

DECEMBER 2002 COMMENTS

NOTES:

WINTER LOCATION:

Vic will be working in Florida for the months of January, February, and March. His direct phone line is 561-392-8138, and direct fax number is 561-393-1255.

You can still call Vic's direct line in New York, 212-588-0015, and your call will be forwarded to the Florida number. But please do not send faxes to Vic's New York fax number.

You can reach Lynette at the Balis NY office: phone 212-350-4393; fax 212-350-1430.

Nick remains in the San Francisco Bay Area: phone 510-601-6662; fax 510-601-6265. Nick and his wife Julie are expecting their third child at the end of February.

TAX REPORTING FOR 2002:

Bear Stearns (BS) has an excellent new Tax Report for Realized Gains and Losses. We will be providing these to you/your accountant during February, March, and April, after you receive your 1099 Tax Reports at the end of January (1099s come directly from Bear Stearns). 1099s report dividends, interest, and proceeds of sales. The additional BS report provides the cost basis along with proceeds of sales, and can be used for the capital gains section of your tax return.

INVESTMENT RESULTS FOR 2002:

By the end of January, we will be providing all our clients with complete year 2002 investment results. After receipt, let us know if you have any questions or comments. We are hopeful for a better year in 2003, and wish everyone a healthy, peaceful, and prosperous new year.

COMMENTS: INDEX RESULTS, period ending December 31, 2002

	<u>YEAR</u>	<u>YEAR</u>	<u>YEAR</u>	<u>YEAR</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)%	(23.4)%	(4.9)%
S&P 500 Growth	28.8%	(22.2)%	(13.0)%	(23.7)%	(5.3)%
S&P 500 Value	12.6%	6.1%	(12.0)%	(20.9)%	(4.4)%
Dow Jones	25.2%	(6.2)%	(7.1)%	(16.8)%	(5.6)%
NASDAQ Comp.	85.6%	(39.3)%	(21.0)%	(31.5)%	(7.3)%
Ext/MidCap US	25.0%	2.6%	(4.8)%	(16.3)%	(3.7)%
Small Cap US	19.6%	(4.2)%	1.0%	(21.6)%	(6.3)%
Intl, EAFE	25.3%	(15.2)%	(22.6)%	(17.5)%	(5.4)%

BONDS, Interm.

Taxable	(0.8)%	11.3%	8.3%	8.2%	2.2%
Tax-Exempt	(2.9)%	9.2%	5.0%	7.9%	2.2%

	<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>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				
NASDAQ COMP	(5.5)	(19.5)	(13.5)	7.0				
BONDS: Interm. Taxable	0.0	2.8	3.6	1.8				

DECEMBER 2002 COMMENTS

During the December period ending Tuesday, December 31, **STOCK PRICES** declined. While prices for the three major indexes remain 12% or more above their early October lows, the December declines were substantial: the S&P 500 was down 4.9%, the Dow Industrials down 5.6%, and the NASDAQ Composite down 7.3%. The full year 2002 marked the third consecutive down year for stock prices, a rare but not unique occurrence.

The following chart, which has been presented in previous Comments, sets out the declines and recoveries from the three 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	(at 10/09 Lows)		
1933	53.99%	550,900	1977	-7.18%	989,600	YrEnd		
1934	-1.44%	540,300	1978	6.56%	1,054,500	2002	-23.37%	614,000
1935	47.67%	801,800	1979	18.44%	1,250,000	2003	???	???
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						

BOND PRICES advanced for the period, completing the third consecutive year of substantial gains. During this entire 2000-2002 bear market for stocks, bonds have realized gains in excess of their interest rate yields. This result is due to the significant decline in interest rates, as the Federal Reserve has tried (so far with only mixed success) to stimulate the economy to a faster rate of growth. (The investment results for the December period, for both stocks and bonds, and for the full year 2002 and the years 1999-2001, are set out on page 2).

