Quarter Notes

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Markets Cool Off After Strong Year to Date Gains

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Year to Date 2003 Returns	
Dow	11.2%
S&P 500	13.2%
NASDAQ	33.8%
Russell 2000	27.3%
MSCI EAFE	15.8%
Bonds	2.5%

The U.S. stock market rally continued well into the third quarter with strong gains in all the major averages until the last week of the quarter when some gains were given back.

The Fed left interest rates at 45 year lows and appears committed to keeping them low for sometime to come. The Fed Funds rate has been kept at 1% since the June meeting.

Market interest rates, however, rose rapidly during July, then retreated. The yield on the 10 year Treasury finished the quarter below 4%.

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Investing in an Era of Changed Expectations

Investors understand that in the long run owning stocks has produced significantly higher returns than investing in bonds or treasury bills, especially if you consider the effects of inflation. Real equity returns are comprised of dividends, earnings growth, and changes in P/E (stock price per $1 of earnings).

Equity Returns are derived from three sources

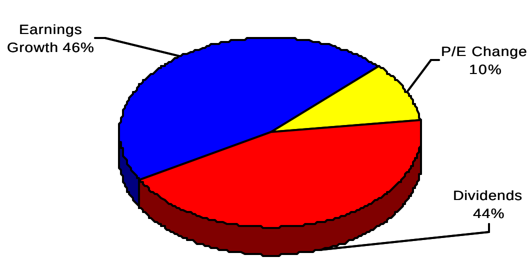
Dividends + Dividend or Earnings Growth + Change In P/E Level = Equity Return

Until recently, dividends have been a major factor in accounting for equity returns *(see exhibits)*. The average dividend yield on the S&P 500 from 1926-2002 was 4.2%. Currently, the dividend yield on the S&P 500 is 1.7%.

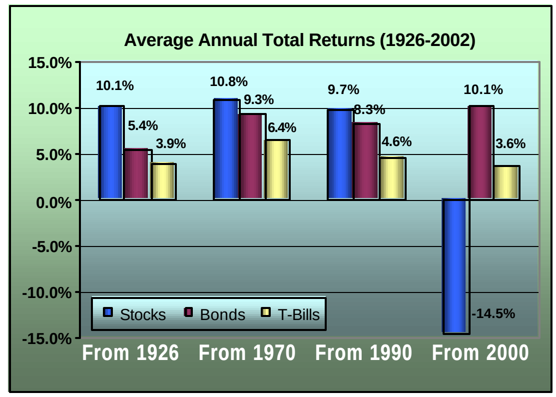
What about real dividend or earnings growth? Although individual companies can outpace others in terms of growth, on average, companies don't grow faster than the economy as a whole. So earnings growth becomes a function of long-term economic (GDP) growth. We agree with most forecasters who conclude that we are entering a period of modest GDP growth. World-wide excess capacity will affect growth by limiting capital expenditures even as economic activity picks up.

During the 1990's, the prices of stocks grew much faster than firms' earnings, especially for companies that had none. Consequently, the change in the Price Earnings levels (P/Es) were unsustainably high. Historically, changes in P/E levels have not been a big contributor to equity returns. Further, we are still in a period where P/E's are high by historical standards.

Contributions to Equity Returns 1900-1999



All of these factors are causing us to reevaluate what returns we can expect from equities over the next 5 to 7 year period.



We are forecasting rates of return on equities of 7% over the next few years. But looking at returns without the associated volatility is only viewing half of the picture. During the past 5 years, the volatility of the S&P 500 Index has been about 19%.

The question we are posing is: Are we going to achieve sufficient excess return from our stock investments to compensate us for the potential excess risk?

For comparison sake and to answer that question, we have to forecast fixed income or bond returns. Since interest rates are near their historical lows, we can not anticipate the significant capital gains from bonds that we enjoyed last year. If interest rates rise rapidly, bonds would suffer capital losses. Our best estimate for bond returns is what we can get on intermediate to long-term Treasury bonds today (which should have a built in inflation factor). These are currently trading in the 4-5% range. In comparison to the volatility of the S& P 500, the Lehman Aggregate Bond Index has had volatility of 3.5% over the past 5 years.

