

NOVEMBER 2002 COMMENTS

YEAR-END TAX MATTERS

As the year comes to a close, various income tax-related matters arise, as listed below. We will be discussing these with you, and /or your accountant, during December to take appropriate actions on your behalf.

- (1) Taking Losses, which can be used against any current or future capital gains, and/or \$3,000 of ordinary income, and/or carried forward indefinitely. Congress is considering increasing the amount of tax benefits related to capital losses. At the time a sale is made to establish a tax loss, we purchase similar, but not identical, indexes. This achieves two desired results:
 - (a) Maintaining the previous investment position; and
 - (b) Avoiding the "wash sale" rules, which require a 31-day wait to purchase the same security that was sold for a loss.
- (2) Required IRA Distributions, for clients over age 70 _ and others, including beneficiaries of IRAs, who have to take distributions.
- (3) Trust Distributions.
- (4) Gifts.
- (5) IRA Contributions, and Other Retirement Plan Contributions, which occur during 2003 for the year 2002.

COMMENTS: INDEX RESULTS, period ending November 29, 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)%	(18.5)%	3.3%
S&P 500 Growth	28.8%	(22.2)%	(13.0)%	(18.4)%	2.6%
S&P 500 Value	12.6%	6.1%	(12.0)%	(16.5)%	4.7%
Dow Jones	25.2%	(6.2)%	(7.1)%	(11.2)%	4.5%
NASDAQ Comp.	85.6%	(39.3)%	(21.0)%	(24.2)%	7.5%
Ext/MidCap US	25.0%	2.6%	(4.8)%	(12.6)%	4.9%
Small Cap US	19.6%	(4.2)%	1.0%	(15.3)%	7.1%
Intl, EAFE	25.3%	(15.2)%	(22.6)%	(12.1)%	5.2%

BONDS, Interm.

Taxable	(0.8)%	11.3%	8.3%	6.0%	0.9%
Tax-Exempt	(2.9)%	9.2%	5.0%	5.7%	1.1%

	<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	

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During the five-week period ending Friday, November 29, **STOCK PRICES** continued the gains that started in mid-October. For the period the S&P 500 gained 3.3%, the Dow Industrials gained 4.5%, and the NASDAQ Composite gained 7.5%

(Note: the period % gains or losses are calculated based on the change from the index value at the beginning of the year, so as to maintain the correct year to date % change. Since the index values are now lower than they were at the beginning of the year, the actual % change from the prior period to the current period is greater than the % change measured from the beginning of the year. For example, the S&P 500 rose 38 points for the November period. This increase represents a 3.3% gain based on the 2002 starting figure of 1,148, but a 4.2% gain from the October 25th close of 898. Illustrating the same point, the 159-point gain in the S&P 500 index from the 10/09/2002 lows to 11/29/2002 represents a recovery of 10% of its value (i.e., from down 49% to down 39%) based on the all-time high of 1,527. The same 159-point increase represents a gain of 20% based on the 10/09/2002 low of 777 (see chart below)).

BOND PRICES showed modest gains for the period, partially recovering from the declines in October, which was the first down month for bonds since March 2002. (The results for the November period, for both stocks and bonds, and for the full-year 2002, are set out on page 2).

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 11). Note that all three indexes have positive average annual returns of 9% to 11% from the end of 1994 to 11/29/2002. **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)%
Nov 29, 2002 Close	936	(39)%	8,896	(24)%	1,479	(71)%

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 '05-11/20/02	0.10%	11.20%	8.00%

The Remainder Of This Month's Comments Addresses The Subject Of Risk In Investing.

A fundamental fact of investing is that there is Risk in all investment choices. The investments we make on your behalf are from the three liquid asset classes: Stocks, Bonds, and Cash Equivalents. An understanding of the Risks in each of these categories is most important.

Cash Equivalents: Examples include Money Markets, Very Short-Term (i.e., less than one-year) High Quality Debt, and Certificates of Deposit. Investment Returns come only from interest, with no price fluctuations. Risk occurs in times of low interest rates (as now), when returns are correspondingly low, and can be negative after taking inflation (defined as the loss of purchasing power of money over time) and taxation into account. Even when interest rates are high, if inflation is correspondingly high, there is the risk that returns will be negative after inflation and taxation.

