

JULY 2002 COMMENTS: INDEX RESULTS, period ending July 26, 2002

	<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>MONTH</u>
S&P 500	19.6%	(10.1)%	(13.0)%	(25.7)%	(11.9)%
S&P 500 Growth	28.8%	(22.2)%	(13.0)%	(25.7)%	(8.7)%
S&P 500 Value	12.6%	6.1%	(12.0)%	(24.8)%	(15.3)%
Dow Jones	25.2%	(6.2)%	(7.1)%	(17.5)%	(9.7)%
NASDAQ Comp.	85.6%	(39.3)%	(21.0)%	(35.3)%	(10.3)%
Ext/MidCap US	25.0%	2.6%	(4.8)%	(19.7)%	(13.7)%
Small Cap US	19.6%	(4.2)%	1.0%	(20.7)%	(16.5)%
Intl, EAFE	25.3%	(15.2)%	(22.6)%	(13.7)%	(12.6)%

BONDS, Interm.

Taxable	(0.8)%	11.3%	8.3%	3.4%	0.6%
Tax-Exempt	(2.9)%	9.2%	5.0%	5.7%	1.3%

	<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>1Q</u>	<u>2Q</u>	<u>3Q</u>	<u>4Q</u>
S&P 500	0.0	(13.8)		
NASDAQ COMP	(5.5)	(19.5)		
BONDS: Interm. Taxable	0.0	2.8		

JULY 2002 COMMENTS

The month of July 2002 provided the worst monthly results for the major US stock market indexes (S&P 500 down 11.9%, Dow Industrials down 9.7%, and NASDAQ Composite down 10.3%) since the October 1987 "Crash" (S&P 500 down 21.5%) and the August 1998 decline (S&P 500 down 14.5%). (See pages 3 and 4 for details on these declines, and the recoveries that followed). Other double digit monthly declines since the 1960s occurred in March 1980 (down 10.0%), November 1973 (down 10.8%), and September 1974 (down 11.7%). Also, during 1962, there were three consecutive monthly declines aggregating to more than 20%. The history of all these stock market declines is that they have been followed by recoveries (see our Special Mid-July Comments, mailed last week and attached hereto).

Figures for the year 2002 are on page 1 of these Comments, and figures covering longer-term results ending with July 2002 are on page 9.

The problems driving the current bear market are formidable, ranging from terrorism, to accounting scandals, to reduced corporate profits, to the declining value of the dollar, to stock price to earnings (P/E) ratios still considered excessive (see pages 6-8 for a discussion of P/E ratios). But the stock market history of recoveries from prior declines includes overcoming financial events such as the stock market crash of 1929, the world wide depression of the 1930s, the Savings & Loan failures of the 1980s, and Russia's debt defaults of the late 1990s; World War II, subsequent wars in Korea, Vietnam, and Iraq, and various Mideast wars involving Israel; political events such as Kennedy's assassination, Nixon's resignation, Clinton's impeachment, and the contested presidential election of 2000; and many lesser crises that appeared significant while they were occurring.

One key point about stock price declines is that at some price level stocks become inexpensive, bringing out buyers looking to benefit from the low prices. As the history indicates, the recoveries from low price levels can be dramatic. Unfortunately, it is only after the fact that it can be determined with certainty when that sufficiently low price level was reached.

Another key point is to relate the history of declines and recoveries to your specific circumstances, and your allocation to stocks. If you have sufficient capital to meet all your financial objectives over your lifetime by earning 3-4% after taxes on the capital, then your exposure to stocks can be quite limited (e.g., 20% or less). But if you need higher long-term investment returns to meet your objectives, then a greater exposure to stocks is necessary.

Investing to meet future financial goals requires a long-term time horizon. Increased life expectancy is a major planning issue, as people routinely live into their mid 80s and beyond. People in their 60s and 70s need to use decades as their time horizon, not months or years. For this reason, the historical record of stocks from 1926 through 2001 --which have outperformed bonds, 10.7% to 5.34%, in average annual returns, and have had essentially no ten-year periods of negative returns (see page 3) --needs to be taken into account in developing and maintaining an appropriate exposure to stocks as part of your overall asset allocation. This point is true even, and perhaps especially, in times of major stock price declines, given the history of recoveries and the significant long-term outperformance of stocks over other liquid investment alternatives.

