 500 Value Index Fund (1)	12.6%	6.1%	(12.0)%	(20.9)%	32.2%	3.7%	2.7%
Dow Jones Industrial Average Index (2)	25.2%	(6.2)%	(7.1)%	(16.8)%	25.3%	(0.2)%	2.3%
NASDAQ Composite Index (2)	85.6%	(39.3)%	(21.0)%	(31.5)%	50.0%	2.2%	3.1%
Vanguard Mid Cap US Index Fund (1)	25.0%	2.6%	(4.8)%	(16.3)%	34.1%	5.8%	2.8%
Vanguard Small Cap US Index Fund (1)	19.6%	(4.2)%	1.0%	(21.6)%	45.6%	7.7%	4.2%
Vanguard International (EAFE) Index Fund (1)	25.3%	(15.2)%	(22.6)%	(17.5)%	40.3%	4.2%	2.4%

**BONDS:**

Vanguard Total Bond Market Index (1)	(0.8)%	11.3%	8.3%	8.2%	4.0%	0.1%	0.6%
Vanguard Interm. Tax-Exempt Bond Index (1)	(2.9)%	9.2%	5.0%	7.9%	4.4%	(0.7)%	0.3%
Vanguard High Yield Taxable Bond Fund (1)	NA	NA	NA	1.7%	17.2%	0.9%	1.3%

	<u>1999</u>				<u>2000</u>				<u>2001</u>			
%	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q
<b>S&amp;P 500</b>	4.1	7.6	(7.7)	15.6	2.0	(3.0)	(1.3)	(7.8)	(12.1)	4.8	(13.8)	8.1
<b>NASDAQ COMP</b>	14.6	10.0	0.0	61.0	12.4	(14.8)	(7.2)	(29.6)	(25.5)	12.9	(26.7)	18.3
<b>BONDS Interm. Taxable</b>	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>2004</u>			
%	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q
<b>S&amp;P 500</b>	0.0	(13.8)	(14.1)	4.5	(1.8)	12.8	2.2	13.2	1.3	1.3		
<b>NASDAQ COMP</b>	(5.5)	(19.5)	(13.5)	7.0	2.5	19.2	12.1	16.2	(0.5)	2.7		
<b>BONDS Interm. Taxable</b>	0.0	2.8	3.6	1.8	0.9	2.7	0.2	0.2	2.7	(2.6)		

1) Results for Vanguard funds include dividends and fund expenses but do not reflect PPA's advisory fee.

2) Results for S&P 500, Dow Jones, and NASDAQ indexes do not reflect dividends or PPA's advisory fee.

## **JUNE 2004 COMMENTS**

During the month of June 2004, **STOCK** index prices rose. For the month, the S&P 500 gained 1.8%, the Dow Industrials gained 2.3%, and the NASDAQ Composite gained 3.1%. Year-to-date (YTD), the S&P 500 is now up 2.6%, the Dow down (0.2)%, and the NASDAQ up 2.2%. Even with the flow of bad news reported in the media --about Iraq, inflation, and interest rates-- stock prices advanced for the second consecutive month. Since there was also good news regarding the continued expansion of the US economy, signs of improved growth elsewhere, and anticipated continued strong US corporate earnings, the net gain for stocks seemed to have some basis in reality.

**BOND RETURNS** (price change plus interest) turned positive in June, after two consecutive down months. These gains occurred even as the Federal Reserve finally began to raise the short-term interest rates it controls from their current historic lows. Since the rate increase had been widely expected, and longer-term bond yields set by the markets had already moved upward during April and May, June's result had reasonable support. Indeed, the WSJ reported (7/1/04, pg. C1) that the manager of the largest mutual fund devoted to bonds was buying five-year US Treasuries, believing that "much of the inflation fear and fed rate rise campaign already is discounted into bond yields, especially among two and five year notes." The weaker than expected employment report for June adds support for this view (see pg. 5).

At the end of June, the benchmark 10-year US Treasury yield was 4.60%, down from May's close of 4.65% and the recent highs of 4.85% reached during mid-May. For June, high quality intermediate-term taxable bonds had returns of 0.6%, while intermediate-term municipal bonds (munis) gained 0.3%. Taxable bonds are now up 0.1% YTD, while munis are down (0.7)%. High Yield ("Junk") bonds also gained, up 1.3% for June and 0.9% YTD.

