

VICTOR LEVINSON

NICK LEVINSON

OCTOBER 2003 COMMENTS

- Page 1:** **What's in This Edition**
- Pages 2-4:** **Index Results for October, and Year-to-Date 2003;**
 Also Years 1999 – 2002, and Various Other Longer Time Periods
- Pages 5-9:** **Investment Concepts:**
- Pgs. 5-6:** **Update of Key Economic Indicators**
- Pgs. 7-9:** **Mutual Funds in the News: What We Do: Cost Matters**
- Page 10:** **Investment Returns From 2000 to Present, and 1995 to Present**

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 October 31, 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)%	24.0%	7.1%
S&P 500	19.6%	(10.1)%	(13.0)%	(23.4)%	19.4%	6.2%
S&P 500 Growth	28.8%	(22.2)%	(13.0)%	(23.7)%	21.2%	7.1%
S&P 500 Value	12.6%	6.1%	(12.0)%	(20.9)%	22.1%	5.0%
Dow Jones Industrials	25.2%	(6.2)%	(7.1)%	(16.8)%	17.5%	6.3%
NASDAQ Comp.	85.6%	(39.3)%	(21.0)%	(31.5)%	44.7%	10.9%
MidCap US	25.0%	2.6%	(4.8)%	(16.3)%	27.0%	8.9%
Small Cap US	19.6%	(4.2)%	1.0%	(21.6)%	37.0%	10.2%
Intl, EAFE	25.3%	(15.2)%	(22.6)%	(17.5)%	27.5%	7.8%

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

Taxable	(0.8)%	11.3%	8.3%	8.2%	2.8%	(1.0)%
Tax-Exempt	(2.9)%	9.2%	5.0%	7.9%	2.9%	(0.6)%
High Yield Taxable				1.7%	13.6%	1.7%

	<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%	

OCTOBER 2003 COMMENTS

During the month of October, **STOCK PRICES** resumed their gains and posted substantial increases across all market cap sizes and styles. For the month, the S&P 500 was up 6.2%, and is now up 19.4% year-to-date; the Dow Industrials gained 6.3%, and are up 17.5% year-to-date; and the NASDAQ Composite gained 10.9%, and is now up 44.7% year-to-date.

These favorable October results occurred during a month that has historically recorded some of the largest declines. Once again, the market has confounded those who see patterns in such data as the month of the year. As you know by now, we prefer the view that stock prices have no memory, but rather depend on future events with as yet unknown effects on future stock price movements. On a similar note, since stock prices increased, there are those who credit the increases to favorable economic data (see pages 5 and 6). As you also know by now, we prefer the view that attributing causes to stock price movements is an extremely complex matter, and that many seemingly relevant news events have already been factored into stock prices by the combined activity of all market participants.

BOND RETURNS (price change plus interest) declined during October. The same factors mentioned last month that suggested bond price declines, which did not in fact occur, remained in place in October, when bond prices did decline. Those factors include an improving economy, a weaker dollar, and higher US budget deficits. While the cause and effect are debatable, the fact of the price declines is not. High-quality intermediate-term taxable and tax-exempt bonds had negative returns of (1.0)% and (0.6)%, respectively. Year-to-date, returns for taxable and tax-exempt bonds are positive 2.8% and 2.9%, 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 return to the starting point is a much higher number, as indicated below:

	<u>High (3/00)</u>	<u>Low (10/02)</u>	<u>% Decline</u>	<u>% Gain Needed</u>
S&P 500	1,527	777	(49)%	97%
NASDAQ Comp.	5,048	1,114	(78)%	353%

History suggests these indexes are likely at some point in time to reach and surpass their prior highs. The really relevant question is in what time frame such a recovery takes place. For instance, if the S&P 500 increases from its current 1,051 back to 1,527 over the next five years, the annualized investment return would be 7.75%, well within reasonable long-term return expectations for the stock market. But if it takes 10 years, the annualized return would be only 3.8%, a return more closely associated with bond returns. Over the same time periods, the NASDAQ recovery would be far more dramatic; to regain prior highs in five years from the current 1,932, the annualized return would be 21.1%; over ten years, 10.0%.