Bonds: Debt with longer maturities, from one year to 30 years, issued by the U.S. Government, State and local governments, and/or private companies. Returns come primarily from interest, but there are definitely price fluctuations, both up and down, depending on changes in interest rates, bond maturities, and the credit quality of the bond issuer. A more extensive discussion of Risk from Bonds is set out below.

Stocks: Shares of ownership in businesses. Returns come primarily from price increases, with income in the form of dividends a minor factor. Risk from Stocks occurs when prices decline substantially over time. A more extensive discussion of Stock Risk begins on page 6.

RISK FACTORS FROM BONDS: Bonds represent a promise by the Borrower to repay the money borrowed at a given future time, and to pay interest on the money borrowed.

(1) **INTEREST RATE RISK**: The price of bonds will vary with **changes in interest rates** on newly issued bonds. When interest rates increase on new bonds, the prices of bonds already issued decline. The converse is also true; when interest rates decline on new bonds, the prices of bonds already issued increase.

(2) The extent of the price changes depends on bond **maturities**; that is, how much time must pass until the bond matures and investors have their money returned. The longer the maturity, the more up and down price variations will occur for any given change in interest rates. To elaborate, the 5-year U.S. Treasury interest rate today is 3%, compared to the 10-year rate at 4%. The reason some investors buy the 3% rate is to avoid the risk of having to wait an additional 5 years before their money is returned, even though they could earn an additional 1% for taking that risk (4% is 33% more interest than 3%). Put another way, investors give up the extra interest to reduce the price changes of their bonds caused by changes in interest rates.

(3) Some investors think that price variations of their bonds based on changing interest rates do not matter, if the bonds are held to maturity. This idea is incorrect. For example, if you buy a 10-year U.S. Treasury bond today at 4% interest, and interest rates on newly issued 10-year Treasuries increase to 6% next year, then your 4% bond will decline in price, and your bond will receive 2% less interest for the next nine years compared to the buyer of the 6% bond (6% is 50% more interest than 4%). To ignore this fact of earning less interest than the market place is providing, based on the rationale that you will at least receive your starting principal back after ten years, is to ignore the prime reason you bought the bond, which is to earn market rates of interest. After all, you can retain your principal by keeping the money under your mattress, but there is no investment return from your mattress.

(4) Another issue that causes confusion regarding Risk in Bonds relates to owning mutual funds that buy bonds rather than owning the bonds themselves. Properly managed bond funds that own bonds consistent with their stated objectives function in the same way as a portfolio of individually owned bonds. Indeed, the fund is nothing more than a portfolio of bonds that mature and have the proceeds reinvested, exactly as an investor would manage a portfolio of individual bonds. It is true the bond fund has no maturity, whereas each individual bond has a specific maturity. In a bond fund, the manager simply reinvests the proceeds of the matured bond in a bond of similar maturity, just as the owner of an individual bond would. Given bonds of similar maturities, the distinction between individual bonds and a bond fund has no effect on the risk of owning bonds in general.

(5) There is an additional risk factor in bonds related to the **CREDIT QUALITY** of bonds. Credit Quality refers to the likelihood the bonds will be paid at maturity, and that the interest will be paid periodically when due. There is a distinct hierarchy of credit quality.

(a) U.S. Government Bonds are the highest quality, since the chance of its bonds defaulting is virtually nonexistent. Why? Because the U.S. Government has the power to tax and to print money, and therefore it should always be able to pay its bonds. By virtue of receiving the highest credit ratings, U.S. Government Bonds pay the lowest interest compared to bonds of similar maturities.

(b) Municipal Bonds, issued by state and local governments, are next on the quality scale, since they are also issued by governmental entities. These bonds pay interest rates that are related to U.S. Government Bonds, but are actually lower because the interest is exempt from Federal taxation. From time to time, municipal government entities have serious financial problems, and their ability to repay their bonds becomes questionable. Some municipal bonds are issued by specific municipal revenue producing entities, and these can also have credit problems. Some municipal bonds are insured, which increases their credit quality.

