QuarterNotes

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Quotes for the Quarter

". . The flight of individual investors and the breakdown of the markets foreshadows the end of the capitalist system as we have known it."
BusinessWeek Sept. 1974
The 4th quarter of 1974 the markets delivered positive returns and the bear market wasover.

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Fear and Uncertainty Create a Difficult Investment Climate
A Rational Look at Where We Are

We are departing from the traditional format of *QuarterNotes* to allow room for an in depth analysis. We want to communicate as clearly as we can what has happened, what we see happening now, what we expect going forward and what we as advisors should do about it.

For the past 30 months we have witnessed the largest stock market meltdown since the great depression. In March 2000, the S& P 500 reached a peak of 1527. As we end the third quarter of 2002 this index is 815 , having lost nearly half its value. In the month of September alone the Dow Industrial Average lost 12.4 percent. This has been the longest bear market since the great depression. The NASDAQ index, home to many of the high flying tech stocks, has fared even worse over this period, losing 77 percent.

During 2000 and 2001, the first phase of the Bear Market, we managed to protect our clients from the worst of the damage by having adequate equity diversification. As we rebalanced portfolios, we captured profits where we could. A few investments including small value stocks and Real Estate (REITs) held better. We continue to believe that portfolios must have exposure to assets that don't move in tandem. Short of selling everything and moving to cash, there has been nowhere to hide this year.

With eleven rate cuts in 2001, interest rates began 2002 at historically low levels. U.S. Government bonds enjoyed gains due to a flight to quality and have provided shelter from the storm, plus a modest income stream. Clients with bonds paying high interest had them taken away as issuers called expensive debt and replaced it with debt costing half as much. Bondholders with cash in hand now have a problem. They must invest more than twice as much to get the same cash flow. High yield bonds, on the other hand, have huge yield spreads. This means they pay significantly more interest compared to governments and high grade bonds because fewer investors feel secure enough to own them. Investors fear that corporations will continue

During the building of the technology bubble, it was hard to restrain client enthusiasm for these stocks. In January of 1999, this publication in an article entitled *Tulipmania* discussed past speculative manias. We expressed concern that the speculative segments driving the market represented another bubble waiting to burst. We believed the run-up in stock prices and price earnings (P/E s) in these "hot" stocks and the skyrocketing initial public offerings (IPOs) were unsustainable, but none of us expected losses this extreme or pervasive. We certainly didn't believe it would take profitable companies with good franchises and solid earnings growth so far down with it. Now that we are two and a half years into this bear market, we are more timid about making the statement, "we have got to be close to the bottom", but we believe it even more.

While we couldn't predict the severity of what happened, this is not the first instance of a nearly 50% decline in the market indices. The most recent such painful time happened a generation ago (1973-1974) before most of today's investors had money in stocks. Remembering 1974 is useful. We had Watergate and Nixon's resignation, the Middle East Oil Embargo, surging inflation combined with recession and a discredited Fed. Pessimism was rampant.

When creating our investment strategies, we do take these historical examples of potential losses into account. For example, each client is asked, "If you invest your $1 million today and a year from now it was worth only $500,000 could you live with that risk?" The response is invariably no. Our retort is, "Then you can't have all your money in stocks, because some day we'll live to see another 50% loss in the stock markets." As unattractive as it looked to force bonds into portfolios during the run-up of growth stocks, it is just as difficult to stay invested in equities at a time when the outlook looks the scariest.

Thoughts for the Quarter

"Life is lived forward, but understood backwards."
Danish Philosopher, Kierkegaard

"The ability to manage the unexpected consequences and decisions is the real secret in investment success . . On the basis of my experience, greater danger lurks in the temptation to chicken out when the going is rough and your precious wealth seems to be going down the tubes."
. . Peter Bernstein

Privacy Statement

Our annual Privacy Statement mailing has been enclosed with client's quarterly reports.

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.

Where are we now?

As we reflect on the past two years and look towards the future, here are our thoughts on major economic issues:

-Economic Outlook: The recovery will continue slowly. Uncertainty over war with Iraq may limit the recovery process in the short term. However, 2003 growth in GDP (gross domestic product) is expected to exceed the 3% forecast for this year. Growth in corporate earnings of 3 to 5% plus inflation are likely over the next five years.

- Consumer Spending: Consumers will tighten their belts. However, low interest rates leave spending power in reasonably good shape as borrowers continue to refinance.

-Business Spending: Capital investment and expansion will remain sluggish. Slow business spending postpones a stronger recovery. Low interest rates and favorable tax incentives should stimulate expansion once demand picks up.

-Monetary Policy: Although interest rates are already at historically low levels, the Fed may cut rates further if the economy stumbles.

-Fiscal Policy: The Federal Government has renewed deficit spending which should trickle down through the economy. Additionally, governments at the Federal and State levels may push through spending stimulus packages to spur capital spending. Tax cuts as a stimulus are also being debated.

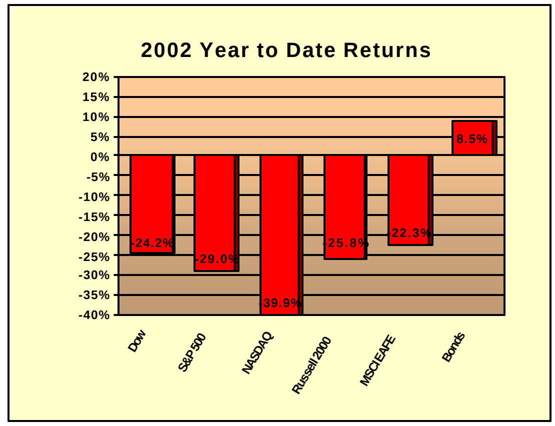
-The Markets: Excess valuations have been rung out of the stock market. A number of valuation models, including the Fed's own show that the market is as significantly undervalued now as it was at the bottom of the '73-'74 Bear Market.

-Corporate Reforms: A spotlight has been focused on certain types of executive behavior, self-dealing and compensation. Too many execs have looked out for themselves rather than their shareholders. Accounting "innovations" will be more thoroughly scrutinized. There will be a return to old fashioned measures of real profitability.

What do we do next?

Maintain sufficient liquidity. There is definitely a comfort factor in having ample cash and cash equivalents.

(Continued next column)



Re-evaluate client's true risk tolerance and adjust investment policy accordingly. It is easy to say that a 20% downside risk is acceptable when you haven't experienced it.

Keep diversified. Tactically overweight specific assets that are in a position to provide the best returns going forward. Usually this means having a contrarian stance, which can be difficult. Now that the pain of a bear market has been felt, clients may have a different perspective.

Consider alternative investments less dependent on the stock market. For years we have used real estate in most portfolios and there are others we are evaluating.

Keep emotions in check. We resisted chasing the IPOs and speculative positions when we were in the bubble and focused our efforts on keeping portfolios balanced and investment policies implemented. We must keep focused and continue to do this. Now we are resisting fear driven thinking and continue to believe that an asset allocation model will keep us from abandoning stocks at precisely the worst moment.

We are now in danger of reaching the "Maalox moment" in some of our portfolios. The difficult thing about this risk threshold is that in a devastating market like this one, the point where we get close to our threshold is also likely to be close to the point where we reach the bottom. No one rings a bell when the bottom has been reached, but based on our 3 decades of investing, when the bottom comes it is better to be invested in the market than out of the market.

We have many reasons to expect better times are coming. Bear Markets as well as Bull Markets are cyclical and this too shall pass. Markets will rebound as they always have.

Remain patient. We don't know where the bottom is, but we believe the markets offer good value. We are long-term investors with faith in the strength and resiliency of our capitalistic system.