Stock and bond investment results for the October 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.

After its substantial gains in October, the stock market rally of 2003 has raised the S&P 500 35% from the 2002 lows. While this is an impressive figure, and has certainly made investors believe that the stock market is not likely to go down in perpetuity (a view that was widely held during the depths of the bear market), the question of whether this recovery turns into a new, sustained bull market continues to be dependent on future events, as yet unknown.

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 9.9% to 11.3% from the end of 1994 through October 2003, and that the much maligned and highly volatile NASDAQ Composite now has the highest average annual return for the almost nine year period covered by these figures.

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)%
October 31, 2003 Close	1,051	(31)%	9,801	(16)%	1,932	(62)%

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 10/31/03	<u>1,051</u>	<u>9,801</u>	<u>1,932</u>
Gain	592	5,967	1,180
Avg. Annual % Gain, '95-10/31/03	9.9%	11.2%	11.3%

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: 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. A recent example of this view occurred this week, when stock and bond prices experienced virtually no changes even after the largest quarterly GDP advance since 1984).

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 September 30th, showed a 7.2% annualized growth rate, the strongest quarterly showing since Q1 1984. Consumer spending and business investment were up strongly. (Sources: Wall Street Journal ("WSJ"), 10/31/03, pg. A1; Vanguard Economic Week in Review ("VEWR"), 10/27-31/03).
- (2) Employment levels showed their first gains in eight months in the employment report issued the first week in September. But the amount of the job gain was modest, and "did not establish whether the nation's labor market is finally beginning to improve substantially" (VEWR, 9/29-10/3, pg. 1). Further, the most recent four week moving average of initial unemployment claims continued below 400,000, "a signal that perhaps businesses are at least beginning to wind down the pace of layoffs, if not to expand payrolls" (VEWR, 10/20-24, pg. 1).
- (3) Interest Rates, which had risen over one full percentage point (or 100 basis points) from the early June lows, declined during September, but increased again in October. The benchmark 10-Year US Treasury now yields 4.30%, up from 3.93% at the end of September but down slightly from the 4.45% level reached at the end of August. As mentioned in previous Comments, when interest rates increase, bond prices fall. The specific bond market declines during October are discussed on page 3.

The Federal Reserve met during the last week in October, and kept the interest rate that it directly affects at a very low 1%. The Fed also repeated its earlier statement that its "policy accommodation can be maintained for a considerable period." The use of this language, widely interpreted as meaning the Fed is in no rush to raise interest rates for fear of hurting the economic recovery, is itself the subject of controversy regarding whether the Fed should or should not commit itself to a specific interest rate policy for a period of time (WSJ, 10/29/03, pg. 2).

- (4) Inflation remains under control. The “core” inflation rates, which exclude volatile food and energy prices, rose 0.1% in September for the Consumer Price Index (CPI) and were flat for the Producer Price Index (PPI). The twelve-month “core” CPI rose 1.2%, the lowest full year rate since 1966 (VEWR, 10/13-17, pg. 2 & 10/6-10, pg. 1).
- (5) Sector Economic Activity is Strong
 - (a) Durable goods orders rose in September (VEWR, 10/27-31, pg. 1).
 - (b) Industrial production and manufacturing activity were slightly higher in September (VEWR, 10/13-17, pg. 1).
 - (c) Retail Sales were also higher for September, excluding auto sales, and sales figures for July and August were revised “substantially upward” (VEWR, 10/13-17, pg. 1).
 - (d) Housing sales remained strong (VEWR, 10/27-31, pg. 1).
- (6) Consumer Confidence also rose in October (VEWR, 10/27-31, pg.1).
- (7) Corporate Profits for the third quarter are up sharply from the comparable year earlier quarter, as measured by the Commerce Department’s broadest measure of corporate profitability (WSJ, 10/31/03, pg. 6 continuation of pg. 1 article). These profit improvements are obviously important for stock prices, but significant questions remain as to the extent and sustainability of the improvement, as well as how much of the improvement is already factored in to current prices.

