

OCTOBER 2002 COMMENTS, period ending October 25, 2002

To: Our Clients
From: Victor and Nicholas Levinson
Re: The Future: "Opportunity for Continuity"

Since Nick joined our investment advisory business in January 2001, one of our primary goals has been to provide you with what we refer to as the "opportunity for continuity." We'd like you get to know Nick over time, so as to become comfortable with his advice and expertise. You would then have the opportunity, if you choose, to continue receiving our investment advice in the event Vic is no longer able to provide it. It is Vic's intention to work into the indefinite future. He has no interest in retiring; indeed, has few interests beyond his work and his family. But all such plans can be altered by circumstances beyond one's control. We therefore think it important to establish continuity with our clients.

Here is a brief review and update of Nick's background and current activities: Nick is 37, and lives with his wife (an attorney in San Francisco) and two young children (with a third due in February) outside of Oakland. Nick has an undergraduate degree from Princeton and an MBA from UC Berkeley. He has all of the licenses required of financial advisors, is a licensed insurance agent, and will soon be finished with the requirements to receive the Certified Financial Planner (CFP) designation.

In terms of our business, over the past two years Nick has been working with more than 20 of his own clients on the West Coast. These clients include individuals and couples, ranging in age from 30 to 60. Most are between 35 and 45, many with young children, who seek advice regarding investments as well as education savings, real estate finance, and life insurance. Nick utilizes the same approach as Vic does: 1) Devising investment programs and, as needed, broader financial planning advice based on the particular needs of our clients; and 2) implementing the investment programs with broad-based and sector-specific index stocks (i.e., Exchange-Traded Funds) and index mutual funds. We review together all advice to clients prior to implementation.

Nick has also gained familiarity with Vic's clients, both through his work on the quarterly billing and performance reports and during several trips to the East Coast. During Nick's most recent trip in October, we met with a number of clients over four days. Going forward, Nick plans to visit the New York area three to four times a year, and to begin to join in important scheduled phone conversations. We will also give many of our younger clients, who face the issues that Nick addresses on a daily basis with his own clients, the opportunity to work directly with him. Nick would also be happy to speak with any of your contacts, family or otherwise, living on the West Coast, and particularly in the San Francisco Bay area.

We want to thank you all for your continued confidence in our work on your behalf, during a period that has turned out to be a bear market of historic dimensions. Please continue reading

COMMENTS: INDEX RESULTS, period ending October 25, 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)%	(21.8)%	6.1%
S&P 500 Growth	28.8%	(22.2)%	(13.0)%	(21.0)%	6.4%
S&P 500 Value	12.6%	6.1%	(12.0)%	(21.2)%	6.0%
Dow Jones	25.2%	(6.2)%	(7.1)%	(15.7)%	7.4%
NASDAQ Comp.	85.6%	(39.3)%	(21.0)%	(31.7)%	6.8%
Ext/MidCap US	25.0%	2.6%	(4.8)%	(17.5)%	2.5%
Small Cap US	19.6%	(4.2)%	1.0%	(22.4)%	2.3%
Intl, EAFE	25.3%	(15.2)%	(22.6)%	(17.3)%	1.4%

BONDS, Interm.

Taxable	(0.8)%	11.3%	8.3%	5.1%	(1.3)%
Tax-Exempt	(2.9)%	9.2%	5.0%	4.6%	(3.2)%

	<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>1Q</u>	<u>2Q</u>	<u>3Q</u>	<u>4Q</u>
S&P 500	0.0	(13.8)	(14.1)	
NASDAQ COMP	(5.5)	(19.5)	(13.5)	
BONDS: Interm. Taxable	0.0	2.8	3.6	

OCTOBER 2002 COMMENTS

During the four week period ending Friday, October 25, **STOCK PRICES** fell to new lows early in the month, rallied strongly during the middle of the month, and leveled off at the end of the period, finishing near their October highs (see highlighted October figures below). The three main stock indexes were up between 6% and 7.5%.

For the first time in many months, **BOND PRICES** fell, as the long-running decline in interest rates finally reversed course. When interest rates rise, prices of existing bonds decline. The extent of the bond price declines was significant; intermediate taxable bond returns were down 1.3%, while intermediate tax-exempt bond returns were down an even greater 3.2%. For the year, the total returns for these bond categories remain positive, at 5.1% and 4.6%, respectively. (The results for the October period, for both stocks and bonds, and for the full year 2002, are set out on page 2.)

