Quarter Notes
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We Survived! Worst Three Years Since Great Depression

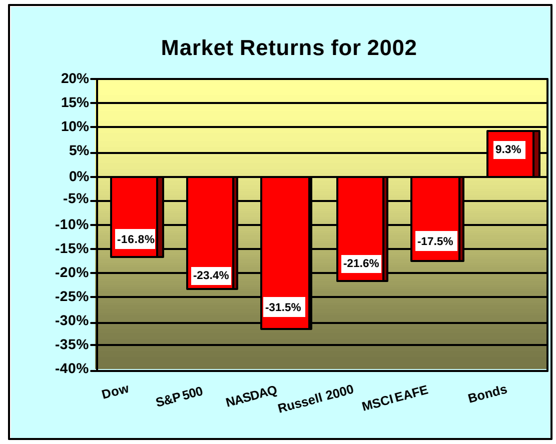
Ugly is all we can say about investments in the year just closed. 2002 was the worst year since the Great Depression. The damage was widespread with growth, value, large-cap, small-cap and foreign stocks all experiencing double-digit declines. The only winners this year were high quality bonds. The ten-year Treasury returned nearly 10% on the year.

It has been more than 60 years since the U.S. stock market experienced three consecutive negative calendar years. For 2002, the Dow lost 16.8%. The broader market S & P 500 lost more than 23% and the small cap Russell 2000 suffered nearly as badly with a 22% loss. International stocks were the only equities which fared better than last year, but the international index, MSEAFE, still lost 17%.

Even though our clients' portfolios have suffered much less than these major market indices due to the benefits of diversification and appropriate investment policy, we know it's trying the patience of most investors. We empathize because our patience is also wearing thin. This year, the message has been that we've outperformed by losing less. While our clients have been amazingly supportive, we're tired of delivering relative performance in a lousy investment climate. We've spent many hours analyzing the factors at play in this environment, looking at data and talking to other investment professionals we respect.

Like you, we're more than ready for something better and we badly want to believe that the stock market is set up for a great run. Since the turn of the new century in 2000, the Dow lost 27%, S&P 500 40% and NASDAQ 67%. After three consecutive years of rotten performance, you would think we would be set up for a huge bull market. While a four year losing streak is not unheard of, it only happened once in the last century during the Great Depression 1929-1932 and conditions today are in no way similar to that era.

After October 9, which we viewed as the bottom, we began to see some rebound in stock prices though November. Then during December, we gave back about half those gains. On the first trading day of 2003 the Dow jumped nearly 3%.



So what is effecting the market?

1. **Economics and profits:** The economic recovery is wavering and forward-looking economic measures are unclear. The manufacturing sector remains stagnant, but is no longer shrinking. Consumer spending has been a positive, but if the trend of increasing layoffs continues, spending will inevitably slow. Signs point to a better 2003. Capital goods orders are up and third quarter spending on equipment rose 6%. Though corporate profits have recovered somewhat this year, the rebound has not been strong. Moreover, some analysts are cutting profit estimates.

2. **International Uncertainty:** One of the risks of war with Iraq is that oil exports out of the region will be disrupted. We are already seeing disruptions in the energy supply resulting from the Venezuelan political crisis. North Korea is also a concern. Terrorist activity from Yemen to the Philippines fuels investor fears. Anything that destabilizes the Middle East tends to worry investors and war with Iraq could have ripple effects in a very unstable region that might fan terrorist flames.

In this Issue

Thoughts for the Quarter

"Most people get interested in stocks when everyone else is. The time to get interested in stocks is when no one else is."
Warren Buffet

Given the stock market's ability to recover from severe setbacks in the past we have good cause to be confident about its future.

As of 9/30/02 the dividend yield of the S&P 500 1.94% was at a 30 year high relative to the 3-month T-Bill 1.56%.

The market, is once again recognizing the value of companies with real earnings. During 1999, at the height of the bubble, companies without earnings outpaced firms with earnings by 40%. As of 9/30/02 companies with earnings were outperforming by 24%

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Revised Definitions

EBITDA: Earnings before I tricked the damn auditor.

EBIT: Earnings before irregularities and tampering.

Profit: Religious guy who talks to God.

