

VICTOR LEVINSON

NICK LEVINSON

AUGUST 2003 COMMENTS

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**INVITATION TO A BOOK READING BY TOM LEVINSON
SATURDAY, SEPTEMBER 20, 2003, 5:30 – 7:30 PM
AT 92ND ST "Y"; 92ND STREET and LEXINGTON AVE, NEW YORK CITY**

In the third major event of 2003 for the Levinson family, Tom Levinson has written the newly released book entitled "All That's Holy {A Young Guy, An Old Car, and The Search For God In America}". Tom will be reading from the book at the time and place above, and you are invited to attend. Please let Vic know if you are planning to attend. We have begun to read the book. It is excellent (how biased can we be?).

"Tom Levinson's entertaining and erudite stories of conversations with the faithful and the seeking get to the heart of religion in America today. *All That's Holy* is a fascinating conversational collage set against the backdrop of the author's deepening appreciation – both intellectually and spiritually – of his own religious roots." (Back cover of book).

If you read this far, the other two major family events for 2003 were the birth of Nick's third son (February), and Tom's marriage (May).

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 August 29, 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)%	18.2%	2.3%
S&P 500	19.6%	(10.1)%	(13.0)%	(23.4)%	14.6%	1.1%
S&P 500 Growth	28.8%	(22.2)%	(13.0)%	(23.7)%	16.1%	1.8%
S&P 500 Value	12.6%	6.1%	(12.0)%	(20.9)%	16.6%	1.2%
Dow Jones Industrials	25.2%	(6.2)%	(7.1)%	(16.8)%	12.9%	1.6%
NASDAQ Comp.	85.6%	(39.3)%	(21.0)%	(31.5)%	35.6%	6.0%
MidCap US	25.0%	2.6%	(4.8)%	(16.3)%	19.9%	5.6%
Small Cap US	19.6%	(4.2)%	1.0%	(21.6)%	28.9%	7.3%
Intl, EAFE	25.3%	(15.2)%	(22.6)%	(17.5)%	16.5%	2.4%

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

Taxable	(0.8)%	11.3%	8.3%	8.2%	1.1%	(0.8)%
Tax-Exempt	(2.9)%	9.2%	5.0%	7.9%	1.1%	(0.3)%
High Yield Taxable				1.7%	9.6%	(0.2)%

	<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)%	12.8%		
NASDAQ COMP	(5.5)	(19.5)	(13.5)	7.0	2.5%	19.2%		
BONDS Interm. Taxable	0.0	2.8	3.6	1.8	0.9%	2.7%		

AUGUST 2003 COMMENTS

During the August period ending Friday, August 29, **STOCK PRICES** increased for the sixth consecutive month. For the period, the S&P 500 was up a modest 1.1%, and is now up 14.6% year-to-date; the Dow Industrials were up 1.6%, and are up 12.9% year-to-date; and the NASDAQ Composite gained 6.0% for the period, and is now up 35.6% year-to-date.

While the year-to-date percentage increases are considerable, it should be remembered that after a decline of a certain percentage, the percentage increase required to regain the amount of the decline is a much higher number. For example, the S&P 500's decline from the year 2000 high of 1,527 to the October 2002 low of 777 was 49%. Such a loss would require a gain of 750, or 97%, to return to 1,527. In the case of the NASDAQ Composite, the decline from the year 2000 high of 5,048 to the October 2002 low of 1,114 was 78%, and requires a gain of 3,934, or 353%, to return to 5,048. Figures on page 4 make this point clearly: the S&P 500 at 1,008 has gained 231 points, or 30% from its October 2002 low, but is still 519 points, or 51%, away from its previous high; and the NASDAQ Composite at 1,810, up an impressive 696 points, or 62%, from its October 2002 low, is still 3,238 points, or another 179%, away from its previous high.

Stock price gains appear to be reflecting the moderately improving economic fundamentals in the US economy (see pages 5-6), but see also the discussion on pages 7-9 regarding, in part, the difficulty of attributing specific causes to the movements of stock prices.

