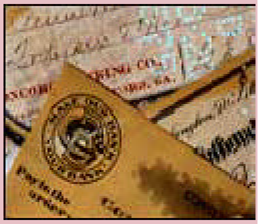
Quarter Notes

FIRESTONE CAPITAL MANAGEMENT, INC.

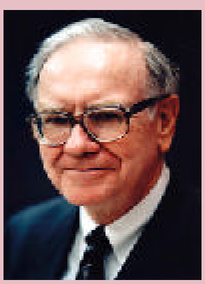
JACK M. FIRESTONE, CFP
CAROL G. KAUFMAN, CFP
www.firestonecapital.com

April 2002 | Second Quarter 2002 | Volume 10 No. 1



In this Issue

- *Market Summary*
- *A fresh look at the benefits of global portfolio diversification.*
- *Outlook for Bonds*
- *Warren Buffett on modifying investor expectaions.*



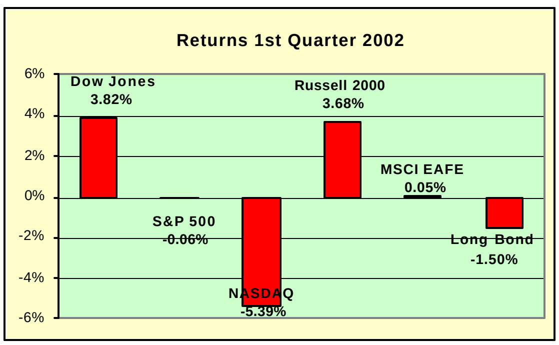
Warren Buffett, the "Oracle of Omaha", Chairman of Berkshire Hathaway and one of America's most recognized investors discusses what he thinks will happen to investment returns in the coming years.

1500 San Remo Ave.
Coral Gables, FL 33146
Tel: 305-669-2119
Fax: 305-669-1976
jack@firestonecapital.com
carolk@firestonecapital.com

Tentative Recovery Already Here - Market Results Mixed

The recession may already be over. Consumers continued to spend through the economic downturn and data suggests with inventories shrinking, business will be forced to start spending again.

Market returns were mixed with the Dow and Russell 2000 up more than three percent. The S&P and international stock indices were flat. Long bonds fell one and a half percent on expectations that interest rates have bottomed out. The Fed seems ready to hold interest rates for the present. Middle East war concerns spiked gas prices which could threaten a quick recovery.



Outlook for Bonds

Bonds gained respect last year, as they provided positive returns in an otherwise "challenging" market. But with the economy beginning to show signs of life, what kinds of returns can be expected in the near future from fixed income or bond holdings?

Total return from a bond is comprised of its interest rate return and its capital appreciation or loss. With the interest component (the bond's coupon), what you see is what you get. A 5% bond is going to pay you 5% of its face value each year. But depending on prevailing interest rates, the value at which you could sell the bond prior to maturity can rise or fall. This calculation affects your total return in any given period. Of course if you hold a bond to maturity you will get back the face or par value.

(Continued next column)

(Continued from previoius column)

Interest rates behave in a cyclical fashion: they start to fall in anticipation of a slowdown in economic activity, longer term rates also fall as inflation concerns abate. The Fed then lowers short term rates to provide liquidity and economic stimulus.

At this point in the interest rate cycle, capital appreciation from falling interest rates has already been realized.

Eventually, longer-term interest rates move up as economic activity improves and reignites inflationary concerns. The Fed, however, usually waits for unemployment to decrease significantly before raising interest rates.

There is another area where potential capital appreciation exists. In all environments, corporations must pay higher interest rates than the US Government as a risk premium in order to attract bondholders. There is also a cyclical component to the risk premium. As the economy experiences a slow down, there is a "flight to quality" where there is a higher demand for Government bonds. Corporations must pay a larger premium on the bonds they issue due to fear of default. Currently the risk premium (the spread) is quite wide. As the economy begins to improve, the premium should narrow and bondholders may realize capital appreciation.

In sum, we do not expect the Fed to raise short-term interest rates steeply, so short to intermediate government bonds should return close to their effective interest rate (currently, a 10 year treasury is yielding about 5.3%), but no more. Corporates, and especially high yield corporates, should have some capital appreciation potential as the economy improves and the risk premium contracts. However, due to default risks associated with individual corporate bonds, we believe mutual funds offer important diversification.