When analyzing bond returns, it is extremely important to understand that the interest portion of the bond return is earned in small increments each month. By contrast, the price changes of bonds, up or down, can take place in short time frames, and can, at times, be quite substantial. Therefore, significant price changes early in the year can have a distorting influence on YTD bond returns, since the certain positive returns come from interest earned month after month for the full year. Also remember that in the liquid markets, there are only two alternatives to bonds: Money markets and other cash equivalents that have stable prices but very low current interest rates; or stocks, which historically have had far more volatile prices along with their higher returns, and currently provide very little steady income flow.

As we have discussed many times, maturities and credit quality are the key variables for bond prices in times of significant changes in market interest rates. To illustrate, we have set out below the 2004 YTD total returns (interest earned plus/minus price changes) for a variety of the bond and other interest-sensitive investments that we select for our client's portfolios.

	<u>Short</u>	<u>Limited</u>	<u>Intern.</u>	<u>Long</u>	<u>Infl. Prot.</u>	<u>HiYld.</u>	<u>REITs</u>
Treasuries	(0.2)%	NA	(0.2)%	(0.3)%	+1.8%	NA	NA
Corporates	0.2%	NA	(0.2)%	(0.4)%	NA	+0.9%	+5.1%
Mixed Govt/Corp	(0.2)%	NA	0.1%	(0.4)%	NA	NA	NA
Municipals	0.1%	(0.5)%	(0.7)%	(1.2)%	NA	(0.1)%	NA

1) Results for Vanguard funds include income and Vanguard fees but not PPA fees

Stock and bond investment results for June, for 2004 YTD, and for the five years 1999–2003 are set out on page 2. The stock market rally that began in March 2003 has raised the S&P 500 by 47% from the October 2002 low, even with the lackluster returns for the first half of 2004. While these gains have made investors believe again that stocks do not go down in perpetuity (a view that was widely held during the depths of the bear market), the question of whether this recovery will continue is, as always, dependent on unknown future events. (Note also that after a price decline of 50%, it takes a gain of 100% to return to the previous price level).

In order to keep the current recovery in perspective, we continue to show the chart below, which sets out the extent of the declines measured from the highs of Q1 2000. The chart also puts these declines in the context of results since the end of 1994 (see also the figures on page 11). Note that the three indexes have positive average annual returns ranging from 10.0% to 11.1% for the 9.5 year period from the end of 1994 through June 2004, very much in line with long term stock returns going back to 1926. Further, as these returns converge more and more, the idea of “regression to the mean” seems quite applicable.

**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&amp;P 500 (1)</u>		<u>DOW (1)</u>		<u>NASDAQ (1)</u>	
1st Qtr 2000 High	1,527		11,723		5,048	
Year End 2000	1,320	(13)%	10,785	(8)%	2,470	(51)%
April 10, 2001 Low	1,103	(28)%	9,390	(20)%	1,684	(67)%
September 21, 2001 Low	965	(37)%	8,235	(30)%	1,425	(72)%
Year End 2001	1,148	(25)%	10,020	(17)%	1,950	(61)%
October 9, 2002 Low	777	(49)%	7,286	(38)%	1,114	(78)%
Year End 2002	880	(42)%	8,342	(29)%	1,336	(73)%
Year End 2003	1,112	(27)%	10,454	(11)%	2,003	(60)%
June 30, 2004	1,141	(25)%	10,435	(11)%	2,048	(59)%

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

	<u>S&amp;P 500 (1)</u>	<u>DOW (1)</u>	<u>NASDAQ (1)</u>
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. Ann. % Gain, '95-'99; 5 years	26.2%	24.6%	40.2%
June 2004	1,141	10,435	2,048
Gain	682	6,601	1,296
Avg. Ann %Gain, '95-6/04; 9.5 yrs	10.0%	11.1%	11.1%

1) Results for S&P 500, Dow Jones, and NASDAQ indexes do not reflect dividends or PPA's advisory fee.

## I. UPDATE OF KEY ECONOMIC INDICATORS

The strength of the overall US and world economies is one of a number of factors likely to influence the future direction of both stock and bond prices. (Note: We, along with many market observers and academics who write about the markets, believe stock and bond prices already reflect consensus expectations of economic growth.) In any event, an understanding of the direction of current economic trends is useful as a context to help understand market conditions. This section of the Comments provides an update of key economic indicators.

