

VICTOR LEVINSON

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NOVEMBER 2003 COMMENTS

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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 November 28, 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)%	25.7%	1.7%
S&P 500	19.6%	(10.1)%	(13.0)%	(23.4)%	20.3%	0.9%
S&P 500 Growth	28.8%	(22.2)%	(13.0)%	(23.7)%	22.3%	1.1%
S&P 500 Value	12.6%	6.1%	(12.0)%	(20.9)%	23.7%	1.6%
Dow Jones Industrials	25.2%	(6.2)%	(7.1)%	(16.8)%	17.3%	(0.2)%
NASDAQ Comp.	85.6%	(39.3)%	(21.0)%	(31.5)%	46.8%	2.1%
MidCap US	25.0%	2.6%	(4.8)%	(16.3)%	30.7%	3.7%
Small Cap US	19.6%	(4.2)%	1.0%	(21.6)%	42.2%	5.2%
Intl, EAFE	25.3%	(15.2)%	(22.6)%	(17.5)%	30.2%	2.7%

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

Taxable	(0.8)%	11.3%	8.3%	8.2%	3.0%	0.2%
Tax-Exempt	(2.9)%	9.2%	5.0%	7.9%	3.8%	0.9%
High Yield Taxable				1.7%	14.7%	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>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%	

NOVEMBER 2003 COMMENTS

During the month of November, **STOCK PRICES** were little changed. For the month, the S&P 500 was up 0.9%, and is now up 20.3% year-to-date; the Dow Industrials declined (0.2)%, and are up 17.3% year-to-date; and the NASDAQ Composite gained 2.1%, and is now up 46.8% year-to-date.

These November results occurred against a backdrop of decidedly mixed influences. On the one hand, there was continuing positive economic news regarding the U.S. economy (see pages 5 and 6 for details). On the other hand, there were a number of factors that are typically viewed as negatives for stock prices, including weakness in the U.S. dollar, high oil and gold prices, threats of retaliatory tariff measures, soaring projected U.S. budget deficits, continuing problems with mutual funds (see discussion on pages 6-8), and the ongoing geopolitical problems of terrorism and Iraq. Indeed, with all these apparent negatives, a breakeven result looks favorable. However, as you know, we believe attributing causes to stock price movements is a 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) were also little changed during November, except for intermediate-term municipal bonds. Some of the same factors mentioned in the above paragraph as influencing stock prices are typically attributed to moving bond prices as well. Here again, causation is a complex matter, and for November the end result in the bond markets was, for the most part, not much change. High quality intermediate-term taxable and tax-exempt bonds had returns of +0.2% and +0.9% respectively. Year-to-date, returns for taxable and tax-exempt bonds are +3.0% and + 3.8%, respectively.

While the year-to-date percentage increases for Stocks continue to be 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, 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 1,058 back to 1,527 over the next five years, the annualized investment return would be 7.6%, well within reasonable long-term return expectations for the stock market. But if it takes 10 years, the annualized return would be only 3.7%, a return more closely associated with bond returns. The NASDAQ recovery would be far more dramatic; to regain prior highs in five years from the current 1,960, the annualized return would be 20.8%; over ten years, 9.9%.

Stock and bond investment results for the November 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, which began in March, has raised the S&P 500 36% 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 of now 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 11). Note that the three indexes have positive average annual returns ranging from 9.8% to 11.3% from the end of 1994 through November 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)%
November 28, 2003 Close	1,058	(31)%	9,782	(16)%	1,960	(61)%

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 11/28/03	<u>1,058</u>	<u>9,782</u>	<u>1,960</u>
Gain	599	5,948	1,208
Avg. Annual % Gain, '95-11/28/03	9.8%	11.1%	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 only modest changes despite confirmation of the largest quarterly GDP advance (see (1) below) since 1984).

