

FINANCIAL MARKETS COMMENTARY

2nd Quarter 2002

“WE BELIEVE THAT INVESTORS WILL CONTINUE TO HAVE A DIFFICULT TIME IN THE STOCK MARKET. WHILE OUR LONG-TERM CONFIDENCE IN THE FINANCIAL MARKETS IS UNTEMPERED, WE CONTINUE TO BE DEFENSIVE FOR OUR CLIENTS. THIS INVESTMENT MANAGEMENT STYLE HAS RESULTED IN SUBSTANTIALLY LESS VOLATILITY ON THE DOWNSIDE FOR OUR CLIENTS THAN MOST INVESTORS ARE CURRENTLY EXPERIENCING.”

ERIC C. GRABER, PRESIDENT

Market Summary

There is no getting around it – this past quarter was awful for stocks. Whatever confidence investors had that a growing economy would eventually lift stock prices was buried under a sea of bad corporate news. Most investors seemed willing to accept the “a few bad apples” argument after Enron and Global Crossing went down late last year, but with June’s relentless stream of accounting fiascoes (most notably WorldCom), faith turned to disgust. Stocks dropped more than -12% as a whole last quarter; again, the index of the largest 500 companies did even worse (-13.4%). Lack of confidence is now by no means confined to the technology, telecommunications, and media areas any more. The health sector, especially biotechnology and pharmaceuticals, was one of the worse performers last quarter (-19.1%). Even utility stocks dropped more than -13%. The only winners were gold (11.1%) and real estate funds (4.9%).

Bad news for corporate America was bad news for the dollar, which dropped sharply last quarter. On the other hand, the falling dollar was actually good news for international funds. In local currency terms, foreign markets hardly did much better than ours. However, with a dollar decline of around -10%, U.S. investors only lost about -3% on their foreign holdings. Investors in Japan actually saw a 3.8% gain, while Latin American investors were the least fortunate (-19.3%).

Bond investors, to some extent, were the beneficiaries of the problems in the stock market. U.S. Treasury bonds moved almost exactly inversely to the stock market in June, acting as a “fear proxy”. Mortgage bonds did not perform quite as well as treasuries due to increased pre-payments. It should come as no surprise that corporate bonds did not have a good quarter, with accounting issues leading to dozens of credit downgrades. The best area of the bond market, again due to currency gains, was international (established markets).

Our Strategy

As we wrote in the June market update, this quarter forced the intelligent investor to turn their attention to preserving capital, as opposed to compounding it. As you know, we have been more defensive since last October. It was our belief that we had entered a period where many of the political and economic variables had more downside potential than upside, so we positioned our clients' portfolios accordingly. This past quarter played out more negatively than we, or anyone expected, but unlike others we did not have to become sellers into weakness. As a result, our portfolios suffered far less than the market overall.

Usually, one can analyze asset values and trends in order to figure out what areas are likely to outperform and which are best avoided. For example, we have had more exposure to "value" funds than growth funds for more than two years now. Also, our portfolios have had more exposure to small and mid-size stocks. These moves and others helped us make money for our clients in 2000 and helped them lose a lot less 2001 and the first half of 2002. Unfortunately, the relative strength of the value and small company stocks began to break down in May. By June, there was no area of the stock market where one could expect above-average performance. The only way to stay out of the storm was not to be in stocks at all -- a temporary solution maybe, but not viable in the long run.

Our Performance

The Capital Strategies Balanced Model Portfolio (comprised of both stock and bond mutual funds and the model for most of our investors) was at a -4.08% for the second quarter and is -2.98% for the year to date. Our Capital Strategies All-Equity Model Portfolio fell by -9.09% last quarter, and is down -8.27% for the year-to-date.

This can be compared to the popular market indices. The Standard & Poors 500 fell -13.39% for the quarter and is -13.15% for the Y.T.D. The Dow Jones Industrial Average fell -10.71% for the quarter and is -6.91% for the Y.T.D. The NASDAQ fell -20.71% for the quarter and is -24.98% Y.T.D. The Lehman Government/ Corporate Bond Index was up by 3.75% for the quarter and is 3.26% for the Y.T.D.