(c) Corporate bonds are issued by private companies, which can and sometimes do go bankrupt. When corporate bonds are first issued, they receive credit ratings. The basic credit distinction is between high-quality bonds, where the market expects repayment, and low-quality, or junk, bonds, where the market has serious questions from the outset about the company's ability to repay. To compensate for the Risk of default, junk bonds pay much higher interest than high-quality corporate bonds. A real problem arises when bonds initially issued as high quality subsequently become bad credits. Recent examples of once highly rated companies whose bonds have defaulted are Enron and Worldcom. Lucent's bonds (like the stock) have also suffered dramatic declines based on vastly lowered credit quality.

(6) **INFLATION RISK** impacts all bonds. The issue is whether the interest earned is sufficient to cover the loss of purchasing power of the initial principal invested, even assuming the timely payment of interest and the repayment of principal at maturity.

(a) Adding to this inflation risk is the issue of **TAXATION**. Bond interest is taxed currently at ordinary income tax rates, except for municipal bonds, whose interest rates are lower because they are not subject to federal tax. Taxable bonds are therefore best owned in retirement accounts, since there is no taxation of the interest (or any other investment gain), until monies are distributed from the retirement account.

RISK FACTORS WITH STOCKS:

Stocks represent a share of ownership in a business. The fundamental risk associated with investing in Stocks is that prices can decline substantially. Since there is no maturity date at which time a set amount of money is returned (as with bonds), the potential extent of the decline is unknown. Investors are willing to take this kind of conceptually unlimited downside risk because investment gains from stocks have historically exceeded gains from bonds by a substantial amount. The comparative average annual percentage returns from 1926 through 2001 are as follows (Source: Ibbotson 2002 Year Book, Stocks, Bonds, Bills and Inflation):

	Annual <u>Return</u>	Value of \$1.00 <u>Compounded</u>
Stocks (Large Co.)	10.71%	\$2,279.13
Bonds	5.34%	52.29
Cash Equivalent	3.81%	17.20
Inflation	3.06%	9.86

Stock prices are impacted by a myriad of factors, some financial, others psychological and emotional. Each factor affecting stock prices can be discussed extensively, but suffice to say for this discussion that the interplay of factors can lead to major price increases and/or major price declines. We believe that no one can predict in advance which result is going to occur in any given time frame.

CORPORATE EARNINGS provide the most basic reason for stock price movements over lengthy time periods. But even this basic idea generates many issues in its application.

- (a) What are the Real Earnings? Recently the accounting issues involved in defining earnings have become widely publicized: How to account for the cost of stock options, the cost of retirement plan contribution levels, “one time” expenditures, and overpriced acquisitions, are among the many issues involving judgment calls by accountants and corporate management in arriving at proper earnings figures. To illustrate the extent of this problem, earnings for the S&P 500 currently range from \$30 to \$48, depending on which items are included are excluded.
- (b) Past Earnings or Future (Forecast) Earnings: Stock valuations are often based on the most recent year's earnings, but are also often based on future earnings forecasts, which may or may not come to pass.
- (c) Appropriate Price/Earnings (P/E) Ratios: Even if earnings and the relevant time frame are clear, what is the appropriate price level for a given dollar of corporate earnings? The historical Price/Earnings ratio (“P/E”) for the S&P 500 is approximately 15, but in times of low interest rates, it is argued that higher multiples are justified. During the great bull market of 1995–1999, P/Es for the S&P 500 exceeded 30, and some hi-tech stock P/E's exceeded 100 (for real companies, not dotcoms). Now, in the midst of the second or third worst bear market since 1926, P/Es have declined, but the issues mentioned in (a) and (b) above leave both the actual P/E level, and its appropriateness, unclear.

One kind of Stock Market Risk that can be eliminated is the risk related to investing in an individual company's stocks. Any company can encounter serious, even fatal problems. But one company's problems can be another company's opportunity. On the other hand, entire industries rarely fail, and the entire stock market can only fail if the world as we know it comes to an end (in itself a risk, more real after 9/11, but still a difficult concept on which to plan one's future). Therefore, if investors make stock investments with industry specific indexes, or indexes that track the entire stock market, they can eliminate the risks that come with investing in specific companies. This does not mean investors should expect higher returns from these indexed investments, but rather that they can reduce the risks of stock market investing by using indexes.

If there is agreement that stocks have historically provided better returns over the long term, and that risk can be reduced by investing in industry-specific or broad market indexes, where is the risk to stock investors who have a long time horizon?