In any event, an understanding of the direction of current economic trends is useful as a context to help understand market conditions. This section of the Comments provides 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 an 8.2% inflation-adjusted annualized growth rate, the strongest quarterly showing since Q1 1984. This figure was even higher than the month earlier "advance" figure of 7.2%. Consumer spending and business investment were up strongly (Sources: Wall Street Journal ("WSJ"), 11/26/03, pg. A1; Vanguard Economic Week in Review ("VEWR"), 11/24-28/03, pg.1).
- (2) Employment levels for October showed a second consecutive month of gains. The economy added 126,000 new jobs, the best monthly showing since January 2003. Disappointing employment levels have been the weak spot in the current economic recovery, and "while economists generally viewed the unemployment report as encouraging, some analysts noted that monthly payroll growth must exceed 150,000 in order to significantly reduce the nation's unemployment rate" (VEWR, 11/3-7/03, pg. 1). This improving employment trend appears to be continuing for November, since the most recent weekly initial claims for unemployment insurance declined, and the figure for continuing claims fell to a nine-month low (VEWR, 11/24-28, pg. 2).
- (3) Interest Rates were essentially flat during November. The benchmark 10-Year US Treasury now yields 4.32%, a figure that was 4.30% at the end of October, 3.93% at the end of September, and 4.45% at the end of August. While these rates are low by historical standards, they are more than one full percentage point (or 100 basis points) higher than the low point reached in early June 2003. Further, "several officials of the Federal Reserve Board voiced the view that short-term interest rates may not rise as quickly as some market participants have predicted" (VEWR, 11/10-14/03, pg. 1).
- (4) Inflation remains low. The "core" inflation rate, as measured by the Consumer Price Index (CPI) and excluding volatile food and energy prices, rose 0.2% in October, and is up only 1.3% for the most recent twelve months (VEWR, 11/17-21/03, pg. 1). The most recent twelve-month gain in the "core" Producer Price Index is just 0.5%, which includes a 0.5% increase for October (VEWR, 11/10-14, pg.1).

(5) Sector Economic Activity is Strong

- (a) Durable goods orders rose sharply in October (VEWR, 11/24-28, pg. 1).
- (b) Industrial production and manufacturing activity were slightly higher in October, but “capacity utilization remained at a relatively low level, suggesting that the economy has room to grow before significant inflationary pressures ignite” (VEWR, 11/10-14, pg. 1).
- (c) Retail Sales fell in October, but for the first ten months of 2003 were 5% higher than the comparable ten months of 2002 (VEWR, 11/10-14, pg. 1).
- (d) Housing sales declined from the record pace of the prior month, but were still reported to be strong for the month of October (VEWR 11/24-28, pg. 1).
- (e) Personal Income rose 0.4% in October, while personal spending, which accounts for two-thirds of U.S. economic activity, was unchanged (VEWR, 11/24-28, pp. 1 and 2).

(6) Consumer Confidence, as measured by the Conference Board's Index of Consumer Confidence for November, reached its highest level since September 2002. “There was a significant decrease in the number of respondents to the monthly survey who were pessimistic about the six-month outlook for business conditions, employment and income growth” (VEWR, 11/24-28, pg.2).

(7) Corporate Profits for the third quarter were up 30% from the comparable year-earlier quarter, as measured by the Commerce Department's broadest measure of corporate profitability. “For many companies, the combination of faster economic growth (which spurs revenue gains) and rapid productivity improvement (which helps contain costs) translates to stronger profits” (WSJ, 11/26, pg.1). The same WSJ article, on page 2, adds that “other measures of corporate profitability have turned decisively higher during the past six months.” The relationship between corporate profits and stock prices is discussed further on pages 9 and 10 of these Comments.

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. **More on Mutual Funds in the News: What We Do:**

The problems facing the mutual fund industry, which were discussed at some length in last month's Comments, continue with no end in sight. Since one of the fund families coming under criticism is one that we owned for a limited number of bond investments, we think it is important to report on the nature of the problems, and our response.

The fund family in question is the Strong funds. Coming into November 2003 we owned, in limited amounts, five different Strong bond funds. These funds had been purchased a few years ago at a time when Vanguard's menu of bond funds did not include certain parts of the bond market that were covered by this group of Strong funds. Accordingly, we had purchased the Strong funds.

The Strong funds were brought under regulatory scrutiny recently when it was reported that Richard Strong, the head of the fund family with \$42 billion under management, had engaged in short-term trading in his company's funds. This activity is improper, and while the dollar amounts involved were not large, the action itself created regulatory problems for the funds. Then, in the November 19th Wall Street Journal (WSJ), it was reported that a second Strong executive had come under investigation, this time for allowing a hedge fund to conduct "short term market-timing trades...even though the Strong prospectus discouraged such trading"(p. C9).

The same WSJ article reported that certain institutional investors in Strong funds had either discontinued Strong's services, or were considering doing so. Based on all this adverse information, we sold all Strong fund positions for our clients last week. Our primary concern was that as more investors withdrew from the funds, the ongoing cost structure for the remaining shareholders would become excessive. Indeed, Putnam, another previously well-regarded fund group, has seen a significant outflow of money from its funds based on recent adverse publicity.