BOND RETURNS (price change plus interest) continued to decline during the August period, in which high-quality intermediate-term taxable and tax-exempt bonds declined by (0.8)% and (0.3)% respectively. Year-to-date, returns for taxable and tax-exempt bonds have shrunk to the same positive 1.1% figure. The economic improvement that appears to be helping stock prices has created conditions for rising interest rates, which in turn causes existing bond prices to decline. While the August price declines were less than those in July, bond prices continue under pressure after three years of excellent results.

Stock and bond investment results for the July period, for 2003 year-to-date, and for the four full years 1999–2002 are set out on page 2. Note how this year's stock gains to date, the first strong year for stocks since 1999, have been accompanied by a reversal of the bond market's 2000-2002 outperformance.

The stock market rally of 2003 has now extended to six consecutive months, during which time the S&P 500 has gained 19.5%; the increase from the 2002 low has now reached 30%. Whether this recovery turns into a new, sustained bull market is of course dependent on future events.

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 10). Note that all three indexes have positive average annual returns of 9.5% to 10.9% from the end of 1994 through August 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)%
August 29, 2003 Close	1,008	(34)%	9,416	(20)%	1,810	(64)%

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 8/29/03	<u>1,008</u>	<u>9,416</u>	<u>1,810</u>
Gain	549	5,582	1,058
Avg. Annual % Gain, '95-8/29/03	9.5%	10.9%	10.6%

I. UPDATE OF KEY ECONOMIC INDICATORS

The strength of the overall U.S. and world economies is one of a number of factors likely to influence the future direction of both stock and bond prices. (Note: Many market observers believe stock and bond prices already reflect consensus expectations of economic growth; this point is a key part of the discussion on pages 7-9).

In any event, an understanding of the direction of current economic trends is useful as a context to help understand market conditions, and this section of the Comments will provide an update of key economic indicators.

- (1) Gross Domestic Product is the broadest measure of goods and services produced in the U.S. economy. The most recent quarterly figures ending June 30th were favorable, showing annualized growth of 3.1%. The previous two quarters had each shown much slower growth of 1.4%. Some projections for the second half of 2003 call for even stronger growth. "Many experts view the combination of a drawdown in business inventories and a sharp increase in corporate profits as a catalyst for solid economic growth." (Sources: Wall Street Journal "WSJ", Aug 29, 03 pg A2; Vanguard Economic Week in Review "VEWR", Aug. 25-29, 03).
- (2) Employment continues to be the weakest spot in the economic recovery scenario. Unemployment remains at 6.2%, a nine year high. However the four-week moving average of initial unemployment claims has fallen below 400,000, which is a favorable trend for more strength in employment (WSJ, Aug 29, 03 pg A2). "The positive effects of fewer claims may take time to filter through to the nation's unemployment rate, given that the number of filings continues to be stubbornly high, gains in worker productivity continue to be resilient, and businesses seem intent on keeping spending in check." (VEWR, Aug.18-22, 03).
- (3) Interest Rates have risen over one full percentage point (100 basis points) since their early June lows. The benchmark 10-Year U.S. Treasury now yields 4.45%, and average 30-Year Fixed Rate Mortgages have risen to 6.22% from their June lows of 5.0% (10-Year U.S. Treasuries, VEWR, Aug 25-29 03; 30-Year Mortgage Rates, WSJ 8/28/03, pg. D2). Interest rates are a double-edged sword; they are both a significant cost to borrowers, and an important source of income to lenders.

Conventional wisdom suggests that low interest rates stimulate economic activity, while higher rates can act to slow growth. The real issue for now is whether the recent increase in rates, up from rates that had declined to historic lows, will prove to be easily absorbed, or act to slow future growth. While many observers believe current rates should not be a problem, the pace of future increases, driven by accelerated economic activity and/or a growing and significant U.S. budget deficit, could provide a real cause for concern.