All in all, most current economic indicators now point to an improving economy. Some analysts, however, believe the current good news cannot be sustained (WSJ articles, 10/31/03, pg. 6 continuation of pg. 1 article, and pg. C1, “Ahead of the Tape”). And even with all the good news, there is the ever-present question of whether this news has already been incorporated into current stock and bond price levels.

II. MUTUAL FUNDS IN THE NEWS; WHAT WE DO; COST MATTERS

The mutual fund industry has been in the news lately, and most of the news has been negative. In a year in which the stock market has recovered sharply, and which therefore should have been a good year for the fund industry in general, a number of highly unfavorable practices have been brought to light. We would like to address this subject, and to let you know how what we do on behalf of our clients differs from the detrimental practices now coming under scrutiny.

A "Getting Going" article by Jonathan Clements in the October 28th Wall Street Journal discusses many of the issues. He starts off: "Let's face facts: To line their own pockets, fund companies and their employees have engaged in a host of unsavory practices. It isn't just this year's scandals over market timing, late-day trading, and the sale of Class B fund shares. There was also the irresponsible behavior of the late 1990s, when fund companies pumped out high-octane technology funds and advertised performance that was clearly unsustainable."

His article continues with some remedies to these problems. First, if a fund's investment result is too good (Clements cites a 40% increase over twelve months as a guide), the fund should warn investors the performance is unsustainable. In addition, funds should not advertise these kinds of results.

WHAT WE DO: We regularly point out in our Monthly Comments that the past performance of a fund, or manager, or market segment, or even the overall results of the stock market, cannot be used to predict future results. Indeed, we believe just the opposite; because the future is inherently unknowable, and because most market prices already account for both known events and even widely anticipated future events (e.g., no interest rate increase when the Federal Reserve met in late October), past price movements are not helpful in making judgments regarding future price movements. Furthermore, we frequently discuss the concept of "Regression to the Mean," which suggests that after a period of outperformance, funds, managers, sectors and investment styles tend to revert to long-term average returns. Current outperformers are therefore equally likely to experience a period of underperformance as to continue their outperformance.

Academic support for these arguments is extensive. In his recent book "The Random Walk Guide to Investing," Professor Burton Malkiel of Princeton University (who also wrote "A Random Walk Down Wall Street", currently in its eighth edition, the classic book advocating asset allocation, indexed investments, and long-term buy and hold investing) writes: "The problem is that there is no persistency to good performance; it is as random as the market. If a manager beats an index in one period, there's absolutely no guarantee that the performance will be repeated in the next... The top funds of the sixties had dismal performances in the seventies... the top funds of the seventies badly underperformed the market in the eighties, and the top funds of the eighties underperformed in the nineties..." (pg. 128). Malkiel also notes that the top twenty funds from 1997-1999 declined twice as much as the market as a whole during the next three year period, 2000-2002. In his words: "Yesterday's genius turned into today's disaster" (pg. 128). And finally, Malkiel writes, "it is true that there are always some funds that beat the market... But... there is no way to choose the best managers **IN ADVANCE** (our emphasis) (pg.130).

Going deeper into the issue of mutual fund costs, Clements writes that “broker-sold B shares are designed to hoodwink investors into thinking they are buying a no-load fund. But in reality, B shares charge outrageously high annual expenses and hefty back-end commissions.” (Our note: Among “load” mutual funds, which, in addition to regular annual expenses to manage the investment portfolios of the funds, include charges to compensate brokers for selling the funds, there are three main “share classes”: Class A shares charge an up-front sales commission, or load, but relatively low annual expenses; Class B shares charge a “back-end” load when the investor sells the fund, plus higher annual expenses; and Class C shares charge higher annual expenses, typically without loads. Clements suggests that Class A and Class C shares can be useful for different investors depending on how long they intend to hold the fund, but that the cost structure of Class B shares only benefits the broker, not the investor.) Clements’ prescription for informing investors about the hazards of B shares is to require fund companies to present a chart comparing the performance of B shares against that of A and C shares.