The proceeds from these sales of Strong funds in our clients' accounts were reinvested in comparable bond funds of either Vanguard, or in the case of taxable high yield bonds, in T. Rowe Price. The reason Vanguard was not used for taxable high yield is that it closed its fund earlier this year when it believed too many people were buying into the fund for inappropriate reasons. This type of responsible action is one reason we use Vanguard almost exclusively when investing in mutual funds. (The main reason for using Vanguard funds, as mentioned in many previous Comments, is that they are the uncontested low-cost provider of indexed funds, covering both the bond and stock markets.)

While discussing changes in client's portfolios, we also want to advise you that the Citigroup preferred stock owned in a number of accounts was called during November. Since we still believe the Citigroup preferred stock represents a favorable holding for many clients, we used the proceeds to purchase another issue of Citigroup preferred stock. Indeed, preferred stocks have become even more favorable holdings for taxable accounts, since the income tax rate on dividends has been reduced from a taxpayer's highest marginal tax bracket to 15%. The reason we bought an individual company's preferred stock, rather than a mutual fund or exchange-traded fund ("ETF"), is that there are no mutual funds or ETFs that invest solely in preferred stocks. There are "closed-end" funds that invest in preferred stocks. These closed-end preferred stock funds typically trade at premiums to net asset value, which eventually disappear. We are unwilling to take this risk of loss of principal in making this kind of income-oriented investment. (Note: Closed-end funds limit the number of shares sold to investors, and can trade at a premium or discount to net asset value, which is the sum of values of all the holdings in the fund. The more prevalent "open-end" funds, by contrast, issue additional shares based on investor demand, and always trade at net asset value.)

Before leaving the subject of mutual funds, we would like to quote extensively from a November 19th WSJ article written by Holman Jenkins Jr. and entitled "A 'Perk' Too Far in the Mutual Fund Biz" (page A21). "So far mutual-fund investors have refused to be whipped into a panic over the equivalent of phone companies rounding up to the next minute... Money has flowed strongly into stock funds, investors being more impressed by a rising stock market than by any nickel-and-diming by fund companies... Investors ought to worry less about how much their financial servants are pocketing under the table and more about why they are paid so much over the table."

Jenkins continues: "We refuse to be surprised every 15 minutes because somebody on Wall Street interprets a "gray area" as his rightful opportunity to get a little richer. It happens in every business. The fund industry's susceptibility to various kinds of opportunistic trading has long been accepted as one of its downsides. The fund industry, though, faces bigger problems than opportunistic behavior at the margin. Slowly, slowly, sense is coming to the individual investor. A survey by the Spectrem Group of those with portfolios of at least \$5 million found that, between 2001 and 2003, 27% fewer were taking advice from a broker, with a commensurate rise in the number seeking out "unbiased" advice from financial planners and investment counselors. If it makes sense for someone with \$5 million to stop playing stock market speculator, it makes even more sense for somebody with \$100,000. But the lesson has been achingly long in coming. The best thinkers in financial economics should have taught us long ago that financial markets are so efficient that you and I can't expect to outguess them on a regular basis; trying only creates a nice revenue stream for other people (namely, Wall Street) to live on" (our emphasis).

Because we so heartily agree with Jenkins, we continue quoting him to the end of the article: "We blame the SEC. Its whole philosophy of enforcement and panoply of rules suggest to the small investor that he should be weighing companies, poring over published accounts, and picking winners and losers in competition with the best minds and most cold-blooded speculators in the world. The fund industry paints itself as the salvation of Mom and Pop, then drowns them in brochures for "growth" funds, "technology" funds, "health care" funds, "overseas health technology growth funds" and other absurd permutations. These are nothing more than an invitation to commit the same mistakes by sector that small investors have always made by chasing the latest hot individual stock. The SEC, if it were really doing its job, would inform the public that it's wasting its money. But the agency considers itself the protector of the "active" small investor so it can't very well tell him his "activity" is the single biggest menace to his investment returns" (our emphasis).

And finally, Jenkins concludes... "Don't get us wrong, speculators and active fund managers are highly useful people. They do the research and risk-taking to make sure prices are "right"- that is, reflect the latest wisdom about what companies and their managements are worth. They make the world safe for "indexers": smart investors who stick their money in cheap, no-load funds like Vanguard's S&P 500 index and let Wall Street support them rather than the other way around" (our emphasis).

We hope you agree that Mr. Jenkins has eloquently and persuasively presented views that are perfectly consistent with our views of investing expressed regularly in these Monthly Comments.