So, if we are forecasting 7% returns on stocks and 5% on bonds, the prognosis for a balanced portfolio is not all that thrilling.

Here is how we are attempting to increase the overall returns of our clients' portfolios:

1. Using actively managed equity funds to enhance risk-adjusted rates of return.
2. Using actively managed fixed income po

Quotes

- *"Fear causes you to panic and sell at the bottom, while greed motivates you to buy near the top" Stan Weinstein*

- *Momentum investing - The fine art of buying high and selling low.*

- *Bull market - A random market movement causing an investor to mistake himself for a financial genius.*

- *Market correction - The day after you buy stocks.*

sitions to take advantage of pockets of excess value.

3. Increasing flexibility in rebalancing, both in frequency and substance.

4. Incorporating alternative assets into our allocations.

5. Enhancing diversification within asset classes.

In closing, we want to highlight that we have come from a decade of declining U.S. Government deficits, a strong dollar, and decreasing interest rates (all of which were remarkably good for investors). Now we are in an era of resurging deficits, a weaker dollar, and increasing interest rates. This could be the beginning of another challenging environment for investors.

2003 Tax Law Changes

The recently passed Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) will change the way taxes effect our investment decisions. How will they impact your investments? Will you be able to save taxes on your portfolio? Let's look at the changes and sort through the complexities.

For investment purposes, the new act reduces the tax rates on dividends and capital gains while lowering the income tax rate. Specifically, we will explain how preferred stocks and mutual funds are affected by the new rates.

Tax rates on long-term capital gains are reduced to 15% from 20%. This means any capital gains you receive on investments held for 12 months or longer (starting May 6, 2003 through 2008) will benefit from the lowered rates. Short-term gains are taxed at your marginal rate (which could be as high as 35%), so an investment would require a significant downside risk before short-term gains would add net value to your portfolio. Therefore, we must avoid realizing short-term gains unless losses can be used as an offset. The lower rates do not apply to corporate taxpayers, gains from sales of collectibles, and gains from certain depreciable real estate.

The dividend tax rate is more involved. With a 60% reduction to 15% from 38.6%, investments in higher-yielding equities have become more appealing. Dividends from mutual funds, preferred stocks, and foreign stocks are included. For mutual funds, the new lower rates will be applied based on the underlying holdings of the fund. This means that ordinary dividends you may receive from a mutual fund will qualify to the extent that the fund received dividends that qualify for the new rate. As a result, fund providers will have to separate dividend income based on its qualification under the new act. The cut on preferred stocks may seem attractive, however most preferred stocks are hybrids and senior debentures, which pay interest to shareholders instead of dividends, so the 15% rate would not apply. For a foreign equity to qualify, it must be considered a "qualified foreign corporation."

How will the tax law affect how we manage your portfolio? For starters, the new lower tax rates may make holding more equities attractive. But we must continue to consider your personal needs. Tax considerations can't be the sole determinant of investment policy. We must continue to consider your tolerance for risk, investment time horizon, volatility, and other needs when creating your specific asset allocation. Routinely, we have held taxable bonds, real estate and other high income producing positions in tax-deferred accounts. Funds that focus on qualified dividend returns as a large component of total return can now be held in taxable accounts.

A Jobless Recovery

Economic recovery seems to be under way. Moves by the Federal Reserve Bank to maintain cheap money and the federal government's tax cuts and deficit spending appear to have stimulated the economy sufficiently to prevent deflation. Consumer spending continues strong and manufacturing activity has finally begun to pick up.

But even as the recovery is firmly taking hold, there has been an absence of employment gains. The reasons may be attributed to fundamental, structural changes due to globalization and outsourcing of jobs. Technological improvements have allowed production increases without additional employment or capital expenditures.

In past economic downturns, the fiscal stimulus of tax cuts or increased government spending and the monetary stimulus of low interest rates had a multiplier effect throughout the economy. More money in the system increased demand, which then required increased supply. This created jobs, which further increased demand. In this recovery, we are seeing the first two steps, with third quarter 2003 growth in real consumption at close to 5% (figure courtesy of Morgan Stanley Institutional Research), but without the benefit of job creation. The question remains; is the economic recovery truly sustainable without job creation?