- (1) Gross Domestic Product (GDP) is the broadest measure of goods and services produced in the U.S. economy. (GDP figures are inflation-adjusted, annualized growth rates.) GDP for Q1 2004 was initially estimated at 4.2%, up slightly from the Q4 2003 figure of 4.1%, and well below the 8.2% for Q3 2003, which was a 20-year high. The final figure for Q1 2004 GDP, reported during the week ending 6/25/04, lowered the growth rate from 4.2% to 3.9% (Vanguard Economic Week in Review, "VEWR," 6/21-25/04). The WSJ noted that "these are still relatively strong growth numbers, but the breathless pace of last year seems long ago" (6/30/04, pg. C1).
- (2) Employment for June (reported 7/2/04) grew by 112,000 new jobs, a figure that was well BELOW the consensus estimates of 200,000 to 250,000. This report also reduced the previously reported May increase of new jobs from 248,000 to 235,000, as well as April's increase from 346,000 to 324,000. Whether this is a temporary slowdown of the recent robust pace of job growth, or a more lasting trend, will be hotly debated in the media and the marketplace, and could have significant impact on the closely related issues of inflation and the pace of future interest rate increases.
- (3) Interest Rates declined slightly for the month of June, reversing their sharp two month rise since the end of March. The much anticipated   % increase in short-term rates controlled by the Federal Reserve actually sent the longer term rates set by the markets lower. The benchmark 10-Year US Treasury bond yield closed at 4.60%, down from the May close of 4.66% but still above the April close of 4.50%. April's increase was a huge 0.6% above the March level of 3.9%. This benchmark yield reached as high as 4.85% during May, before falling to current levels.
- (4) Inflation, as measured by The Consumer Price Index ("CPI") "core" rate, which excludes the volatile food and energy sectors, rose 0.2% in May. For the last twelve months, this core rate is 1.7%, still quite low but higher than the historically low annual rate of 1.2% reached a few months earlier. With food and energy included, the CPI increase was 0.6% in May and 3.1% for twelve months; these numbers are far less benign than the core rate figures. Further, the Producer Price Index (PPI) core rate was up 0.3%, with the rate for the last twelve months now at 1.7%. Here again, with food and energy included, the PPI increases were much higher, 0.8% for May and 5.0% for the most recent twelve months (all these figures are set out in VEWR, 6/14-18/04). The WSJ article reporting the PPI figures (6/18/04, pg. A2) commented that "the rise in wholesale prices ....suggests the prices consumers pay for goods probably will move upward in the months ahead" ....and that the report "indicates producers are having success passing higher costs on to consumers."

(5) Sector Economic Activity was Mostly Higher

- (a) Durable goods orders fell 1.6% in May, following a substantial drop of 2.6% in April. These declines in turn followed the largest two-month gains since 1992. The WSJ quoted an economist that “the gains in February and March were so large that if you go back to the beginning of the year, we’re still growing at a pretty strong pace” (VEWR, 6/21-25/04; WSJ, 6/25/04, pg. A2).
- (b) Industrial production rose 1.1% in May, “the largest one-month increase in almost six years,” as capacity utilization rose to “a new three-year high” (VEWR, 6/14-18/04).
- (c) Retail Sales rose in May, and are now almost 10% higher than in May 2003 (VEWR, 6/14-18/04).
- (d) Housing sales for new and existing homes soared in May. Instead of blaming higher interest rates for a slowdown (see April), the May results were explained by citing rising employment and personal income, and “a rush by fence-sitters to buy before mortgage rates rose even more” (WSJ, 6/25/04, pg. A2). (Our comment: Any result has its built-in explanations, which is why we are so skeptical of all the articles on causation for such and such an event).
- (e) Personal Income rose 0.6% in May, while personal spending, which accounts for two-thirds of U.S. economic activity, rose 1.0%, both strong figures (WSJ, 6/29/04, pg. A2).

(6) Consumer Confidence, as measured by the Conference Board’s Index of Consumer Confidence, rose to a two-year high in June, as “the revival of the job market and increases in wages boosted consumer spirits and gave them more money to spend, overwhelming the hit caused by higher energy costs and interest rates” (WSJ, 6/30/04, pg. A1). (Our comment: How will next month’s figures be explained now that June’s disappointing employment figures have come to light?)

(7) Corporate Profits for the first quarter of 2004 were strong. Second quarter profits will begin to be reported during July. Analysts are projecting continued strong earnings growth in excess of 20% (WSJ, 7/1/04, pg. C11), but Price/Earnings (“P/E”) ratios for stocks continue to be closer to 20 than their historical average of 15 (pg. C12).