III. Relationship of Company Profits and Stock Price

The page 1 article in the November 26th edition of the WSJ reported that corporate profits for the third quarter of 2003 increased by 30% over the comparable quarter of 2002, and that these profits are now running at an annual pace “above \$1 trillion for the first time in history”(our emphasis). The material that follows describes the relationship between company profits and stock prices.

At its most basic level, profits are the difference between a company's revenues and expenses. All businesses that are designed to make a profit offer goods or services for sale, and these sales represent the company's revenues. To conduct business, companies have costs, including salaries, the purchase of goods that are resold, supplies, shipping, advertising, income taxes, and so on. Profits are the difference between sales and expenses. (Note: “Profits” and “earnings” are used as interchangeable terms in this discussion).

There are many complex issues that arise in the accounting of revenues and expenses. It is not our purpose to explore these issues, although the many different measures of corporate profitability used today do cast a high degree of uncertainty on the accurate measurement of corporate profits (an issue touched on in the WSJ article referred to above).

Continuing our discussion of the relationship of profits to stock prices, let's assume a large, successful company has profits in a given year of \$2 billion (which would be about 2/10 of 1% of the \$1 trillion figure reported above). Assume the same company has 1 billion shares outstanding, so that the profits per share are \$2.00. Now the key question related to the price of this company's stock is what price should investors be willing to pay to own a share of this company's profits. A price per share of \$20 would mean investors are paying ten times the company's current profits, whereas a price per share of \$40 would mean investors are willing to pay twenty times the company's current profits. The relationship between the stock price and the profits is referred to as the Price/Earnings (P/E) ratio. Since both these prices are perfectly plausible, what factors explain the difference between the prices paid, assuming the same profits per share? Put another way, what explains the different P/E ratios of different companies? This is indeed one of the key questions in the investing world.

Perhaps the most important factors in explaining a stock's P/E ratio are the company's rate of growth of profits, both historical and anticipated. Predictability of levels of profitability is also a factor. Further, broad economic factors such as the relative economic health of the industry in which the company operates, actual and anticipated competition, and interest rate levels are also relevant.

A company whose per share earnings history for the most recent five years was \$1.00, \$1.25, \$1.50, \$1.75, and then \$2.00 would likely be accorded a very different P/E than a company whose road to \$2.00 of earnings per share was \$1.75, \$2.40, \$1.85, \$2.25 and then \$2.00. But this is only the historical part of the story. Even more important would be the view of countless professional and amateur investors as to what the future pace of earnings growth is likely to be. Here estimates and projections come to the forefront, and those smart enough or lucky enough to predict with even some degree of accuracy the future course of earnings growth have the opportunity of looking good to the investing community.

John Allen Paulos, in his book "A Mathematician Plays the Stock Market" (which was quoted extensively in our August and September Comments), discusses the subject this way: "A company's stock is worth only what it returns to its holders in dividends and price increases. To determine what that value is, they try to make reasonable estimates of the amount of cash the stock will generate over its lifetime, and then they discount this stream of payments to the present. And how do they estimate these dividends and stock price increases? Value investors tend to use the company's stream of earnings as a reasonable substitute for the stream of dividends paid to them since, the reasoning goes, the earnings are, or eventually will be, paid out in dividends....If the earnings of the company are good and promise to get better, and if the economy is growing and interest rates stay low, then high earnings justify paying a lot for a stock. And if not, not....One very common way to interpret the P/E ratio is as a measure of investors' expectations of future earnings. A high P/E indicates high expectations about the company's future earnings, and a low one low expectations. A second way to think of the ratio is simply as the price you must pay to receive (indirectly via dividends and price appreciation) the company's earnings. The P/E ratio is thus both a sort of prediction and an appraisal of the company.... (And finally), the P in the numerator is not invulnerable to psychological factors nor is the E in the denominator invulnerable to accountants' creativity" (pages 100-102).

This subject of the relationship between company earnings and their stock prices can be discussed extensively. We have covered the topic in previous Comments, and will do so in future Comments. For current purposes, suffice to say that in an environment of higher corporate earnings it is reasonable to expect higher stock prices. But as we consistently point out, the fact of improving profitability may already be incorporated in current stock prices, so that the good news may well have already been anticipated and accounted for.

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)%
November 28, 2003	1,058	(28.0)%	9,782	(14.9)%	1,960	(51.8)%

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%
November 28, 2003	<u>1,058</u>		<u>9,782</u>		<u>1,960</u>	
8.9 Year Gain; Annualized %	599	9.8%	5,948	11.1%	1,208	11.3%



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