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SEPTEMBER 2003 COMMENTS

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More on "ALL THAT'S HOLY," Written by TOM LEVINSON

We want to thank everyone who attended Tom's reading at the 92nd Street Y in New York of his newly published book, "All That's Holy {A Young Guy, An Old Car, and The Search For God In America}". In our unbiased opinion, it is an excellent book, and you all should be buying multiple editions of it. To quote the back cover of the book, "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."

We have attached to these Comments an interview with Tom that appeared in the most recent edition of NEWSWEEK Magazine. Can the best-seller list be far away?

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 September 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)%	16.9%	(1.3)%
S&P 500	19.6%	(10.1)%	(13.0)%	(23.4)%	13.2%	(1.4)%
S&P 500 Growth	28.8%	(22.2)%	(13.0)%	(23.7)%	14.1%	(2.0)%
S&P 500 Value	12.6%	6.1%	(12.0)%	(20.9)%	16.1%	(0.5)%
Dow Jones Industrials	25.2%	(6.2)%	(7.1)%	(16.8)%	11.2%	(1.7)%
NASDAQ Comp.	85.6%	(39.3)%	(21.0)%	(31.5)%	33.8%	(1.8)%
MidCap US	25.0%	2.6%	(4.8)%	(16.3)%	18.1%	(1.8)%
Small Cap US	19.6%	(4.2)%	1.0%	(21.6)%	26.8%	(2.1)%
Intl, EAFE	25.3%	(15.2)%	(22.6)%	(17.5)%	19.7%	3.2%

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

Taxable	(0.8)%	11.3%	8.3%	8.2%	3.8%	2.7%
Tax-Exempt	(2.9)%	9.2%	5.0%	7.9%	3.5%	2.4%
High Yield Taxable				1.7%	11.9%	2.3%

	<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>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%	2.2%	
NASDAQ COMP	(5.5)	(19.5)	(13.5)	7.0	2.5%	19.2%	12.1%	
BONDS Interm. Taxable	0.0	2.8	3.6	1.8	0.9%	2.7%	0.2%	

SEPTEMBER 2003 COMMENTS

During the month of September, **STOCK PRICES** declined modestly, their first down month after six consecutive months of higher prices. For the month, the S&P 500 was down (1.3)%, and is now up 13.2% year-to-date; the Dow Industrials declined (1.7)%, and are up 11.2% year-to-date; and the NASDAQ Composite declined (1.8)%, and is now up 33.8% year-to-date.

The month of September has historically been one of the worst months for stocks (along with the coming month of October), so a historian of stock prices based on the calendar would probably be pleased with the modest September decline. We prefer the view that stock prices have no memory, but rather depend on future events as yet unknown for their future movements. We also have great difficulty attributing causes to stock price movements (see pages 7-10, and prior Monthly Comments). Therefore, these results are reported, and our Comments cover other topics.

BOND RETURNS (price change plus interest) had sizeable gains during September, reversing their two-month downward trend, even in the face of various news items that would have tended to move interest rates higher and bond prices lower (e.g. improving economy, weaker dollar, higher deficits). But once again, prices moved unpredictably, in this case higher. High-quality intermediate-term taxable and tax-exempt bonds had returns of + 2.7% and +2.4%, respectively. Year-to-date, returns for taxable and tax-exempt bonds are 3.8% and 3.5%, respectively.

While the year-to-date percentage increases for Stocks 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 996 has gained 219 points, or 28% from its October 2002 low, but is still 531 points, or 53%, away from its previous high; and the NASDAQ Composite at 1,787, up an impressive 673 points, or 60%, from its October 2002 low, is still 3,261 points, or another 182%, away from its previous high.

Stock and bond investment results for the September 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, even with the modest September declines, has raised the S&P 500 28% from the 2002 lows. Whether this recovery turns into a new, sustained bull market continues to be 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 11). Note that all three indexes have positive average annual returns of 9.2% to 10.6% from the end of 1994 through September 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)%
September 30, 2003 Close	996	(35)%	9,275	(21)%	1,787	(65)%

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 9/30/03	<u>996</u>	<u>9,275</u>	<u>1,787</u>
Gain	537	5,441	1,035
Avg. Annual % Gain, '95-9/30/03	9.2%	10.6%	10.4%

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 7-10).

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 (GDP) is the broadest measure of goods and services produced in the U.S. economy. The most recent quarterly figures, for the period ending June 30th were favorable, and were revised upward at the end of September from a 3.1% annualized growth rate to 3.3%. "The GDP report showed that businesses started spending again across all categories and that consumers picked up their spending as well." (Sources: Wall Street Journal ("WSJ"), 9/29/03, pg. A2; Vanguard Economic Week in Review ("VEWR"), 9/22-26/03).
- (2) Employment continues to be the weakest spot in the economic recovery scenario. Unemployment was reported at 6.2% at the end of August, a nine year high (but see discussion on page 8 for conflicting results of employment reports, also referred to in VEWR, 9/22-26, pg. 2). However, the most recent weekly figure of initial unemployment claims fell below 400,000 to its lowest level in more than seven months (VEWR, 9/22-26, pg. 2).
- (3) Interest Rates, which had risen over one full percentage point (or 100 basis points) from the early June lows, declined during September, retracing almost half the increase. The benchmark 10-Year US Treasury now yields 3.93%, down from the 4.45% level reached at the end of August.