The economic news for June, while mostly favorable, had some negative features, including the lower-than-expected employment numbers, the decline in durable goods orders, the increase in inflation, and the beginning of the Federal Reserve’s much expected short term interest rate increases. Which of these factors, amongst many others (e.g., Iraq, terrorism, oil prices, presidential election), have and have not been anticipated by stock and bond prices is of course unknown. The debate is well framed by a front page WSJ article (7/2/04), in which a survey of economists projects “steady expansion for the rest of this year,” while at the same time “investors on Wall Street are uneasy about a number of global and domestic developments, among them rising interest rates..., inflationary pressures...and terrorism.” In our view, regardless of the number and weight of predictions and analysis by the so-called pundits and gurus, only the unfolding of actual future events will determine the course of future price movements.

## II. WHAT'S IN YOUR INDEXED INVESTMENTS

“What Lurks Inside Your Index Fund” was the headline of an article appearing on the front page of a recent Sunday New York Times Business Section (6/20/04). The article focused on the fact that the financial sector of the US stock market had grown to 20% of the entire S&P 500 Index, and that “whenever an industry dominated the index, that sector was at or near its peak value and soon began a steep decline.” The author cites as examples the energy sector, which grew to 27% of the index in 1980, and the technology sector, which grew to 28% of the index in 1999. As this article goes to the core of the investments we favor in our management of clients’ assets and the implementation of asset allocations, we think it important to present our views on this subject.

First, some facts about the broad stock market indexes that dominate our client’s portfolios. The list that follows comes from the 3/31/04 Barclays iShares Annual Report, which uses the Russell 1000 Index as representative of the 1,000 largest companies (including all of the S&P 500) by market value (share price multiplied by total shares outstanding); and the Russell 2000 Index for 2,000 companies with smaller market values than those of the largest 1,000. The Russell 1000 sectors, and the largest companies in each sector, are as follows:

- #1 - Financial Services (banks, brokerage, insurance): 23.6%  
 Citigroup, AIG, Bank of America, Wells Fargo, JPMorganChase
- #2 - Technology: 14.5%  
 Microsoft, Intel, Cisco, IBM, Verizon
- #3 - Consumer Discretionary (retail, media, hotels): 14.1%  
 Walmart, Home Depot, Time Warner, Viacom, Comcast
- #4 - Health Care: 13.7%  
 Pfizer, Johnson & Johnson, Merck
- #5 - Consumer Staples (household products, beverages): 7.3%  
 Proctor & Gamble, Coca Cola, Altria (formerly Philip Morris)
- #6 - Utilities: 7.1%  
 Exelon, Southern Co., Dominion Resources
- #7 - Oil and Other Energy: 5.9%  
 Exxon Mobil, Chevron Texaco
- #8 - Other Sectors: each under 4%, combined 13.8%  
 General Electric, 3M

The largest 25 stocks by market value in the US stock market, and their sectors, are as follows: (values as of 12/31/03, in billions of \$):

GE	311	Other	IBM	160	Tech	ChevTex	92	Oil
Microsoft	296	Tech	J&J	153	Health	Dell	87	Tech
Pfizer	270	Health	P&G	130	Cons. St.	SBC	86	Tech
ExxMob	270	Oil	CocaCola	124	Cons. St.	Home Dep	81	Cons. Di.
Citigroup	250	Financial	BofA	120	Financial	Pepsi	80	Cons. St.
Walmart	230	Cons. Di.	Altria	111	Cons. St.	Amgen	79	Health
Intel	210	Tech	Merck	103	Health	Eli Lilly	79	Health
AIG	173	Financial	Wells	100	Financial			

			Fargo					
Cisco	168	Tech	Verizon	97	Tech			

With regard to Small Cap sector analysis (again using the Barclays iShares data from its 3/31/04 Report), the sector mix of the Russell 2000 is as follows (no companies are named because they are likely not to be familiar, as they are all by definition smaller companies with little or no name recognition):

Financial Services	22.5%
Consumer Discretionary	18.9%
Technology	14.1%
Health	13.2%
Materials and Processing	8.6%
Producer Durables	8.1%
Other Combined (each under 4%)	14.6%

Given these facts about the current composition of the broad based indexes, both large cap and small cap, let's examine the article again. It points to the "overconcentration" of financial holdings (in fact, 23.6% of the Large Cap Index) as a problem for the index. The article is essentially suggesting that it makes sense to "market time" the index because of this overconcentration, particularly in a time when interest rates are likely to rise, presumably leading to price declines among the financial stocks. Implementing this market timing decision would lead to either selling the index, or underweighting the financial sector by overweighting other sectors. It is also worth noting that this suggestion comes in the context of the recent outperformance by the financial stocks, which is why the sector has reached its high percentage of the total. But is this suggestion really a good idea, i.e., likely to bring you improved investment results? To answer this question, we need to look at the alternatives available for investing in stocks.

