

***FINANCIAL MARKETS COMMENTARY***  
***3<sup>rd</sup> Quarter 2002***

**Market Summary**

This past quarter was very hard on stock investors. Stocks had fallen more than 10% in three of the previous six quarters, so investors might have figured they were due for some relief (after all, stocks never fell ten percent in any quarter in the entire decade of the 90s). Instead, stocks had their worst quarter since 1987. Stocks plunged more than 17% as measured by the Dow Jones Industrials and the S&P 500 and almost 20% on NASDAQ. This time, small company stocks were not a haven – the Russell 2000 dropped over 21%. International stocks provided no shelter (-19.7%); neither did gold, real estate, energy, nor emerging markets. It was a complete rout. The only way to have avoided losses was to be in high quality bonds or the money market (cash).

Bonds (government bonds, at least) had a very good quarter. U.S. treasury bonds are widely viewed as a safe haven from economic and political turbulence. By the end of the quarter, they traded at “lifeboat” levels (as if the economic ship was sinking, and they were the only lifeboat). In truth, the economy is bound to stabilize, and deflation is still unlikely. Bond investors may soon realize they accepted yields too small to protect them from inflation. Though popular now, government bonds may be setting up for a repeat of 1994. We have done well in bonds so far, but the time to take profits may be near. We expect to move from government to corporate bonds, where yields are higher and prices lower. International bonds might also be a good alternative.

**Our Strategy**

Our approach to portfolio management involves two things – finding the right balance between stocks, bonds, and cash for each investor, and finding the right funds in both the stock and bond markets. We did a very good job of asset allocation, having early on recognized that we were in a bear market and adjusted stock weightings lower and bond weightings higher. This saved our investors a tremendous amount over the last two years. As for fund selection, there just isn’t much you can do when the whole stock market is falling. In 2000, moving from growth to value was worth almost 30% in excess performance. In 2001, moving from big stocks to small stocks was worth close to 15%. This year (especially since June) there have been no tactical opportunities. We can only identify managers with proven experience and discipline and trust they will again come through for us. A few of them began buying aggressively during the sell-off in July. When selling resumed in the second week of September, these purchases went into the red. However, we are confident that the buys made at these levels will look very good in the fullness of time.

## Our Performance

The Capital Strategies Balanced Model Portfolio (comprised of both stock and bond mutual funds and the model for most of our investors) declined by -6.93% for the second quarter and is off -9.71% for the year-to-date. Our Capital Strategies All-Equity Model Portfolio fell -14.44% last quarter, and is down -21.52% year-to-date.

Once again, we outperformed the popular market indices. The Standard & Poors 500 plunged -17.27% last quarter and is -28.15% Y.T.D. The Dow Jones Industrial Average lost -17.45% for the quarter and -23.15% for the Y.T.D. The NASDAQ fell -19.90% for the quarter and is -39.91% Y.T.D. The Lehman Government/ Corporate Bond Index was up by 5.69% for the quarter and is up 9.14% for the Y.T.D.

Our Balanced Portfolio continued to benefit from our lower-than-normal stock positions and our astute mutual fund selections. The All Equity Aggressive Portfolio does not have the leeway to underweight stocks. Without any area of the stock market exhibiting relative strength, it was next to impossible to sidestep the market downturn.

## Commentary – The Forest Fire

We are often asked when the bear market is going to end. We don't know the answer to this question, nor does anybody else. However, it does help to understand that declining phases are an essential part of the market cycle, not unlike how forest fires are an essential part of nature's cycle. Just as forest fires clear underbrush and allow new plant growth, bear markets clear excess speculation and abusive market practices. Enron, Tyco, WorldCom, Imclone, and the like did not come out of nowhere. They rose out of a culture that made CEOs almost demigods. No amount of salary and perks were too much for a CEO who could make his stock go up, so some CEOs resorted to illegal means to boost their stocks (and by extension, themselves). Many Wall Street analysts knew this, yet the culture was such that they went along with it (and in some cases, actually abetted it). The same can be said of the accountants. A 10% market correction does not fix excesses like these. Lowering interest rates might well have worked to stop the decline if this were a normal downturn. Unfortunately, there was so much "dead wood" in the market that it is taking a financial forest fire to clear it, one like we haven't seen since the late 1930s. Now we are left with singed portfolios (where others have been completely reduced to ash). This is why it is in all of our interests that markets are fair and rational, even if it means there are no more 400% one day gains on technology IPO's.

## Outlook

Right now it is hard to imagine much of a worse set of circumstances for the stock market. We have to endure the threat of war, a key industrial lock-out, an ongoing crisis of confidence in corporate leadership, overcapacity in the technology sector, financial crisis in the airline sector, a growing bad loan problem in the financial sector, a possible housing bubble, and costly legal woes for companies with asbestos or tobacco exposure. All of this should have investors feeling nervous, and stock prices should reflect this. And they do.

## *CAPITAL STRATEGIES FINANCIAL CORPORATION*

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One of the concerns we had three years ago was that everything was going right but that stock prices fully reflected it, so there was a lot more room for deterioration than there was for improvement. At the time you don't necessarily know specifically what is going to get you, but inevitably something will. With prices leaving no margin for error, the loss potential was high (of course, we now know things were never as good as we thought they were).

With all of the difficulties investors face, the first temptation is to sell and wait for some of these issues to be resolved. But this may be the flip side of 1999 -- with prices now discounting a host of problems, the potential for improvement likely exceeds the potential for further deterioration considerably. In other words, things aren't as bad as they now seem. Again, the specifics that bring about a positive change can only be guessed at -- an end to the lockout, a resolution of the Iraq situation perhaps -- but the ability to look out farther than the average investor and make good decisions on that basis is what leads to excess returns.

It is ridiculous to think we can time the exact market low. The question is whether current stock prices fairly reflect the prospects for appreciation in the future, giving appropriate discount for the obstacles that the economy and especially certain industries face. For the most part, the answer is yes. Stock investors are finally getting fair compensation for the risk they are taking. They are going to be coming back soon.

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