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FINANCIAL MARKETS COMMENTARY ***4TH Quarter 2003***

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Summary

Finally, after a three year drought, a strong up year in the financial markets! Believe me, it feels good to say to our clients, “Yes, your accounts are up for the year.” rather than “well, you haven’t lost as much as the major financial indices or many other investors”!

Last quarter was another very good one for stocks. The average stock fund advanced 12% on the quarter and more than 32% for the full year. That is a dramatic improvement over the previous three years. The combination of very low interest rates, stimulative economic and tax policies, and reasonable valuations produced the kind of market that investors and policymakers hoped for. The risk was that the deficit would soar, causing the dollar to fall and forcing the Federal Reserve to raise rates. The deficit did soar, the dollar did fall, but the Fed was able to hold firm on rates (with the help of Japan and China). Since the inflationary 1970s, every increase in economic activity has brought pressure on the Fed to raise rates. Their ability to withstand this pressure this time is notable, and has bullish implications (in the short term).

Once again, smaller companies performed better than large companies. However, this quarter the difference was much smaller (13% to 11.5%) than it had been through the first nine months of 2003. In fact, large companies were stronger in December as investors began to anticipate a reversal. This view was predicated on the belief that interest rates would move higher in 2004 (since rising rates tend to be more harmful to smaller companies). Investors have concluded that stocks are the place to be, but interest rates will place a big part in determining which part of the market they favor.

International funds were the strongest of all last quarter as well (at least for U.S. investors). The falling dollar turned international stock gains of less than 20% in local currencies to over 38% in dollars. Looked at another way, a European investor in the Dow Jones Industrial Average last year made about 6% in his home currency (it was up 28% in dollars).

There was concern that that the weak dollar would cause foreign investors to flee U.S. assets, but that didn’t happen. The Japanese and Chinese were more than happy to lend to us at low rates; Japan to depress their own currency so it

wouldn't be too expensive for Americans to buy Japanese products, the Chinese because they wanted to insure U.S. interest rates stayed low so that again, the U.S. consumer would be able to keep buying.

While the surge in the economy and the stock market did not push interest rates up much, it was enough to virtually wipe out the small amount of yield that government bonds offered. If you were willing to take a little risk (or a lot, for that matter), there were much better returns to be had. Bonds will reward investors if interest rates fall or if credit quality improves. Since interest rates didn't fall, any gain in bonds would have to come from credit quality improvement. Government bonds are already rated AAA (the highest), so their credit quality cannot improve. Corporate bond credit quality can improve, and it did. As investors perceived that a very low interest rate environment would mean virtually any company could get credit and at a reasonable price, they concluded that default risk was almost nil. They bought corporate bonds - the higher the yield the better. High yield bonds gained 5.6% last quarter on average, while investment grade corporate bonds gained just 1.6%. International bond funds average a 4.3% gain, almost all from currency.

Strategy

We did not make any changes to our balanced portfolio strategy for most of our clients' portfolios. We continued to emphasize funds that have performed well in both up and down markets, since we did not want to commit to this being a long-term bull market. The only exception was the All-Equity Aggressive portfolio, where we took a position in an Emerging Markets stock fund. This increased the international weighting, and gave us exposure to a rapidly growing (yet volatile) sector of the market. Our willingness to be more opportunistic in bonds also paid off handsomely, as the best returns were earning by high yield and international bonds.

Performance

Our Balanced Model Portfolio gained 7.45% another last quarter, bringing its full year gain to 19.54%! Remember, this is an all-weather portfolio that has as its main objective performing much better in down markets. Our Aggressive Model Portfolio rose a very strong 13.23% during the quarter. This made its full year gain 33.02%.

Very strong performance by two small company funds was largely responsible, though international stocks also helped. Again, this portfolio is aggressive because it is an all-stock portfolio, not because all of the individual funds were very aggressive.

We always look for funds that will gain more in up markets than they will lose in down markets by a wide margin, therefore we should make significant progress over each full market cycle. Our Capital Strategies long-term investment track record bears this out.

Outlook

On one hand, the economy is clearly in an upturn, borrowing costs are low, and investor confidence continues to improve. This is a good environment for stocks, so one has to have a positive outlook. On the other hand, stock prices have moved up a long way in ten months. Today's prices reflect hopes for 2005 (and beyond) rather than end-of-2003 earnings. Valuations are not a timing tool, but they are important. A good argument can be made that the economy and corporate earnings will do very well in 2004, but the stock market itself may advance only modestly. There is a great deal of historical precedent for the stock market to peak several months to a year before the economy does (think back to 2000, where the market peaked in March but the economy didn't turn lower 'til October). We see a stronger first half of 2004 than second half. We expect to continue increasing exposure to international markets, where the dollar decline is helping returns and where the markets have not discounted as much future growth as U.S. stocks have.

Commentary – The Unattended Cat

We are very pleased with 2003 results! Even though we underestimated the strength of the recent recovery, we still delivered results that were very competitive given the lower risk we took in our clients' portfolios. Our emphasis continues to be *risk-adjusted return*. From time to time this means accepting a little bit less upside (as it did last quarter and may continue to in the short run). If you remember the fourth quarter of 2001, the stock market soared on the belief that cutting interest rates in the wake of the terrorist attack would lead to a robust 2002. We didn't believe this would happen, and it fact made our clients' portfolios more conservative. Of course, 2002 turned out to be the worst year for stock investors since the 1970s. Much will be made this year about the presidential election cycle and the tendency for stocks to rise in an election year. Whether it has anything to do with presidential elections or not I don't know, history does seem to suggest that there are market cycles that tend to average about four years. Economic expansions tend to last about three years or so, followed by a downturn. If this downturn only reduces the rate of growth for several months, followed by a re-acceleration in the economy, financial pundits will refer to it as a "soft landing". If we actually go into a recession, that is of course a hard landing. In theory it would be possible to perfectly manage each expansion so that it moved up modestly every year and never had any kind of landing. Even if the Fed had such precise economic measuring tools, however, it is unlikely that investors could regulate their own behavior similarly. For investors tend to behave like unattended cats.

Imagine you were to leave your cat alone for four days with four days of food. The cat doesn't eat one days rations and then wait until the next day to move in on to the second bowl. Likewise, investors don't react to the beginning of a profit upturn by discounting only the present year's growth. We anticipate next year's growth and the year after that. We keep anticipating future growth until something happens that tells us that a downturn is coming and that the future gains we expected will need to be factored back out of prices. Depending on how greedy the cat was, by the fourth day they might get awfully hungry; depending on how greedy investors get, the "factoring of future gains back out" process can also be quite painful.

What we are ultimately saying is that we are comfortable staying in the middle of the risk range. Despite very impressive recent performance of the stock market, value has once again become scarce. Especially in areas like electronics and technology, the market is discounting profits years ahead. This makes us uncomfortable. We will continue to base our approach to the financial markets on thorough research and on the mutual fund managers' selection rather than on an aggressive asset allocation posture. We make no claim as to having an ability to time the markets, but we do know our funds and their managers very well.

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