As for the extent of the stock market declines for the entire 2000-2002 Bear Market, as 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 10). Note that all three indexes have positive average annual returns of 7.5% to 10% from the end of 1994 to the end of 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)%
Dec 31, 2002 Close	880	(42)%	8,342	(29)%	1,336	(73)%

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, '95-12/31/02	8.5%	10.2%	7.5%

You may recall last month's Comments discussed in detail the Risks associated with the major liquid asset classes that make up an asset allocation, namely cash, bonds, and stocks. The balance of this month's Comments will discuss the various specific investments we use in implementing your asset allocation, in the context of all the investment choices available in the marketplace. The figures on page 2 of these Comments present the annual investment results for years 1999 through 2002 for many of the investment choices discussed.

CASH EQUIVALENTS – We use the Reserve Fund Money Market (RFMM) Taxable or Tax Exempt fund, as appropriate for each specific account. RFMM has a relationship with our clearing firm, Bear Stearns (BS), so all cash credits to the BS accounts are swept daily into RFMM, and transfers from RFMM to BS are immediate. Other Cash Equivalents include short-term U.S. Treasuries and short-term Bank CDs. There is very little interest rate difference among these short-term investments, which currently pay very low interest rates and are designed to have no fluctuation in principal value.

In today's very low interest rate environment, with cash equivalent returns so low, we are more inclined to use short-term bond funds, with 1- to 3-year maturities, for all except the most current of cash needs. We also discuss the availability of debit balances (i.e. borrowing against the value of the holdings in your account) to satisfy certain short-term cash needs, given Bear Stearns' very low current rate of 2 _% annually.

RFMM can also provide you with checks if you would like. Using the check-writing feature can make our management of your accounts more difficult, however, because we would only know about outstanding checks if you inform us when you've written them. If you want to discuss this further, please call.

BONDS – As with all investments, trying to earn higher returns, or higher yields, from bonds means taking on additional risk. We use a number of different bond investments to provide portfolio balance between the yields earned and the risk of price declines. For any bond investment, there is the alternative of taxable or tax-exempt yields; we make that choice based on the tax status of each account for each client.

(1) The lowest yield and lowest risk come from Short-Term Bond Funds, which invest in high credit quality corporate or U.S. Government securities with 1- to 3-year average maturities.

(2) Higher yields, with more risk of price changes, come from Intermediate-Term Bond Funds, which also invest in high credit quality bonds. Intermediate-Term bonds typically have 4- to 7-year maturities; the longer the maturity, the more price sensitive the portfolio will be to changes in interest rates (higher rates causes existing bond prices to fall, while lower rates cause existing bond prices to rise).

(3) Even higher yields, with more risk of price declines, come from Long-Term Bonds, which have maturities longer than seven years. The yields on these funds are somewhat higher than those for shorter-term bond funds, but we do not use them because we believe the risk of price declines outweighs the benefit of only moderately higher yields.

(4) Higher-Yield Securities with Credit Risk. To obtain higher yields as part of a bond portfolio, we use junk bond funds, preferred stocks, and funds that invest in commercial mortgages.

(a) Citibank Preferred and Pimco Mortgage are examples of the latter two categories of high yield securities. Both have had favorable results these past few years.

(b) Within the junk bond category, different funds have different risk profiles. We use funds from Vanguard, Strong, Scudder, and T. Rowe Price. Strong Funds have provided the highest yields, with the most price volatility, while Vanguard's bond funds typically offer lower yields and less price volatility. All have yields well in excess of the high quality bond funds, however. Over the past few years, junk bonds have not done as well as high quality bonds, although the category outperformed stocks by more than 15% in 2002. As with all bond funds, interest comes in to your account as cash. If a junk bond fund had a price decline of 20%, but earned income of 10%, the overall result attributable to that particular fund is minus 10%, not minus 20%. And if the price of the fund increases, the increase is in addition to the interest earned

STOCKS – The choices with stocks are extremely varied. We use mostly **indexed investments** rather than actively-managed stocks or mutual funds in implementing portfolios. **Indexed investments** are available in no-load mutual funds (from Vanguard, for example) and no-load stocks (referred to as Exchange Traded Funds, or ETFs). **Indexed investments** are available for all the categories of stock choices discussed below. **Indexed investments** seek to equal the results of the market segments in which they invest; actively-managed investments seek to outperform the market segments in which they invest, while running the risk of underperformance.

