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FINANCIAL MARKETS COMMENTARY
1st Quarter 2004

April 20, 2004

Summary

The stock rally of 2003 continued into 2004, but at a slower pace. The first five weeks of the quarter were every bit as strong as the previous eight months, but by quarter's end the combination of higher oil prices and uncertainty about the Iraq conflict and the Federal Reserve's timetable for raising interest rates erased much of the gains. Because there was still very little upward pressure on interest rates, investors continued to favor small companies, real estate, and bonds. They were less enthusiastic about large companies and the technology sector.

Both the Dow Jones Industrial Average and the NASDAQ Composite actually lost money over the quarter (though less than one half of one percent). Fortunately, most investors experienced better results. The average stock fund gained almost three percent on the strength of international and smaller companies. Real estate, financial services, and natural resources were the strongest sectors, benefiting from increased economic activity, a shortage in key commodities, and still very reasonable borrowing costs.

Japan emerged as the strongest international market last quarter (+13%), as a rebound in the economy combined with a stronger currency. Stocks in the rest of the Pacific Rim rose 10.5%, but those in Europe gained only two percent. Slow economic growth and a fall in the Euro versus the dollar were responsible.

While reported economic growth figures were strong during the quarter, employment data came in quite weak. This enabled the Federal Reserve to maintain very low short-term interest rates. Many have been looking for an increase in interest rates, but that has yet to materialize. In fact, the best move in the bond market last quarter was to buy long-term government bonds (up over 3%). Less interest rate sensitive bonds gained 1.8% (high yield bonds), 2.0% (international bonds), and 1.1% (short maturity bonds).

Strategy

We did not buy into the bond rally; in fact we used it to reduce high quality bond exposure. We have added funds like FPA New Income, which currently has an extremely short average maturity. We have also added a commodity-

oriented fund (PIMCO Commodity Real Return Strategy) to give us an opportunity to participate in rising prices for tangible assets such as oil, gasoline, copper, aluminum, soybeans, and gold. Our small company funds continued to perform well. RS Partners rose 9% to lead the way. Our international stock funds all gained more than 6%.

Performance

Our Balanced Model Portfolio gained 3.57% last quarter. This compares with the 2.75% return for the Balanced Benchmark. Our Aggressive Model Portfolio gained 3.82% during the quarter, versus the Aggressive Benchmark's 3.24%. It wasn't so much being aggressive or conservative that affected performance last quarter (since bond and stock returns were fairly close). The key was fund manager selection, which is something we pride ourselves on.

Outlook

The factor that is most important right now in trying to determine where the markets are heading is the timing and magnitude of the increase in interest rates. The Federal Reserve is going to raise interest rates this year. Whether this is in May, November or sometime in between is of great import to both markets. It is difficult to see the stock market doing much until the Fed removes much of the uncertainty. Rising rates don't have to hurt stocks (especially as low as they are now) as long as investors believe that the moves are keeping inflation under control. For bonds, rising short interest rates would probably negatively affect all but the most long-term bonds. This is will be a tough period for bonds.

Commentary

Stocks average a little bit more than 10% per year over the long term (though any particular year may be much better or worse than that). It follows that each quarter one should expect a return of 2-3%, so the first quarter of 2004 shapes up as a very uneventful quarter. And, truthfully, it was. There was no important turning point in the market. Investors entered the year with the belief that interest rates were going to rise in 2004. There were some weak economic reports in February and March that led some to think rates might remain stable all year, then in April the key reports showed strength and the market moved back to where it began the year. Stocks are fairly priced at these levels - there just aren't any significant sector mis-pricings that offer high returns to those who spot them first. Greed and fear appear to be in balance.

Truthfully, this is the case most of the time. Once or twice a year the markets make a modest re-adjustment that offers alert investors an opportunity for a few percent more in return. Cyclical market cycles last 3-5 years or so, giving investors the chance to buy or sell at very good prices every 20-30 months or

so. True watershed events, secular changes, shifts that you absolutely have to be on the right side of, occur less than once in a decade. The 1980-81 peak in interest rates and hard asset priced was such a move. The bursting of the technology bubble in 2000 was another. The difference between getting these moves right and wrong was critical to one's portfolio. If one had shifted from technology to consumer and financial stocks in the spring of 2000, they would have stayed above water for all but two months in the next four years and would be ahead some 30% right now. If you stayed with tech the whole time, you have less than half of what you had four years ago, even after a strong 2003.

These "sea-changes" are the things that professional advisors really look for. Unfortunately, they don't walk up and announce themselves. Most of the information one gets from the market on a daily basis is noise, that is, of no lasting importance. Just as one can boil a frog is he turns up the heat gradually enough, one can train himself to make sense out of that which is increasingly irrational, if the information is steady and incremental. Analysts justified the surge in technology stock prices in 1999 by steadily ratcheting up revenue expectations. My biggest concern these days is not technology stocks or the bond market but the <u>real estate</u> market. This is the sector where there is the greatest imbalance between greed and fear.

There is a pervasive feeling that real estate only goes up in value. Prices in this sector have been rising sharply for many years now – much more than can be explained by inflation, a growing population or rising household incomes. Low interest rates are the main reason for the surge in home prices. If the thesis is that interest rates are headed upward, that can't be good news for the housing market (since a given level of income qualifies for less of a mortgage the higher rates are). I'm not predicting an imminent collapse in the housing market or real estate in general, but I am getting nervous. The economy has been fueled to a large part in recent years by gains from selling or refinancing one's home, and if that extra income is taken out of the economy, future economic growth is going to slow considerably. This might not have much effect on industries such as biotechnology, but it will certainly hurt the financial services and retail sectors.

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