What Warren Buffett Says About Future Stock Returns

Fortune magazine recently featured an article (Dec. 10, 2001 issue), in which the "Oracle of Omaha", Warren Buffett, outlined his view on market returns and how he justifies his analysis. His analysis examines the two seventeen year periods: 1964-1981 where the Dow increased 0.1% and 1981-1998 where the Dow increased over 1000%

According to Buffett, it wasn't growth in Gross National Product (GNP) which caused the Dow to rocket. Actually from '64 to '81 GNP grew twice as fast as the '81 to '98. The two critical factors in the spectacular difference in the Dow's gain between the two periods he attributes to the change in the interest rate environment and investor expectations.

During the first period, interest rates on long-term government bonds increased from 4.2% in 1964 to 13.65% in 1981. For the second period, rates went in the other direction, dropping from 13.65% in 1981 to 5.09% in 1998. When interest rates fall, assets you hold increase in value. You can see this easily with bonds. If interest rates are 10% then fall to 5%, the higher stream of interest payments on the 10% bond become more valuable.

Although not as easy to see, the same is true of stocks, and other financial assets. Because a stock represents a claim on future earnings and distributions, the value of those earnings are like the future interest payments on a bond. So as interest rates fell the Dow exploded.

The second element has to do with investor behavior. Stockholders are driven by corporate profits and expected profits in the future. Investors tend to project current trends and growth rates indefinitely, so that "people are habitually guided by the rear-view mirror, and, for the most part, by the vistas immediately behind them." This behavior led to the speculative bubble which culminated in the market collapse in 2000.

Buffett concludes that, since it is unlikely for interest rates to fall any lower, long-term returns from equities will likely track the growth of U.S. business (represented by GNP) plus a factor for inflation. GNP is forcast to grow at 4-5%. If he is correct then equity valuations are likely to grow at no more than 6 to 7% (4-5% plus 2% for inflation).

Benefits of Global Diversification

The recent economic weakness has been global in nature, affecting most major economies. The signs of recovery, which we are experiencing in the U.S., are also emerging in other parts of the world. These synchronized movements have caused us to reexamine the benefits we expect from international diversification.

Past data suggest that using international investments in portfolios has helped to reduce risk and increase returns. In light of the increasing globalization of world economies, are there still benefits in owning international investments? In truth, not all events influence global economies identically. A worldwide increase in oil prices might dampen global growth while a bursting of the real estate bubble or banking reorganization in Japan will have a more regionally isolated effect.

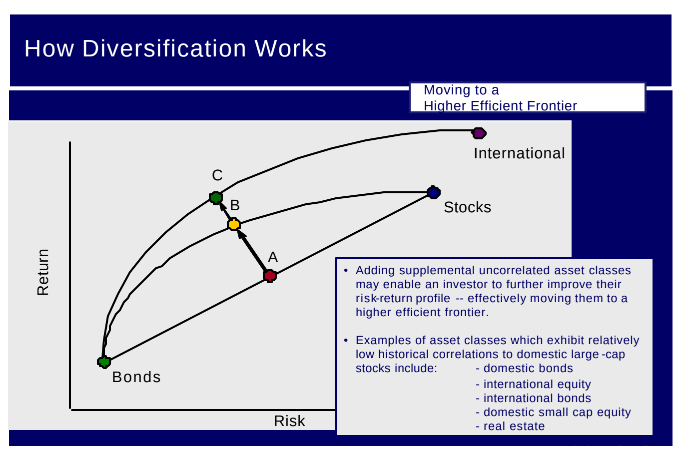
Correlations measure how closely investments move together. The closer the correlation is to 1.0, the more similar the behavior and the less helpful in

(Continued middle of next column)

(Global from column one)

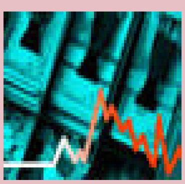
reducing risk. In the past decade, historic correlations among the developed countries have increased approximately 20 percent from .42 to .51 Therefore, while the benefits of global diversification are somewhat diminished, risk-reducing and return enhancing attributes still exist.

The conclusion we reached is that there are benefits to keeping international investments in our clients'portfolios.



How we continue to add value to our relationship

- *Creating well diversified portfolios, monitoring them and reporting on your progress.*
- *Capital gains tax planning.*
- *Rebalancing portfolios.*
- *Giving you access to institutional, low cost investments.*
- *Keeping clients on track and invested during difficult markets.*
- *Assisting with other issues including college funding, retirement needs planning, risk management, and estate planning.*



Web Site Upgrade

Our new website is now working with far more tools and robust content. You can also look for past issues of these Newsletters as they are added this quarter.