Since our fundamental approach to investing is to focus on the long-term, using an asset allocation of stocks, bonds and cash appropriate to your circumstances, it is worth looking at 10-year time frames of stock performance (Source: Ibbotson, Large Cap US Stocks, most recently the S&P 500...see mid-July Comments for full reference). The figures are the average annual percentage returns earned within each ten-year period (except for the shorter periods of 1926-29 and 2000-02).

1926-29	+ 19.2%	1960s	+ 7.8%
1930s	-(0.1)%	1970s	+ 5.9%
1940s	+ 9.2%	1980s	+ 17.5%
1950s	+ 19.4%	1990s	+ 18.2%
2000-02 (through July 26, 2.6 years) -(19.0)%			

In only the ten-year period of the 1930s was there an average annual negative return, and it was a mere negative 1/10 of 1%. The historical details of that decade are presented in our Mid-July Special Comments. All other ten-year periods had positive returns, in a range of +5.9% to +19.4%. (Note: S&P 500 figures include dividends as part of total return, whereas the often-cited Dow Jones Industrials reflect only price changes). So if history holds true to form, there is simply no precedent for negative annual returns over any ten-year period, or any longer time period. As we quote in our summary of Professor Jeremy Siegel's recent Wall Street Journal article on pages 7 and 8 of these Comments, he concludes: "History is definitive that once investors have suffered this much pain, subsequent stock returns will be very rewarding."

WHY NOT USE STRATEGY OF MARKET TIMING?

But what about selling now, as prices are declining, and buying back later, when the recovery takes place? This is another way of saying you, or someone out there with an opinion on this subject, can be a successful MARKET TIMER. The basic idea of market timing is to be out of the markets when they are declining, and to come back in when they are rising. The problem with market timing is that you might miss some or all of a recovery before buying back the stock positions sold during the decline.

To evaluate whether market timing can be done successfully, let's examine a number of the recent periods of stock market declines and recoveries, to see whether anyone could reasonably anticipate what eventually occurred. Let's start with the Crash of 1987 and its aftermath. (Stock figures are for the S&P 500 Index of Large Cap U.S. Stocks).

Crash of 1987 and Its Aftermath:

During the first nine months of 1987, the stock market gained over 30%, following the years 1982-1986 when the average annual return exceeded 20%. (Sound familiar? During the 1995-1999 period, average annual returns exceeded 25%). Then came the October 1987 crash, with stocks down 21% for the month, followed by another 8% decline in November. Time to sell? Not based on subsequent events, because following the two-month, 30% decline, stocks gained more than 7% in December 1987, then 17% in 1988, and 31% in 1989. After a modest 3% decline in 1990, stocks had nine consecutive years of positive returns, capped by the great Bull Market of 1995-1999.

Decline of 1990 – Iraq Invades Kuwait; U.S. Recession:

During August and September of 1990, stocks declined 15%. Time to sell? No again, as stocks rose 9% in the fourth quarter (the full year ended down 3%), and then increased substantially during the remainder of the 1990s, as cited above.

Declines of 1997 and 1998:

In the middle of the great Bull Market of 1995-1999, there was a 5% decline in August 1997, and a 14% decline in August 1998. Even with these declines, stock prices increased by 33% and 28% for the full years 1997 and 1998, respectively. Clearly, selling after these declines would have been a mistake. The 1998 decline was triggered by the failure of the large investment fund Long Term Capital and Russia's default on its bonds. The media reporting at the time would have led you to believe that the world was coming to an end. But since stocks rose 28% in 1998, and another 21% in 1999, selling during the August 1998 crisis would not have been advantageous.

Bear Market of 2000-2002:

2000 - First 9 months were flat, 8% decline in November, and 9% for the full year. Was this a convincing enough decline, at the time, to think that the stock market would not come back as it had during the prior declines starting with the 1987 crash?

2001 - First Quarter, down 12% Third Quarter, down 14% (including 9/11/01)
Second Quarter, up 5% Fourth Quarter, up 10%

Total year down 12%. The 10% increase in the fourth quarter appeared at the time to be a positive sign for stocks. Remember, the fourth quarter was dominated by the recent tragedy of 9/11 and fears of continuing terrorist attacks.

2002 - First Quarter, flat
Second Quarter, down 14%
July, down an additional 12%

Now, any prior sale looks good. But who would have expected these declines after the fourth quarter of 2001 and the first quarter of 2002? And the really key question is, what happens from here?