- (1) Your need for your money may arise in the short-term, which could coincide with a time frame when stocks are down substantially (like now).
- (2) The much more significant risk, and one that must be addressed: What if the History does not Repeat?

Contrast these positions on history...

"History is definitive that once investors have suffered this much pain, subsequent stock returns will be very rewarding." Professor Jeremy Siegel, University of Pennsylvania, Professor of Finance, author of "Stocks For the Long Term", in WSJ Op Ed piece dated July 25, 2002.

"Don't wish for the good old days. In 1972, problems were worse. We did overcome communism, stagflation, Watergate and Vietnam. For all our momentary problems, at the turn of the century the Soviet empire had collapsed, democracy was spreading to unlikely places, and the American free-enterprise model was established as the route to development. Even with today's problems the U.S. has no serious rival. In the sweep of this history, today's problems loom as another set of momentary nuisances. What I think I've learned over 30 years is that in this society, rationality wins out, progress happens, and problems have solutions. This, I like to think, is what happens when a society incorporates the editorial credo of my newspaper, free markets and free people. In that kind of a society, optimism pays." Article by Robert Bartley, WSJ, Nov. 18, 2002. Mr. Bartley, editor of the Journal, will become editor emeritus on Jan. 1. He will continue to write his column, "Thinking Things Over." This is an excerpt from his valedictory address, delivered on November 17, 2002 in New York.

"Beware the history that draws theories from past events without allowing for the fact that such combinations of events might have arisen from randomness", page 48. "It can be disturbing...to be questioned about the histories that did not take place rather than the ones that actually happened." page 34. "But somehow, overall, history is potent enough to deliver, on time, in the medium-to long-run, most of the possible scenarios, ...", page 50. All three quotes are from the brilliant and highly recommended book by Nassim Nicholas Taleb, "Fooled By Randomness, The Hidden Role of Chance in the Markets and in Life."

Taking a look at some relevant history, ...

- (1) The following chart, which has been presented in previous Comments, sets out the declines and recoveries from the two worst bear markets since 1926, and figures related to the current bear market, from which there has been no significant recovery as yet. The figures show the declining and then recovering value (except for 2000–2002) 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						

- (2) The following list presents past crises overcome by the Stock Market.

		<u>Dow Jones Six Months Later</u>
Pearl Harbor:	12/07/41	- (9.5)%
Korean War:	06/25/50; 07/13/50	+ 2.4%; + 19.2%
Cuban Missile Crisis:	10/22/62	+ 25.1%
Kennedy Assassination:	11/22/63	+ 12.0%
Nixon Resignation:	08/08/74; 08/29/74	- (10.7)%; + 12.5%
Stock Market Crash of 1987:	10/19/87	+ 15.0%
Iraq Invasion of Kuwait:	08/02/90	- (5.8)%
Asian Financial Crisis:	10/27/97	+ 25.0%
9/11 Attacks:	09/11-9/21/01	+ 21.2

If you are a believer in this history, the current bear market is an opportunity to add to your stock exposure, in order to experience the gains from a recovery that history suggests is likely to occur. If, on the other hand, you believe this is only one history, and that alternative outcomes very different from those that have occurred so far are entirely possible, even likely, then this history will not provide solace to you.

This is an issue you need to consider. As investment advisers, we use the history that is known and available primarily because it is the history that is known and available. Of course, alternative histories are possible, and of course, the future need not play out like the past. But as even Taleb observes, "Somehow, overall, history is potent enough to deliver, on time, in the medium to long run, most of the possible scenarios." So time is a key factor in relying on history. **Your investment program has a reasonable chance to succeed in meeting your objectives if you can correctly evaluate your time frame for the use of your money, and develop an asset allocation appropriate for that time frame, taking no greater risk than you need to achieve your objectives.** It is our job to help you put all these factors together so as to attain your goals.

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)%
Nov 29, 2002	936	(29.0)%	8,896	(17.5)%	1,479	(40.1)%

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)%
Nov 29, 2002	936	(36.3)%	8,896	(22.6)%	1,479	(63.7)%

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%
Nov 29, 2002	<u>936</u>		<u>8,896</u>		<u>1,479</u>	
7yr&11mo Gain; Annual. %	477	9.4%	5,062	11.2%	727	8.9%



Victor Levinson



Nicholas Levinson