- (4) Inflation remains under control. The Consumer Price Index (CPI) and Producer Price Index (PPI) both rose 0.2% (2/10 of 1%) in July, and the twelve-month CPI was a modest 1.5% (VEWR, August 11-15, 2003).
- (5) Sector Economic Activity is Improving
 - (a) Durable goods orders were up significantly in July (WSJ, 8/27/03, pg. 2).
 - (b) Industrial production and manufacturing activity were higher in July (VEWR, August 11-15, 2003).
 - (c) Retail Sales were also higher for July, and up over 5% from July 2002 levels (VEWR, August 11-15, 2003).
- (6) Consumer Confidence was higher in August, which also tends to be a positive for future growth. However "lingering doubts about employment prospects", provided a cautionary note in the consumer confidence survey (WSJ, 8/27/03, pg. 2).
- (7) Corporate Profits are often used to finance future business expansion. While profits have been improving recently, businesses have been reluctant to use profits to increase spending, and are instead waiting for signs of stronger demand for their products and services. This attitude, while sound for each individual business, results in a slower growth pattern for the overall economy. "Most U.S. corporations appear for now to be sticking to the sidelines, waiting for stronger economic signals before moving to upgrade their desktop computers, or making major purchases of new business software." (WSJ 8/25/03, front page).
- (8) Stock Prices have been higher every month since March 2003. Since the stock market is sometimes seen as a forward-looking indicator of future economic conditions, rising stock prices could be a sign of improving economic growth. However, stock prices can often represent factors other than economic fundamentals, so their use as a future indicator of real economic conditions needs to be considered carefully.

All in all, most current economic indicators point to a moderately improving economy. Again, whether this has already been incorporated into current stock and bond price levels will only be clearly known based on developments still to come. Indeed, the issues of determining the "causes" of market price moves, and the difficulty of "beating" market results based on the use of certain systems or information, are the subjects of the next section.

II. THE DIFFICULTY OF ATTRIBUTING "CAUSES" TO STOCK PRICE FLUCTUATIONS, AND OF "BEATING" THE MARKET

Long time readers of these Monthly Comments should be familiar with certain books on investing that form the basis of many of our views. These books include:

- "A Random Walk Down Wall Street", Burton Malkiel
- "Common Sense Investing", John Bogle
- "Against the Gods, the Remarkable Story of Risk", Peter Bernstein
- "Fooled by Randomness", Nicholas Taleb

Added to this list is a new book by John Allen Paulos, a professor of Mathematics at Temple University and author of six other books on financial related topics. The book, "A Mathematician Plays the Stock Market", contains valuable explanations and insight regarding the investment process.

We now focus on Paulos's observations regarding the difficulty of attributing specific "causes" to the movements of stock prices, and "beating" the market.

One part of this discussion involves the so-called Efficient Market Hypothesis, which "maintains that, at any given time, stock prices reflect all relevant information about the stock." The information includes both "events that have already occurred, and events which, as of now, the market expects to take place in the future." "Efficient market theorists tend to believe in passive investments such as broad-gauged index funds..., which offer broad diversification and very low fees, and generally beat the more expensive, managed funds. Investing (in indexes) does have a cost, however; one must give up the fantasy of a perspicacious gunslinger/investor outwitting the market." (pp 59-62). (Our note: refer to July Comments, pages 6-8, for our discussion of Indexed Investments).

"And why do such theorists believe the market to be efficient? They point to a legion of investors of all sorts all seeking to make money by employing all sorts of strategies. These investors sniff out and pounce upon any tidbit of information even remotely relevant to a company's stock price, quickly driving it up or down. Through the actions of this investing horde the market rapidly responds to the new information, efficiently adjusting prices to reflect it." Therefore, "it's not that subscribers to technical or fundamental analysis can't make money; they generally will. They just won't make more than, say, the S&P 500 (index)." (pp 59-62)

"There is a close connection between the Efficient Market Hypothesis and the proposition that the movement of stock prices is random. If present stock prices already reflect all available information ... the future stock prices must be unpredictable. Any news that might be relevant in predicting a stock's future price has already been weighed and responded to by investors whose buying and selling have adjusted the present price to reflect the news.... What will move stock prices in the future are truly new developments (or new shadings of old developments), news that is, by definition, impossible to anticipate. The conclusion is that in an efficient market, stock prices move up and down randomly." (pp 59-62)

Paulos then discusses certain implications of randomness. "Given the large number of stocks, funds, and analysts, we might reasonably expect there to be a stock (or fund, or analyst) among the thousand that does well for ten consecutive years BY CHANCE ALONE." (our emphasis). (pg 65) "Phenomena that are truly random often appear almost indistinguishable from real-market behavior. This should, but probably won't, give pause to commentators who provide a neat post hoc explanation for every rally, every sell-off, and everything in between." (pg 67) "There is so much complexity in the market, there are so many different measures of success and ways to spin a story, that most people can manage to convince themselves that they've been, or are about to be, inordinately successful. If people are desperate enough, they'll manage to find some seeming order in random happenings." (pg 69) "People often attribute meaning to phenomena governed only by a regression to the mean, which refers to the mathematical tendency for an extreme value of an at least partially chance-dependent quantity to be followed by a value closer to the average." (pg 108)