If more declines are coming, then sales now would obviously be advantageous, **as long as you are able to buy back before prices increase beyond your selling point** (assuming a recovery in stock prices in our future). Can this be done successfully? Perhaps in the abstract, but it is extremely difficult to implement given current volatility levels, both up and down.

The point of reciting all this recent history of periodic declines followed by subsequent increases to new highs is to highlight the difficulty of picking when to sell and when to buy back. Who would have expected the Crash of 1987 to give rise to substantial increases in so short a time, or for the damaging months during 1990, 1997, and 1998 to dissipate so quickly into record breaking increases? But they all did. Since 1973-1974, only during the most recent late-2000 to July 2002 period have declines been followed by declines, rather than recoveries. And the 1973-74 decline was followed by two years of recoveries that brought the market back to, and then above, where it had been prior to the declines.

So unless you know when to buy stocks back, it doesn't make much sense to sell your stocks now unless you believe that the stock market's history of positive returns, outperformance compared with bonds and cash, and recoveries from declines is going to be reversed by today's bad news. If your allocation to stocks is correct (and it should be, based on our work with you), the idea is to live through the declines, remain invested so as to take advantage of the recoveries, and not despair at the day-to-day bad news.

Furthermore, by selling stocks now, you would be locking in losses at a time of very low interest rates (and high bond prices), when the safe alternative investment of short- and intermediate-term US Treasury bonds yields less than 4%. (See the one-page addendum for another alternative, which we do not recommend). By maintaining the stock portion of your portfolio, you are at least in position to earn more when stocks do recover. Of course the recovery has to occur in a time frame relevant to us. But as longevity increases, the need for annual investment returns in excess of 4% becomes apparent, and most of our time frames for needing to use our investment money are likely to be longer rather than shorter than we think.

INVESTING WITH INDEXES

A number of clients have raised questions as to whether investments based on the S&P 500 index, which are a core stock position for all our clients, contained such stocks as Enron and Worldcom. The answer is yes. An explanation of how stocks become part of an index (specifically the S&P 500), and how indexes are compiled and valued, should prove helpful in understanding the actual impact of the Enron and Worldcom "blowups" on your investments.

The S&P 500 is an index of 500 of the largest U.S. companies (the few non-U.S. based companies in the index are being removed). S&P is Standard & Poors, a financial information company, and there is a group within S&P that selects the stocks that make up the index. This group does not base its decisions on earnings prospects, or news, or analysis. The index is passively managed, and market value is the key criteria for inclusion and/or removal (see next two paragraphs for more detail). Otherwise, stocks stay in the index, for better or worse.

The basic criterion for inclusion in the index is the size of a company, with size measured by market value (also referred to as market "cap", short for capitalization). Market value is determined by multiplying the price per share of a company's stock (which is constantly fluctuating), by the number of shares outstanding (a figure that stays relatively constant, aside from such events as stock splits and new stock issuances, which would include issuance on the exercise of stock options. Accounting for stock options is becoming a major issue in its own right, but that is a discussion for another day).

Any company with a market cap that exceeds \$5 billion will certainly be in the S&P 500. Some companies with lower market caps will also make the list. S&P tries to have the various market sectors --such as financial, technology, and healthcare, among others-- adequately represented by individual companies in those sectors. In fact, when technology stocks were rising in value in the late 1990s, S&P increased the technology component of the index from 14% to 18%, to reflect the then-increasing values of companies in that sector. You can see that this methodology tends to add stocks as they are rising in value (i.e., price).

Here are some real numbers to illustrate these points. At the end of 1999, at close to the height of the Bull Market, Microsoft's stock price was over \$110 per share and General Electric's (GE) stock price was over \$50 per share. Factoring in the number of shares outstanding, Microsoft's market value was \$600 billion and GE's \$500 billion. Since the S&P 500 index at the time had a market valuation of \$11.3 trillion, these two companies alone represented 10% of the entire index. Since reaching these highs, both of these well-respected companies have declined in value by more than 50%, or a combined dollar amount in excess of \$500 billion. These declines have reduced the value of the S&P 500 by approximately 5%.

Now let's go back to Enron and Worldcom. When they were small companies, they were not in the index. As they grew in market value, they were included, and as their value increased, they were part of the increase in the value of the index. At their all time highs, Enron and Worldcom had market caps of \$65 billion and \$120 billion, respectively. They remained in the index until their values fell so low as to be eliminated, but by then the damage had been done. Assuming that all \$185 billion of the combined market value of Enron and Worldcom at their highs was lost while the companies were included in the index, the loss would amount to a decline of less than 2% of the S&P 500 from its highs, whereas the decline attributable to Microsoft and GE, as described above, has been over 5%. The significant difference between Microsoft and GE, and the Enron-Worldcom duo, is that Microsoft and GE continue to function, with the opportunity to be part of the stock market's hoped-for recovery. Enron and Worldcom, on the other hand, having filed for bankruptcy, cannot be part of a recovery.