Momentum Investing: the fine art of buying high and selling low.

Value Investing: The fine art of buying low and selling lower.

Yahoo: What you yell after selling it to some poor sucker for $240.

Windows 2000: What you jump out of when you are the sucker that bought.

ADV Annual Offer

Each year the SEC requires that we notify clients when we are updating our ADV Part ii. If you would like a copy of the updated form please call the office we will be happy to send one out to you.

Statement Bundling

Schwab is now beginning to "household" the mailing of monthly statements to the same address with the same tax ID. You can further reduce your mailings, by signing a form to have all statements to the same address mailed in a single package. Call us to obtain this form.

3. **Investor Hangover:** In the early days of 2000, many investors were unconcerned about valuations, fundamentals, or any sort of rational analysis of risk. The last few years have been one heck of a reality check. Investors are now much more cognizant of risk, so much so that their angst may be causing them to shift to a glass-is-half-empty mindset. There is also a general confusion about valuations. It is not unusual after a period of speculative excess for the investor sentiment pendulum to swing all the way to irrational paralysis, leaving markets at undervalued levels for several years. History has shown that once a bubble is popped, investor confidence is slow to return.

Do we believe the market is undervalued?

P/Es (Price Earnings Ratios), while not at an all time low, are consistent with other market bottoms when adjusted for interest rates and inflation. In addition, P/Es have also looked higher since earnings have been unusually depressed. So, are the stock markets undervalued, we are not certain, but we believe so.

It is nothing new to see widely divergent opinions among "experts" about the market's valuation. That said, we must repeat that valuation analysis is only part science and involves judgment about what investors are willing to pay to own riskier assets like stocks.

So does this mean that the market has bottomed and that stock prices will rebound quickly?

Unfortunately not. Stocks can stay undervalued for extended time periods. Research tells us nothing about timing. There are real risks. How they play out will determine whether a rebound is imminent or will take longer to materialize. In the near term it appears unlikely that stocks will surge given uncertainty about Iraq. However, there are many scenarios that could reduce the perceived risk (or increase it). But absent more clarity, it will be hard for the stock market to stage a prolonged rally.

In addition, the economic risks are real. It is important to note that the market is pricing in some of these risks. But there are some pessimistic scenarios that are not fully priced in. At present a lot of the economic news is negative. When a recovery takes hold the profit outlook will improve and stocks are likely to rebound. Yes, economic statistics are discouraging today, but that does not mean that more encouraging numbers might not be around the corner.

(Continued next column)

If stocks are a long-term bargain but near future is unclear… then why own stocks now?

One lesson we have learned well is that it is dangerous to underestimate the ability of the stock market to surprise us. This lesson was learned on the heels of the Asian meltdown in 1998, and when the Gulf War started in January 1991, to give just a couple of examples.

At present, fear and pessimism are much more apparent than greed and optimism. Clearly many negatives are already priced into stocks and a few unexpected positives could turn things around. Events in the Middle East could surprise on the upside just as they could on the downside. Being intellectually honest, even a pessimist must admit that the negative scenarios are not sure things. So, the point is that we don't want to risk missing out on the rebound simply because we can't say for sure when it will come. We recognize that it's possible that a *sustained* rebound might not come soon, but if it does we will have missed an opportunity to profit from the undervaluation that we believe is now reflected in stock prices.

A related point is that moving into defensive positions requires knowing when to increase stock allocations again. To say this is tricky is a huge understatement. Stocks tend to surge long before the indicators that signal that risk has declined are clear. Waiting for confirmation that risk has abated causes investors to miss major market moves. For example, in the month after the first Gulf War began the stock market rose 17%. It was up 19% in the month after it bottomed in 1998. We're simply not confident that any investor can turn on a dime to catch these types of moves. With the market undervalued based on a long-term analysis, it makes sense for investors to be patient and wait for the returns that will be delivered sooner or later.

So is staying the course still the best strategy?

While staying the course may suggest complacency to some, we view the term as implying discipline. We take pride in this discipline, which we believe is a key to good long-term wealth management. We continue to evaluate other risk reducing alternatives and strategies. We are ready to consider making larger allocations to other asset classes but only if they offer comparable return potential with different risk characteristics.