The author proceeds to make his observations about the ability to predict market price movements. "What is the relative importance of private information, investor trading strategies, and pure whim in predicting the market? What is the relative importance of conventional economic news (interest rates, budget deficits, accounting scandals, and trade balances), popular culture fads..., germane political and military events (terrorism, elections, war) too disparate even to categorize? It is (our note: "it" refers to predicting the market) as broad a problem in social prediction as there is." (pp 171-2)

"Certainly, too little notice is taken of the complicated connections among the variables, even the more clearly defined economic ones. Interest rates ... have an impact on unemployment rates, which in turn influences revenues; budget deficits affect trade deficits, which sway interest rates and exchange rates ... an increase in some quantity or index positively (or negatively) feeds back on another, reinforcing or weakening it.... These associations ... bring to mind ... nonlinear dynamics, known as Chaos Theory ... described as any collection of parts whose interactions and connections are described by nonlinear rules or equations.... Not surprisingly, trying to predict the precise long-term behavior of such systems is often futile." (pp 171 & 172). And the author continues with more of the same: "... long range precise prediction of nonlinear systems isn't generally possible. This non-predictability is the result not of randomness, but of complexity too great to fathom." (pg 174)

"The inexorable march towards increased complexity arises from the actions of your co-investors, who, if they notice (or infer, or are told) that you are performing successfully on the basis of some simple technical trading rule, will try to do the same. To take account of their response, you must complicate your rule and likely decrease your excess returns Soon enough your rule assumes a near-random complexity, your excess returns are reduced essentially to zero, and you're back to relying on chance." (pp189&190)

“The more efficient the market is, the greater the complexity of price movements, and the closer the approach to a completely random sequence of price changes. Outperforming the market requires that one remain on the cusp of our collective complexity horizon. . . . If this is possible for anyone or any group to achieve, it’s not likely to remain so for long.” (pg 196)
“One fact remains incontrovertible: narratives and numbers coexist uneasily on Wall Street. Markets, like people, are largely rational beasts occasionally provoked and disturbed by their underlying animal spirits. . . . The basis for the application of the mathematical tools discussed (in the book) is the sometimes shifting and always-shifty attitudes of investors. Since these psychological states are to a large extent unpredictable, anything that depends on them is less exact than it appears.” (pp 201&2)

These ideas represent themes we have presented regularly in our Monthly Comments. We are firm believers that efforts to predict the future direction of stock and bond prices, or to provide specific causes for these price movements, are for the most part unproductive. In the absence of either predictive capability, or the ability to provide precise causation, we continue to recommend that our clients focus on the asset allocation most appropriate for their specific circumstances. The asset allocation should take into account the level of risk that needs to be taken in the effort to achieve reasonable investment returns sufficient to reach reasonable financial objectives. We believe this is a far sounder approach to the uncertainties of investing, as compared with, to requote Paulos, relying on “the fantasy of a perspicacious gunslinger/investor outwitting the market.”

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)%
August 29, 2003	1,008	(31.4)%	9,416	(18.1)%	1,810	(55.5)%

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

Start of 1995	459		3,834		752	
End of 1999	<u>1,470</u>		<u>11,500</u>		<u>4,070</u>	
5 Year Gain; Annualized %	1,011	26.1%	7,666	24.6%	3,318	40.2%
End of 2001	<u>1,148</u>		<u>10,020</u>		<u>1,950</u>	
7 Year Gain; Annualized %	689	14.0%	6,186	14.7%	1,198	14.6%
End of 2002	<u>880</u>		<u>8,342</u>		<u>1,336</u>	
8 Year Gain; Annualized %	421	8.5%	4,508	10.2%	584	7.5%
August 29, 2003	<u>1,008</u>		<u>9,416</u>		<u>1,810</u>	
8.67 Year Gain; Annualized %	549	9.5%	5,582	10.9%	1,058	10.6%



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