For the record, the 20 largest companies currently in the S&P 500 index, amounting to 36% of its total value, are GE, Microsoft, ExxonMobil, Walmart, Pfizer, Citigroup, AIG Insurance, Johnson & Johnson, Coca Cola, Intel, IBM, Procter & Gamble, Bank America, Cisco, Royal Dutch, Merck, SBC, Verizon, Philip Morris and ChevronTexaco.

ISSUE OF PRICE/EARNINGS (P/E) RATIOS

In the current stock market environment, there are two separate, interrelated issues regarding Price/Earnings ratios. The first issue is whether stock prices (the "P") are still too high relative to underlying corporate earnings (the "E"). The second issue is whether the earnings are being reported properly, i.e., can the earnings figures be trusted. This is the accounting credibility issue, which, in different ways, has already brought down both Enron and Worldcom.

First, let's review the idea of the P/E ratio, which is the investment community's way of relating a company's stock price to its earnings, or profits. A company that earns \$1 billion, with 1 billion shares outstanding, has earnings of \$1 per share. If the company's stock price is \$15 per share, the P/E ratio is 15; if the company's stock price is \$30 per share, the P/E ratio is 30. Just as an individual company's stock has a P/E ratio, so too a stock index has a P/E ratio, made up of the combined prices and earnings of all the companies in the index. Companies with high P/E ratios are expected to increase their earnings fast enough to justify the high P/Es. These expectations have given rise to a number of the current accounting scandals.

The problems presented by these accounting scandals, and the issue of how much of the reported profits are real, is beyond the scope of these Comments. We have no way of knowing how many other serious accounting problems exist, or to what extent the current efforts at accounting reform are going to impact future earnings reports. At the end of the day, we believe these problems are capable of being solved, as have all the other problems that in prior times led to stock market declines and eventual recoveries of stock prices.

The issue we would like to address is the one concerning whether stock prices are still too high relative to earnings. Unfortunately, many different earnings measures are used to support various answers to this issue. In the current environment of controversy over even acceptable accounting practices (e.g., expensing stock options, adding as income estimated future returns of pension plans), the appropriate earnings figures to use are difficult to determine. Indeed, this difficulty appears to be one very important reason for the magnitude of current stock price declines.

While some analysis is based on stock prices in relation to the most recent twelve-months of earnings (i.e., actual past earnings), most analysis uses anticipated or expected earnings over the next twelve months (i.e., estimated future earnings). This makes sense since the stock market purports to be a forward-looking pricing mechanism, always trying to sort out what is likely to happen in the future. There are firms that survey analysts at major Wall Street firms for their estimates of future earnings, and create "consensus" figures based on all the responses. However, given the current criticism of the entire Wall Street analyst community, we decided to look elsewhere for earnings information sources we believed to be credible.

We would like to focus on two recent articles from the Wall Street Journal, one from the 7/15 edition written by Arthur Laffler, a highly regarded economist, the other from the 7/25 edition written by Jeremy Siegel, a Wharton School Professor and author of "Stocks for the Long Term". Laffler's article uses earnings data compiled by the Department of Commerce's Bureau of Economic Analysis, which he writes is "the best profits data available," and which presents "data virtually unaffected by all the flim-flam financial accounting practices." The article proceeds to discuss a methodology for "capitalizing these profits in order to estimate the appropriate market value of U.S. corporations," and presents a chart that compares, since 1970, these capitalized profits with actual stock prices. The chart shows lengthy periods when profits and stock prices moved closely together, and other times when market prices either rose much faster than profits (e.g., the late-1990s, indicating an overbought stock market), or fell well below the level of profits (e.g., the mid-1970s, when a severe two-year bear market was followed by two years of recovery). For today, Laffler concludes, "for those who like price/earnings ratios, the conclusion is simply that stock prices are uncommonly low when compared to bond prices and properly reported corporate profits.... The bottom line is that stock prices are currently substantially undervalued..., and the pessimism prevalent today is entirely