Our Balanced Portfolios have benefited from our lower-than-normal stock positions and our mutual fund selections. The All Equity Aggressive Portfolio did not have the leeway to underweight stocks. While it did outperform the NASDAQ, this was primarily due to our under-weighting of the NASDAQ in our benchmark model portfolio. The All Equity Aggressive Model Portfolio also benefited from small cap exposure and not having as much exposure in foreign stocks.

Outlook

Confidence is a fragile thing, and when it goes, it can be slow to come back. Whatever hope there was at containing the sell-off to areas of the stock market where the most egregious speculation occurred pretty much vanished when the accounting scandals blew up. Tyco International, Bristol Myers and Elan are not Internet stocks, so when their prices plunged

on accounting concerns, investors naturally got a little shook, and they wondered who is going to be next. WorldCom and Qwest were always regarded somewhat suspiciously (and their stock prices reflected this concern). When they went down, however, it was the sheer volume of their debt that roiled markets. When banks lose money lending to corporations, they naturally cut back on their future lending. This slows down economic growth. When individuals lose money in the markets, they are inclined to reduce future purchases (especially when they regard those losses as unnatural; in other words, not related to normal economic/business cycle factors).

That being said, the actual economy is performing rather well. Given the negatives of an ongoing War on Terror, a stock market crisis, and the descent of the budget from surplus to deficit, you might expect that the economy would be limping along. That is not the case. Unemployment claims have been trending lower, new orders have been increasing, and both industrial production and capacity utilization have been moving up. It would be unusual to have the economy and the stock market move in diametrically opposite directions for much longer. Something has to give, and it may well be the trend of stock prices if the market can be convinced that real measures are being taken to ensure the misleading or outright fraudulent practices of the past do not occur again.

At this moment, there is no reliably strong area of the stock market. Without some sector to provide leadership, investors will continue to sell into rallies, despite the fact that now there are many very cheap stocks. In a bear market, investors buy at 30 hoping to sell at 35. In a bull market, they buy at 30 and buy more at 35.

Comment – If it looks too good to be true . . .

Accounting didn't get questionable late last year. Accounting had been used to inflate values for much of the 90s, especially after 1997. Nobody objected when it pushed stock prices higher. They should have. If the foundation of a house is not solid, the house will ultimately not stand. Similarly, the rally was built with increasingly inferior materials – off-balance sheet transactions, options in lieu of salary, aggressive revenue recognition tactics, and borrowing money to buy back stock to boost earnings per share, etc. – and ultimately it didn't stand either. If you were a gambler and you noticed that a certain team always beat the spread by exactly one point, you would probably conclude that the team was fixing games. If you bet a lot of money on that team, then saw the league's officials step in and throw out several key players before the big game, you would have a difficult time complaining when the team lost. Certain companies were known to beat quarterly earnings estimates every quarter by exactly one cent. Such perfection was not an accident. Rather than adopting a buyer-beware attitude, investors bid them up like crazy.

Of course, it did not help that supposedly objective analysts were lauding the companies for their consistency, that the supposedly objective media was fawning over the CEOs (who stood to make tens if not hundreds of millions from stock options if the stock kept rising), and the supposedly objective accounting firms were aiding and abetting the company's management in its deception. It was generally acknowledged that games were being played, but as one investor told me at the time "who is being hurt?" We all were. It looked too good to be true, and it was. Investors bid up stocks at least 20% every year between 1995 and 1999, even though the "enhanced" financial data did not support this.

This generation just learned the lessons on greed and speculation that history suggests each generation needs to learn for itself. We are entering an era now where if nothing else, we will be more demanding of our financial authorities, more discerning in how we allocate our money, and we will have more reasonable expectations of future stock market returns. We believe that while this is a painful lesson today, it is positive one in the long run.

Mark A. Carlton, CFA