Unlike other stock market cycles, when declining interest rates helped fuel higher stock prices, both interest rates and stock prices have declined in this current bear market cycle for stocks. When viewed in the context of alternative uses of money, it makes sense for declining interest rates to be a factor in rising stock prices, since lower interest rates mean lower future returns for bonds. On the other hand, if interest rates decline in the context of a weak economy (as now), then it makes sense for stock prices to decline. While the timing is uncertain, it is anticipated that when the economy does turn up, stock prices are likely to benefit, while interest rates rise and bond prices decline.

As for the extent of the declines for the entire 2000-2002 Bear Market, measured from the highs of Q1 2000, the following figures chart these results and put them in the context of results since the end of 1994 (see also the figures on page 7).

	<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)%
Oct 25, 2002 Close	898	(41)%	8,444	(28)%	1,331	(74)%

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%
Avg. Annual % Gain, '95-10/25/02	9.0%	10.6%	7.6%

Near Term Outlook For Markets:

The near term outlook for stocks and bonds continues to be influenced most by the general economic conditions in the U.S. and the profitability of companies in this slow growth (and in some sectors, negative growth) economy. Employment levels and broad measures of economic output are key indicators of general economic conditions. In a 10/28/02 WSJ article discussing the likelihood of an interest rate decrease by the Federal Reserve in order to further stimulate the economy, the estimate for current projected growth is 1.8%, as compared to a more desirable rate of 3%. How to move the economy from its current slow growth to faster growth, and particularly how to stimulate business investment, has become a key question for stock prices. In another WSJ article, dated 10/30/02, an analysis of Consumer Confidence included consideration of a variety of general economic factors. These factors include consumer spending, business investment, government spending, international trade, and the employment rate. Throughout this current slow-growth period, only consumer spending has held up, whereas business investment, government spending, and international trade have all declined. According to this article, since mid-2000, consumer spending, which includes housing, has grown at an average annual rate of 2.7%, while the other three categories have declined at an average annual rate of 3.1%. Because consumer spending is the largest category, the overall total growth rate has averaged 1.0% annually.

On Thursday, 10/30/02, the Commerce Department reported that the overall economy grew at an annual rate of 3.1% for the third quarter ended 9/30/02. This growth rate was much better than the 1.3% growth rate for the second quarter. In its 11/1/02 article, the WSJ noted that economists' consensus fourth-quarter growth rate is less than 2%. The report also showed slow growth in personal incomes, as well as a small increase in business investment, the first such increase in two years.

With regard to corporate earnings, actual quarterly earnings reports and projections by companies of their sales and earnings outlooks for the next quarter or two are the key factors in investors' evaluations of the corporate profitability picture. During the October quarterly earnings reporting, profits were somewhat better than anticipated, but still below levels that had been projected earlier this year. Depending on how profits are measured, the S&P 500 is reported to be selling at between 18 and 30 times the next twelve months' projected earnings. This is a huge range, with much controversy over two key accounting items: stock options and pension contribution requirements. In this environment, the optimists could argue that conditions are not as bad as the bears had predicted, while the pessimists could argue with equal validity that conditions are not nearly as good as the bulls had hoped. The result has been significant volatility, both up and down, from August through October, with no clear trend.

Other factors cited as creating significant short-term moves in securities prices are geopolitical concerns (Iraq, Palestinians, Terrorism) and corporate accounting issues, including the correct standards for measuring profits. Despite the ongoing uncertainty, it should be remembered that stock prices soared, for example, after the U.S./Iraq War of 1991.

Longer Term View of Markets:

Moving beyond short term considerations to a longer-term view (measured in years, not days or months) of the securities markets, we once again return to our ongoing themes: (1) Relying on the history of the long-term outperformance of stocks relative to bonds and cash; and (2) controlling the risk of an always uncertain future with an asset allocation appropriate to your specific goals and circumstances, while ignoring predictions of so-called market pundits as well as the lure of trying to time the market's ups and downs.

Our view is that a long-term outlook to investing is more likely to provide a favorable outcome than responding to even severe stock price declines by abandoning stocks altogether. In support of this view, we are presenting again the history of two other periods of major stock price declines, and the recoveries that followed.

The figures below show the declining and then recovering value of a \$1 million stock portfolio, based on an index of Large Cap US stocks (most recently the S&P 500), as reported in Ibbotson Associate's 2002 Year Book: Stocks, Bonds, Bills and Inflation.