WHAT WE DO: None of the indexed investments we use, including Vanguard’s mutual funds and the various exchange traded funds (ETFs), have any sales loads or ongoing commission costs. The indexed investments charge annual management fees to oversee the investment portfolios; these fees average about 2/10 of 1%. Our compensation for the selection of investments, and our overall financial and investment advice, comes in the form of annual fees of of 1% of the assets we manage. Finally, when we process a transaction, there is typically a one-time \$100 “ticket charge”, or commission. The average annual cost to our clients (before any transactions, which we make every effort to minimize) is therefore 7/10 of 1% of assets under management.

By contrast, actively managed mutual funds sold without a broker (i.e., “no-load”) typically charge at least 1%, and often 1.5% or more, without any investment advice. An article entitled “In a Land of Giants”, in the Sunday New York Times Business Section of November 2, 2003, includes a reference from Morningstar’s mutual fund guide that the average management fee for all stock and balanced funds is 1.57%. As mentioned above, broker-sold, or load, mutual funds also include additional costs to pay the selling broker.

Active management does hold out the possibility of outperforming the indexes, but also runs the risk of underperforming. According to Malkiel, “For over thirty years...the broad stock market indexes have outperformed two-thirds or more of the actively managed funds. The indexes...over the past twenty years, beat the performance of over 80 percent of professional actively-managed mutual funds (periods ending December 31, 2002)” (pgs. 124 & 125). Malkiel explains these results as follows: “If professional investors such as mutual fund managers and pension fund managers own essentially all of the shares, they should earn the market return. Clearly, if you add up all the players in the stock market, they must by definition earn the market return...The fact is that they do earn the market return **BEFORE EXPENSES. IT IS THEIR EXPENSES THAT DRAG THEIR RETURN DOWN BELOW THAT AVAILABLE FROM THE MARKET AS A WHOLE** (our emphasis)...In total, expenses siphon off somewhat more than two (2) percentage points from the net return investors receive. Actively managed funds underperform the market by essentially the amount of their management fees and transaction expenses” (pgs. 126 & 127). We concur, as highlighted in the section heading, “Cost Matters”, at the top of page 7.

The Clements article continues by advocating additional disclosures, and the enforcement of appropriate policies, by mutual funds so as to put an end to various abuses. These include the personal trading by employees, use of funds for market timing, and after-hours trading that have featured so prominently in news stories over the past month. Clements also picks up on Malkiel's discussion of expenses by discussing the costs associated with excessive trading within a fund, and calls for developing a methodology to quantify these costs and then to disclose them. The importance of appropriate disclosures, and of costs on investment returns, are the themes running through the Clements article and the quoted sections of the Malkiel book.

WHAT WE DO: We agree, and believe our model for providing quality investment advice at a reasonable cost using indexed investments can be part of the solution to the problems currently affecting the mutual fund business. While we write our Monthly Comments to be educational, from time to time we consider it appropriate to promote our approach to investing. We hope you agree.

	<u>S&P 500</u>		<u>Dow</u>		<u>NASDAQ</u>	
<u>I. Figures From Period Starting 2000 (% Figures Are Cumulative 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)%
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)%
October 31, 2003	1,051	(28.5)%	9,801	(14.8)%	1,932	(52.5)%

<u>II. Figures From Period Starting 1995 (% Figures Are Gains From 1/01/95)</u>						
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%
October 31, 2003	<u>1,051</u>		<u>9,801</u>		<u>1,932</u>	
8.8 Year Gain; Annualized %	592	9.9%	5,967	11.2%	1,180	11.3%



Victor Levinson



Nicholas Levinson