Points in favor of Indexing include:

- (1) Precision: The composition of an indexed portfolio reflects precisely the segments of the market it tracks, and does not vary its focus.
- (2) Difficulty of Active-Management Outperformance: Most individual stock managers and mutual fund managers do not consistently outperform the indexes over time.
- (3) Low Cost: At least 1% lower cost compared to most stock investments. A 1% cost differential on a 10% investment return makes the cost differential 10% of the investment result.
- (4) Tax Efficiency: Many fewer transactions result in significantly reduced tax consequences.

A summary of stock investing alternatives follows:

- A. **By Size of Company**: Size refers to market value, which is calculated by multiplying price per share by number of outstanding shares.
 - (1) Large Cap: Market value over \$5 billion; approximately half the S&P 500 companies meet this Large Cap size criteria. Large Cap companies are typically household names.
 - (2) Mid Cap: \$1-2 to \$5 billion in market value.
 - (3) Small Cap: Market value below the Mid Cap starting level. Figures on page 2 for the S&P 500 and Dow Jones Industrials are Large Cap results. The “Extended/Mid Cap” category provides Mid Cap results, and the “Small Cap” category provides Small Cap results. Historically, Small Cap stocks have had higher investment returns compared to Large Cap, but with significantly greater price volatility. As always, seeking more reward entails taking greater risk.

B. By Style: Growth Style or Value Style.

(1) Growth investors buy stocks without much regard for the relationship between the current stock price and the underlying earnings, relying instead on the future earnings growth rate to move the stock price higher.

(2) Value Investors, by contrast, look to the relationship between the current stock price and current earnings, and only buy stocks if that relationship (the P/E ratio) is reasonable. Figures on page 2 for S&P Growth and S&P Value provide results for these two styles for Large Cap stocks. The distinction between Growth and Value also exists for Mid Cap and Small Cap, but these results are not included in the page 2 figures. During certain periods, one style or the other may have better results, but over time the results tend to even out.

C. By Sector: Major sectors include Technology, Health Care, Financial, Utilities, Energy, Industrials, and Consumer Products. There are sector index stocks and funds for all these categories and more, and these sector investments may be limited to Large Cap stocks in the sector (e.g., the S&P Sector ETFs), or can include a broader range of Large, Medium, and Small Cap stocks (e.g., the Barclays *iShares* sector ETFs).

(1) The NASDAQ 100 index (QQQ) is a sector fund of sorts, since it consisted predominately of technology companies. The composition of QQQ has changed over the past few years, however, based on the extreme underperformance of the technology sector.

(2) Biotech and Real Estate Investment Trusts (REITs) are two other examples of highly specialized sectors.

D. By Geography – This is the distinction between U.S.-based companies and companies based outside the U.S., either in more developed parts of the world (e.g., Europe and Japan, with Royal Dutch, Unilever, Sony, and Honda as examples of local companies), or the so-called “emerging markets” (e.g., countries such as Indonesia, Mexico, and Russia (?)).

We use a mix of most of these investments, but with different degrees of emphasis.

(1) Large Cap, Mid Cap, Small Cap is an important distinction for us. We either own a mix of each size separately, or, more recently, have begun to buy indexes that include all three categories in one investment in a percentage mix that reflects the market value that each of these size categories bears to the overall value of the stock market. Examples include:

(a) Separate investments: S&P 500 (symbol SPY), Mid Cap Index (MDY), and Small Cap (Russell 2000) Index (IWM).

(b) Single investment: Total Stock Market (IYY), with over 5,000 stocks, or Russell 3000 (IWV), which consists of 1,000 Large Cap and Mid Cap stocks plus 2,000 Small Cap stocks. The approximate mix is 70% Large Cap, 15% Mid Cap, and 15% Small Cap.

(2) Less important for us currently are the distinctions between Growth and Value, and the Sector choices.