Within the indexing approach to investing, investors can alter their mix of broad based indexes. Broad based indexes include the S&P500 (LargeCap), Midcap, SmallCap, and variations that include these basic three categories in different percentages. Broad based indexes can also be broken down into a Growth style, which emphasizes high P/E (price to earnings) stocks, or Value investing, which emphasizes low P/E stocks. Alternatively, investors can use sector indexes, which provide a convenient way to own specific sectors and not own others. (The sectors available are the ones presented above in the paragraphs discussing sector weightings within the broad based indexes).

It is important to recognize that as investors move away from the broad based indexes to focus on one style or the other, or certain sectors to the exclusion of others, they are essentially actively managing/market timing the stock portion of their investment portfolios, and simply using low cost, tax efficient indexed investments as the vehicle of choice. We do not advocate this sort of activity, as we believe it runs counter to the fundamental reasons for using broad based indexes in the first place. Those fundamental reasons include: (1) no one knows in advance which sector/style will do better than some other sector/style in the future; (2) because markets tend to be priced efficiently most of the time, you are just as likely to make the wrong choice, and buy the sector/style that underperforms going forward, as you are to pick the correct sector/style that does better; and (3) additional transactions increase

costs and tax consequences (in taxable accounts), negating some of the built-in advantages of indexes.

The alternative to indexing is to actively manage your stock allocation, which can include picking individual stocks that you and/or a professional manager believe will outperform the market and/or other stocks that could be chosen; or picking mutual funds with the objective of outperforming the market and/or other funds. Given that actively managed mutual funds typically charge expenses 1% to 1.5% more than indexed funds, if long term stock returns continue to average 10%, then active management by definition costs an additional 10% to 15% of the hoped-for return. That is, you need to believe your choices will outperform the market by 10% to 15% to cover the additional costs. The only time you do not incur these costs is when you pick your own stocks, because picking actively managed mutual funds, even by yourself, will cause you to incur these costs by way of management fees charged by the funds. Do you really have the information/inclination to compete against the professionals and pick individual stocks?

Perhaps the biggest flaw in the idea of active management is the belief that past performance of a stock, or fund, or manager, is a reliable indicator of its/his/her future performance. To the contrary, the academic studies indicate superior past performance does not persist. Instead, most performance regresses to some long term average return, which then falls below the market's return because of the drag of costs (see Malkiel, "A Random Walk Down Wall Street;" Bogle, "Common Sense on Investing;" Bernstein, "Against the Gods, the Remarkable Story of Risk;" Paulos, "A Mathematician Plays the Stock Market.>"). While there is no doubt that at any given time there are stocks/funds/managers that do outperform the market, the real trick is to identify the outperformers in advance of their period of outperformance. It is this trick that has proven so elusive to most investors.

Returning for a moment to the performance of the indexes, the Barclays Report informs us that for the large cap Russell 1000, the technology and financial sectors were the best performers for the year ending 3/31/04. For the small cap Russell 2000, on the other hand, the outperforming sectors were technology, materials and healthcare, with financials actually cited as a lagging sector. Furthermore, the small cap stocks in general greatly outperformed the large caps, even during a period where large cap stocks as a category rose 36%. Does any of this information provide any meaningful insight as to the future performance of anything? We think NOT!

Finally, we return to the question posed in the NY Times article: Is the S&P 500 index's overconcentration in the financial sector a problem? We know only the future can give us the definitive answer to this question. Since the likely upward move in interest rates has been well publicized, perhaps the markets have already priced in the impact of at least the expected interest rate increases. Further, perhaps the financial sector will do better than other sectors (rather than worse) because the future turns out differently than the conventional wisdom. In sum, the same objections to market timing in general apply to the implicit market timing suggestion of the Times article.

### **III. HOUSING AS AN INVESTMENT**

Throughout the bear market for stocks covering 2000-2002, the rising stock market of 2003, and the flat stock market of the first half of 2004, housing prices have only risen. In a separate section devoted to Real Estate in the Wall Street Journal (6/14/04), this recent past performance, and the likelihood of its continuation into the future, is discussed at length in a cover story "The New Housing Reality."

