7705 TANGLEWOOD COURT ■ EDINA, MN 55439 ■ 952.926-3000 ■ www.capstratcorp.com ■ e-mail: capstrat@mn.rr.com

FINANCIAL MARKET SUMMARY

Fourth Quarter, 2002

Summary:

Stocks made a modest recovery during the fourth quarter of 2002. The rally was led by the technology and telecommunications industries – precisely the ones that lost so much earlier in the year. Technology's 17.6% quarterly gain still left it down more than 43% in 2002. On the other hand, real estate funds posted a 4.1% gain last year, but rose less than 1% in the fourth quarter. Reversal was the rule over the last three months, the exception being precious metals, which soared 12% during the quarter and 63% for the year. Large company stocks tended to do better than small company stocks, the anti-thesis of the trend earlier in the year.

For the first time in perhaps three years, credit-sensitive bonds outperformed interest-sensitive bonds. Investors began to anticipate economic recovery, so they shifted somewhat from government bonds to corporate bonds to take advantage of better yields or possible capital appreciation. Also, international bonds benefited mightily from the falling dollar. International bonds performed better than any class of domestic bond. International stocks declined 25% in local currency terms, but that loss was less than 16% for dollar-based investors.

Strategy

We did not make any changes to portfolios during the quarter. We have been more defensive since October of 2001, and while there have been brief rallies, the stock market has mostly moved lower. Stocks rallied from deeply oversold levels from October 9th to December 3rd, but gave back much of that gain through the 27th. From a technical standpoint, stocks have yet to make a higher high in any of its rallies. With investors willing to take profits every time the Dow rises a couple hundred points, we cannot presume that a new bull market is imminent. Therefore, no changes are warranted.

Performance

Our Balanced Model Portfolio gained 4.56% last quarter. This compares with the 4.28% return for the Balanced Model benchmark. This is telling us that even though we are at the more conservative end of the asset allocation parameters that we have set for our balanced risk investors, we still outperformed the benchmark. We expected to do better when the market went down (as it did the first nine months of the year). The fact that it did better during an up quarter is testament to our good fortune selecting mutual funds. Our Aggressive Model Portfolio gained 7.52% during the quarter, versus 7.34% for the Aggressive Model Benchmark. For the full year 2002, the CSFC Balanced Model Portfolio fell 5.59%, almost five percent better that the 10.55% loss for the Balanced benchmark. The CSFC Aggressive Model Portfolio declined 15.60%, but that was significantly better than the Aggressive benchmark's 20.15% loss.

Outlook

Market movements are likely to be subdued until there is some form of resolution to the Iraq situation. Oil prices above $30 act as a tax on the economy, so it is likely that any meaningful economic recovery is being stalled by the "headwind" from high energy prices. It seems clear from the comments of Microsoft, Intel, and IBM in recent days that business capital spending isn't going to accelerate much in the short term. The consumer sector of the economy has had to carry the load for the last few years as business spending declined. There are signs that the consumer is losing steam, most notably the disappointing holiday season for retailers. The economy needs a shock. President Bush intends to give it one through his bold tax cut proposal. The cuts are aimed mostly at businesses, and have maximum effect at tax time next year. There would be very little stimulus in the short term. A highly successful Iraq campaign might provide the shot of confidence that would help in the short term. It might also help bring oil prices back below $25, and that would be significant in and of itself. Without that, I think we are likely to see the market remain in a fairly narrow trading range.

Commentary – The Limits of History, the Limitations of Experts

2002 was the third straight down year in the U.S. stock market, and the worst of the three on most averages. This bear market has defied several maxims that had previously guided investors, including the one that virtually guarantees that the market will rise within twelve months after the Federal Reserve starts cutting interest rates. We have learned that the market can go down whenever it has reason to, even during statistically favorable months like December and January. It can even utterly fail to have a summer rally. Maxims provide psychological safety, but not actual safety. History is a guide, not a guarantee.

The haplessness of baseball's Angels franchise through it's first 40 years led sports pundits and anyone with a sense of history to predict their swift elimination at the hands of the perennially powerful New York Yankees. Instead, Anaheim made short work of the Yankees on their way to the World Series Championship. It is a misuse of history to expect it always to repeat itself. Barron's magazine recently published the 2001 and 2002 predictions of Louis Rukeyser's regular panelists, by way of showing how awful the conventional wisdom has been recently. As ridiculously over-optimistic as the predictions turned out to be, the same people were largely under-optimistic from 1995 through 1999.

I bring this up not to poke fun at the panelists but to emphasize that trying to predict the future is likely to prove embarrassing. The stock market averages a gain of about 10% per year, so pundits go on TV every January and predict gains of 5 to 15 percent. Invariably the market does much better or worse. In retrospect we will determine that the problem was that the market began the year too cheap or too expensive, and that investors eventually wised up to the situation. At any given time the price of all stocks seems perfectly logical; it is only in hindsight that the folly of so many investment decisions becomes apparent. Who on Wall Street deduced at the time that the merger of AOL and Time Warner would be a case of 1 + 1 = _? Those of us in the financial services industry need to stop telling our clients we can do what we can't, and focus on doing for you what we can do best.

Among those are

- Educating you on the historical returns and volatility of each asset class, and the benefits of diversification, compounding, and patience.
- Helping to elevate your returns by providing sound guidance during difficult periods, rather that fanning your greed during up markets and your fear during down markets, in order to sell more product.
- Advise you on the prudent use of financial tools and programs, like Roth IRAs, 529 programs, stretch IRAs, etc.

The financial planning profession has a lot to offer as long as it views itself as a profession and not as an industry. Doctors have a code that says "First do no harm". We strive to take the same approach with our clients. We protect you first and make you money second.

Mark A. Carlton, CFA