(a) During the bull market of the late 1990s, we added the Growth style (but not Value) to some portfolios, and this style has underperformed in the bear market of 2000-2002 (see page 2 figures for Growth and Value).

(b) We also used three sectors, Technology, Financial, and Health Care (formerly Consumer Staples in the S&P 500 sector index). While the latter two outperformed the broader S&P 500, the underperformance in technology outweighed the outperformance of the other two sectors.

(c) The previously mentioned NASDAQ 100 (QQQ), Biotech, and REIT sectors, were also used. With regard to QQQ, since it is no longer a precise reflector of technology but rather a more mixed index of the 100 largest companies traded on the NASDAQ (many of which are also included in the S&P 500), we will be selling QQQ in 2003. Note the sale is not due to its dismal most recent three-year investment result, since it could well recover faster in the future than other indexes, as it had grown faster in the 95-99 bull market, but rather because it has lost its ability to precisely reflect technology results.

(3) Of least importance to us is the Geographical distinction. We own very few non-U.S. international positions, for the following reasons:

(a) Many large U.S. based companies have significant international business activities.

(b) In our view, the U.S. is still the best place to invest because it is the world's dominant economic power. Almost all the other international economies look to the U.S. for leadership and protection (even those places that do not support our policies).

(c) While currency fluctuations are a factor in the relative merits of investing in different countries, given the world situation as we see it today, it is difficult to identify legitimate challenger(s) to continued U.S. dominance.

We hope this discussion helps you to better understand the many choices we employ in managing your investment portfolios. Note that no one knows in advance which parts of the stock market will do better than others in any given time frame, and so we use a variety of these investments to provide the benefits of diversification.

As for the upcoming year 2003, we note the following:

(1) Many problems still exist:

- (a) General economy is not strong.
- (b) Unemployment remains high.
- (c) Business investment is still weak.
- (d) High oil prices.
- (e) High levels of corporate and individual debt.
- (f) Geopolitical issues: Iraq, North Korea, Terrorism.
- (g) Uncertainty regarding reporting of corporate profits.
- (h) Level of corporate profitability relative to stock prices (P/E ratios are still high).
- (i) Increasing budget deficit and weakening dollar (these have mixed effects).

(2) Some bright spots exist:

- (a) Consumer spending continues to be strong.
- (b) Housing sector continues to be strong.
- (c) Historically low interest rates and low inflation.
- (d) Potential for pent up demand based on previous slowdown in business spending.

(3) History suggests stock price improvement:

- (a) After three years of declines, only the 1929-32 depression resulted in four consecutive down years.
- (b) The third year in a presidential cycle is generally an up year, perhaps due to the incumbent's efforts to stimulate the economy in advance of the next election. Since 1933, the only exception was 1939, the first year of the three-year decline from 1939 through 1941.

(4) Beware bond investments, given low current interest rates and high prices. Short-term bond holdings are the best antidote to the risk of rising interest rates and declining bond prices.

(5) Eliminating the income tax on dividends is currently in the news as part of President Bush's tax proposal. This should not make a significant difference in adding to demand for stocks. First of all, even if dividend yields increased to 3%, the tax savings in a 33% tax bracket is only 1%. Also, much investing is done in retirement accounts, in which there are no taxes. Finally, we are generally in favor of companies reinvesting their profits in their businesses, rather than returning small portions to stockholders. Therefore, we would be skeptical of media reporting that links an increase in stock prices directly to this tax proposal.

(6) What will happen? We'll let you know, but only after the fact.

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	(41.1)%	7,286	(32.4)%	1,114	(54.9)%
End of 2002	880	(33.3)%	8,342	(22.6)%	1,336	(45.9)%

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)%
End of 2002	880	(23.4)%	8,342	(16.8)%	1,336	(31.5)%
Three Years		(40.1)%		(27.5)%		(67.2)%

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%
Dec 31, 2002	<u>880</u>		<u>8,342</u>		<u>1,336</u>	
8 Yr Gain; Annualized %	421	8.5%	4,508	10.2%	584	7.5%



Victor Levinson



Nicholas Levinson