The article begins by stating that "in the past five years, home prices nationwide have climbed an average of more than 40%,...and more than 75% in some areas, including Boston, suburban New York, and San Diego. Homeowners have tapped that equity to take vacations, buy second homes, and build up their nest eggs. They have counted on rising home prices to bolster their future -- and shore up their present." The article then continues, somewhat ominously, "But now homeowners have to face a new reality: The party can't last forever." Since housing values make up substantial parts of many of our client's total asset mix, it is worth reviewing the factors presented as possibly slowing down, and perhaps even reversing, what seems to be the latest "sure thing," i.e. ever-increasing home prices.

The article begins its discussion of key factors by citing the close connection between housing prices and personal incomes. From 1980-2001, median incomes in the US rose 138%, and housing prices rose 136%. The immediate problem for housing prices, according to the article, is that in the shorter time frame of 1996-2003, incomes have risen by 22%, while housing prices have risen by 47%. The disparity is even greater in some of the most popular locations cited above. The problem is that "if home prices grow faster than incomes, houses will then become unaffordable, and that will force a slowdown in price appreciation until the market balances out."

The next factor discussed is the exceptionally low interest rates that have prevailed recently. Since most home buyers use mortgage financing, low interest rates make the monthly payments lower, thereby encouraging buyers to pay higher prices. If, as many believe, rates are about to move higher, this could be another reason for the growth of home prices to slow.

Another factor discussed is the aging population, and the fact fewer households are being formed currently. But the article concedes that the older population has a variety of impacts on housing demand, some positive and some negative. Other factors discussed include immigration trends (more people adds to demand), the availability of credit (easier credit adds to demand), and the ease, or lack thereof, of building new homes in specific areas (restrictive zoning limits supply and tends to raise prices).

On page R8 of the same section there is a debate between two experts, one contending that the housing price run-up cannot last, the other arguing for the continuation of the price run-up. The key points raised: The housing "bear" argues that loose credit and low interest rates have allowed purchases to be made at very high prices, and that as these conditions change, mortgage defaults will increase and prices will decline. The "bull" on housing prices stresses that supply is tight in most areas, and that rising interest rates are accompanied by stronger economic growth, a plus for housing prices. Only the future will tell us which arguments were more correct. We believe that, as with all markets, prices do not rise at extraordinary rates indefinitely, and "regression to the mean" is a powerful force in pricing.

**S&P 500 (1)**

**DOW JONES (1)**

**NASDAQ (1)**

1) Results for S&P 500, Dow Jones, and NASDAQ indexes do not reflect dividends or PPA's advisory fee.

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

<b>Start of 2000</b>	1,470		11,500		4,070	
<b>End of 2000</b>	1,320	(10.1)%	10,785	(6.2)%	2,470	(39.3)%
<b>Sept. 21, 2001 <u>Low</u></b>	965	(34.3)%	8,235	(28.4)%	1,425	(65.0)%
<b>End of 2001</b>	1,148	(21.9)%	10,020	(12.9)%	1,950	(52.0)%
<b>Oct. 9, 2002 <u>Low</u></b>	777	(47.1)%	7,286	(36.6)%	1,114	(72.6)%
<b>End of 2002</b>	880	(40.1)%	8,342	(27.5)%	1,336	(67.2)%
<b>End of 2003</b>	1,112	(24.3)%	10,454	(9.1)%	2,003	(50.8)%
<b>June 2004</b>	1,141	(22.2)%	10,435	(9.3)%	2,048	(49.7)%

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

<b>Start of 1995</b>	459		3,834		752	
<b>End of 1999</b>	<u>1,470</u>		<u>11,500</u>		<u>4,070</u>	
<b>5 Year Gain; Annualized %</b>	1,011	26.1%	7,666	24.6%	3,318	40.2%
<b>End of 2001</b>	<u>1,148</u>		<u>10,020</u>		<u>1,950</u>	
<b>7 Year Gain; Annualized %</b>	689	14.0%	6,186	14.7%	1,198	14.6%
<b>End of 2002</b>	<u>880</u>		<u>8,342</u>		<u>1,336</u>	
<b>8 Year Gain; Annualized %</b>	421	8.5%	4,508	10.2%	584	7.5%
<b>End of 2003</b>	<u>1,112</u>		<u>10,454</u>		<u>2,003</u>	
<b>9 Year Gain; Annualized %</b>	653	10.3%	6,620	11.8%	1,251	11.5%
<b>June 2004</b>	<u>1,141</u>		<u>10,435</u>		<u>2,048</u>	
<b>9.5 Year Gain; Annualized %</b>	682	10.0%	6,601	11.1%	1,296	11.1%



**Victor Levinson**



**Nicholas Levinson**