<u>Year</u>	<u>% Losses or Gains</u>	<u>Portfolio Value</u>	<u>Year</u>	<u>% Losses or Gains</u>	<u>Portfolio Value</u>	<u>Year</u>	<u>% Losses or Gains</u>	<u>Portfolio Value</u>
1929	-8.42%	915,800	1973	-14.66%	853,400	2000	-9.10%	909,000
1930	-24.90%	687,800	1974	-26.47%	627,500	2001	-11.90%	800,800
1931	-43.34%	389,700	1975	37.20%	860,900	2002	-32.32%	542,000
1932	-8.19%	357,800	1976	23.84%	1,066,200	(thru 10/09 Lows)		
1933	53.99%	550,900	1977	-7.18%	989,600	2002	???	???
1934	-1.44%	540,300	1978	6.56%	1,054,500	(post 10/09 Lows)		
1935	47.67%	801,800	1979	18.44%	1,250,000			
1936	33.92%	1,073,800	1980	32.42%	1,654,000			
1937	-35.03%	697,700						
1938	31.12%	914,800						
1939	-0.41%	911,000						
1940	-9.78%	821,900						
1941	-11.59%	726,700						
1942	20.34%	874,500						
1943	25.90%	1,101,000						
1944	19.75%	1,318,400						
1945	36.44%	1,800,000						

Two questions remain crucial in evaluating the likelihood that history will again work in favor of the patient long term stock investor: 1) Whether economic conditions in 2000-2002 will eventually become worse than in 1929-32 or 1973-74 (current conditions are far better than in either of those periods); and 2) whether the stock price gains of the 1980s and 1990s reached such unsupportable levels as to necessitate a lengthy period (i.e., more than the current two plus years) of low stock prices.

Behavioral Finance: Investor Traits that Affect Reactions to Markets

There is a significant body of academic work being done in a field referred to as Behavioral Finance ("BF"). BF attempts to explain the behavior of investors under various market conditions, behavior that is often at odds with the classic economic theories that investors act rationally and that markets are efficient at pricing securities.

Indeed, two of this year's Nobel Prize winners in Economics (Professors Daniel Kahneman and Vernon Smith) are experts in the field of BF. We think their insights, and the insights of others on this subject, can be useful in helping to navigate a period of severe market declines. The following are some of the key principles that have emerged from this work:

- (1) People tend to be overconfident in their skills, and exhibit excessive optimism when times are good. Related to markets, these traits send prices higher than the underlying fundamentals would justify.
- (2) Related to (1) above, people often view the likelihood of the occurrence of low probability events (such as severe market declines) as zero. When low probability events do occur, surprise, and even panic, can result. This reaction sends prices to lower levels than would otherwise be the case.
- (3) Loss Aversion – People react much more strongly to loss than they do to the same amount of gain. As a result, when losses do occur, the reaction is often to sell the asset causing the loss in order to reduce the pain. This can lead to selling at the wrong time, at depressed prices, and to oversold market conditions in the midst of declines.
- (4) Endowment Effect – People tend to value an item more highly if they own it already than if they are asked to purchase that same item in the marketplace. Related to securities pricing, this tendency results in people asking, or holding out for, a higher price for stocks owned than they would be willing to pay for the same stocks if not owned. This is borne out by the frequent behavior of not selling a stock you own at a given price, even if you wouldn't buy that same stock at the same price. This behavior illustrates how people do not like to admit mistakes.
- (5) Looking at Your Periodic Statements – Should you look? This is perhaps the most interesting insight of all of the BF principles, particularly as it affects long-term investors. Why look at your monthly statements if knowing the figures is not going to affect your long-term allocations? Intelligent people react to information, thinking they need to do something; but the long-term, buy-and-hold strategy emphasizes doing nothing. So, BF theorists ask, why look, particularly if your investments consist of broadly diversified indexes designed to match long-term market results?

S&P 500

Dow

NASDAQ

I. Figures From Period Starting 2001 (% Figures Are Declines From 1/01/01)

Start of 2001	1,320		10,785		2,470	
Sept. 21, 2001 <u>Low</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)%
Oct 2002 <u>Low</u>	777	(49.0)%	7,286	(38.0)%	1,114	(78.0)%
Oct 25, 2002	898	(32.0)%	8,444	(21.7)%	1,331	(46.1)%

II. Figures From Period Starting 2000 (% Figures Are 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)%
End of 2001	1,148	(13.0)%	10,020	(7.1)%	1,950	(21.0)%
Two Years		(21.8)%		(12.8)%		(52.0)%
Oct 25, 2002	898	(38.9)%	8,444	(26.5)%	1,331	(67.3)%

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

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; Annualized %	1,011;	26.1%	7,666;	24.6%	3,318;	40.2%
7 Yr Gain; Annualized %	689;	14.0%	6,186;	14.7%	1,198;	14.6%
Oct 25, 2002	<u>898</u>		<u>8,444</u>		<u>1,331</u>	
7yr&10mo Gain; Annual. %	439	9.0%	4,610	10.6%	579	7.6%



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