This decline in rates occurred even in the face of various news events that would suggest higher rates, including: (a) signs of economic recovery in the US; (b) an increasing US budget deficit; and (c) efforts by US spokespeople to have the value of the dollar decline (more on this topic on page 9). The discussion on pages 7-10 regarding Causation and Market Price Movements emphasizes how difficult it is to predict price changes even when certain apparently relevant facts are known.

- (4) Inflation remains under control. The "core" inflation rates, which exclude volatile food and energy prices, rose 0.1% in August for both the Consumer Price Index (CPI) and Producer Price Index (PPI). The twelve-month "core" CPI rose 1.3%, the lowest full year rate since 1966 (VEWR, 9/15-19/03 and 9/8-12/03).

- (5) Sector Economic Activity is Mixed
- (a) Durable goods orders fell in August, for the first monthly decline since April ((VEWR, 9/22-26).
 - (b) Industrial production and manufacturing activity were slightly higher in August (VEWR, 9/15-19).
 - (c) Retail Sales were also higher for August, their fourth consecutive month of increase, but below analysts' expectations (VEWR, 9/8-12).
 - (d) Housing sales remained strong. (VEWR, 9/22-26).
- (6) Consumer Confidence slowed in September (WSJ, 9/29, pg. A2). However, in a report with contrary implications, Consumer Spending rose sharply in August, after a similar sharp increase in July (WSJ, 9/30, pg A2).
- (7) Corporate Profits for the third quarter will begin to be announced shortly. These profits are obviously important for stock prices. While profits continue to improve, the big questions remain as to the extent of the improvement, and how much of the improvement is already factored in to current prices (WSJ articles, pg. C1, 9/29 and pg. C1, 9/2).

All in all, most current economic indicators continue to 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.

II. More on CAUSATION and Market Price Movements

An understanding of the role of CAUSATION in the changes in Stock and Bond prices is absolutely essential to forming a view as to whether anyone can predict, IN ADVANCE, these price changes. If there are factors that can be identified and isolated as truly causing stock and bond prices to change, and if these factors can be predicted in advance, then there may be an argument that some shrewd and insightful analysts/investors can consistently outperform the results of the markets for reasons other than pure CHANCE. Otherwise, the notion of analyzing this and that presumed cause of price changes is probably an unproductive endeavor.

A number of regular readers of these Monthly Comments were interested in last month's material on this subject, which highlighted the views of Professor John Allen Paulos in his recently published book, "A Mathematician Plays the Stock Market." We refer to passages from this book in the following discussion.

Some investors try to TIME, or otherwise OUTPERFORM, the markets by using what are referred to as TECHNICAL methods. Typically this methodology involves analyzing prior price movements in an effort to predict future price movements. According to Paulos, "if the stock market is efficient, that is, if information about a stock is almost instantaneously incorporated into its price, then any stock's future moves will be determined by random external events. Its past behavior...is irrelevant and its future movement is unpredictable." (pg. 44).

A second methodology employed by many investors in an effort to outperform the markets is referred to as FUNDAMENTAL analysis. Those using this methodology scrutinize what they believe are all relevant news items, and use this information in an effort to predict future price movements. Because this methodology seems to make such good common sense, and is used by so many, professionals and amateurs alike, this approach will be our focus.

The starting point of this discussion should be which news items are material and relevant; that is, which news items are likely to be referenced as possible/probable CAUSES of changes in market prices. Pertinent topics range from world news (wars, terrorism, election results), to broad economic news (measures of Gross Domestic Product, employment, budget deficits, interest rates, inflation rates, currency fluctuations), to company-specific financial news (earnings, competitive developments, new products, accounting issues). The first obvious thought is that there are a very large number of variables that can affect market prices, and that many of them have an impact on other variables, making any analysis quite complex, and the identification of the real causal factors very much of a moving target.