The Siegel article starts with what he thinks are the causes of the current Bear Market, even in the face of “the real economy doing far better than almost anyone had expected following the September 11th terrorist attacks.” He cites two reasons: “lack of dividends and disbelief that the earnings reported by firms are real and can substitute for this cash return. In past bear markets, the dividend yield served as a natural cushion for falling stocks...and...investors would buy when stocks fell to levels where the dividend yield became attractive.” He continues that in the late 1990s, dividend yields fell to near zero and stock prices depended solely on earnings; now that faith in earnings has been undermined, and with dividend yields so low, stocks have fallen hard. After reviewing the various reasons for the decline of dividends and ascent of earnings as the key driver of stock prices, Siegel continues by citing a new, rigorous standard of earnings, referred to as “core earnings,” devised by Standard & Poors with the help of Warren Buffett and highly regarded academics and accountants. Using an earnings estimate for the next twelve months made by macroeconomists (not Wall Street analysts), and adjusting this estimate to arrive at core earnings, Siegel writes that the S&P 500 P/E ratio is 18. He notes that while this is a higher P/E than the average of 15 over the past 50 years, “that average is not measured against the gold standard ‘core earnings’ definition.” Furthermore, his research “suggests that the proper P/E level...given low transaction costs, low inflation, and favorable capital gains rates, should be in the low 20s, not 15.”

Siegel then presents the history of the stock market over the past 100 years, and writes that “after the market has dropped by 40%, subsequent five-year returns have averaged 8.6% per year above inflation, and none has been negative.” He adds that subsequent longer-period returns have all also been above the 7% long-run average real return on stocks. (Our note: ‘real’ returns refer to the returns above the average annual rate of inflation, which has been approximately 3%). Siegel then compares these returns with the likely returns from long-term bonds, whose annual returns since 1982 now exceed the 8.4% average annual return from stocks since 1982. These bond returns are the result of a period when yields fell from 14% to the current 4%, and he states that “it is mathematically impossible for bonds to repeat these returns over the next decade.” The article concludes: “By the toughest definitions of earnings, the prices of stocks are now more than reasonable. History is definitive that once investors have suffered this much pain, subsequent stock returns will be very rewarding.”

Of course the anticipated earnings may not materialize, particularly if the economy weakens, due in part to reduced spending by consumers and reduced investments by businesses caused by the sharp decline in stock prices. But these issues are considered in the process of generating anticipated earnings, and are part of the reason for the current high level of uncertainty. Our current conclusions to the issue of “still too high P/Es” are that (i) P/Es are certainly much lower now than they have been, and (ii) if the anticipated earnings do materialize, the current P/E level is not likely to be considered too high for very long.

	<u>S&P 500</u>		<u>Dow</u>		<u>NASDAQ</u>	
<u>I. Figures From Period Starting 2001 (% Figures Are Declines From 1/01/01)</u>						
Start of 2001	1,320		10,785		2,470	
Sept. 21, 2001 <u>Lows</u>	965	(26.9)%	8,235	(23.7)%	1,425	(42.3)%
End of 2001	1,148	(13.0)%	10,020	(7.1)%	1,950	(21.0)%
July 26, 2002 (New Lows)	853	(35.4)%	8,264	(23.4)%	1,262	(48.9)%
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<u>II. Figures From Period Starting 2000 (% Figures Are Declines From 1/01/00)</u>						
Start of 2000	1,470		11,500		4,070	
End of 2000	1,320	(10.1)%	10,785	(6.2)%	2,470	(39.3)%
End of 2001	1,148	(13.0)%	10,020	(7.1)%	1,950	(21.0)%
Two Years		(21.8)%		(12.8)%		(52.0)%
July 26, 2002	853	(42.0)%	8,264	(28.1)%	1,262	(69.0)%
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<u>III. Figures From Period Starting 1995 (% Figures Are Gains From 1/01/95)</u>						
Start of 1995	459		3,834		752	
End of 1999	1,470		11,500		4,070	
End of 2001	<u>1,148</u>		<u>10,020</u>		<u>1,950</u>	
5 Yr Gain; Anlzed % Gain	1,011;	26.2%	7,666;	24.6%	3,318;	40.2%
7 Yr Gain; Anlzed % Gain	689;	14.0%	6,186;	14.7%	1,198;	14.6%
July 26, 2002	<u>853</u>		<u>8,264</u>		<u>1,262</u>	
7yr&7mo Gain; Anl % Gain	394	8.5%	4,430	10.6%	510	7.0%
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