Again, Paulos has insightful observations: “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 as broad a problem in social prediction as there is. . . . 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. . . . 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.” (171,172,174)

But the problems of attributing causation of market price changes to one or another key factors of the day go beyond the complexity of the interrelationships among these factors. For instance there are certain seemingly crucial measures over which there are basic differences as to the measurements themselves. Exhibit A for this point appeared in a signed article on the Wall Street Journal editorial page dated September 26, 2003. In this article, the author, Allan H. Meltzer, a professor at Carnegie Mellon University, compared two measures of employment data, both compiled by the US Labor Department. One survey, referred to as the “Establishment Survey”, “asks manufacturing and service sector companies how many employees they have.” The other, the “Household Survey” . . . “asks a sample of people whether they have jobs.” The author continues that for the one year ending August 2003, the Establishment Survey shows a loss of 463,000 jobs, while the Household Survey shows a gain of 313,000 jobs. The author concludes: “One of the enduring half-truths about the economy is that small firms create most new jobs. Downsizing large firms in the interest of greater efficiency is a big source of the new, small firms. It's good to get the efficiency gain, but many of the new jobs are the same old jobs repackaged.”

If this kind of discrepancy exists in two government measures trying to report on the condition of U.S. employment, how can fundamental analysts using the condition of employment as a “CAUSE” of the movement of stock or bond prices draw any reasonable conclusions about the very factor they are using as a “cause”?

Another example of significant differences in the measurement of key data appeared in a Sunday, NY Times "Portfolios" column by Jonathan Feuerbringer, which appeared Sept. 14th. The article points out that the same firm, in this case Standard & Poors, has three entirely different measures for forecasted 2003 corporate earnings, ranging from a year over year gain of as low as 17% to as high as 78%. Each measure of earnings is obviously different; one reports "operating earnings", the second reports "reported earnings," and the third reports "core earnings." A detailed discussion of these different earnings measures is beyond the scope of this month's Comments, but the very fact that these three measures exist emphasizes the difficulty of providing a clearly relevant factor with a uniform number on which decisions/predictions can be based. The article quotes one market observer as follows: "It is difficult for the professional to figure it out." If difficult for the professional, where does this leave the rest of the investing public?

Another problem with citing an event as a cause for market price movements relates to the ambivalent nature of an acknowledged relevant factor. For example, if inflation rates move up, this may be a negative if the change translates into higher interest rates and a slower economy; or it may be a positive, if companies can raise prices, make more money, invest more in future production, and hire more people. The event occurs, but the impacts cut in many different directions. Another example of this difficulty came up just recently, in the week starting with Monday September 22nd. The news reported that various U.S. spokespeople were advocating, in effect, a decline in the value of the US dollar against the Japanese and Chinese currencies. The stock market declined that week, and the media promptly cited the currency issue as a "cause." But the effects of a declining currency cut two ways: the negative impact is that foreign investors in US securities see the value of their holdings decline, which sometimes (but not always) can contribute to higher interest rates in the US, or to these same investors selling their U.S.-denominated securities. Interestingly, during the same week of September 22nd, interest rates in U.S. markets declined, which means many investors were buying U.S. bonds. The positive effect is that U.S. goods become less expensive in foreign markets, which sometimes (but not always) leads to more business activity in the U.S.

Yet another problem with trying to attribute causation to seemingly relevant factors is whether the anticipated reaction to a news event is the one that actually occurs. Exhibit A for this point is September 11, 2001. Everyone knows that this horrible event was new news. There could not have been too many market observers who expected such an event. The immediate aftermath of these attacks was an approximately 11% decline in the S&P 500 index of stock prices during the week that followed the reopening of the stock and bond markets. This presumably made sense, and the media widely reported the declines as "caused" by the event. How then to explain that by the end of December 2001, a mere three months after 9/11, S&P 500 stock prices were 19% higher than their September lows, and 5% higher than their price levels on 9/10?

Last but not least, even if the factors can reasonably be used as “causes,” there is the argument that the so-called news has already been anticipated by market participants, and is therefore already reflected in the level of current prices. An example of this concept relates to a rally in stock prices that ANTICIPATES an economic recovery. Indeed, there are many market pundits who believe the 2003 stock price rally is an example of just such anticipation. If this is so, then to react positively to a current piece of good economic news would not be a good idea, since the anticipation of the news is already reflected in stock prices.

Given all these problems with “causation”, we agree with Paulos when he writes that “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, then 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. Evincing no memory of their past, they take what is commonly called a random walk, each step of which is independent of past steps... It is foolhardy... to predict changes in a company’s business environment. To the extent these predictions reflect a consensus of opinion, they’re already accounted for. To the extent that they don’t, they’re tantamount to forecasting coin flips. Whatever your views on the subject, the arguments for an efficient market... can’t be grossly wrong. After all, most mutual fund managers continue to generate average gains less than those of say the Vanguard 500 fund.” (62)

Our conclusion to all these difficulties is to develop an appropriate asset allocation between stocks and bonds that is likely to meet our client’s reasonable financial goals, with a degree of risk they can tolerate, and then to implement this allocation with a suitable mix of indexed investments.

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)%
September 30, 2003	996	(32.2)%	9,275	(19.3)%	1,787	(56.1)%

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%
September 30, 2003	<u>996</u>		<u>9,275</u>		<u>1,787</u>	
8.75 Year Gain; Annualized %	537	9.2%	5,441	10.6%	1,035	10.4%



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