Quarter Notes

FIRESTONE CAPITAL MANAGEMENT, INC.

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

October 2000 | Fourth Quarter 2000 | Volume 8 No. 3

In this Issue

- *Downside volitality continues in the third quarter.*
- *Exchange Traded Funds (ETFs) - do they have a place in your portoflio?*
- *Eye on the Economy*
- *Star Ratings*

Bits and Pieces

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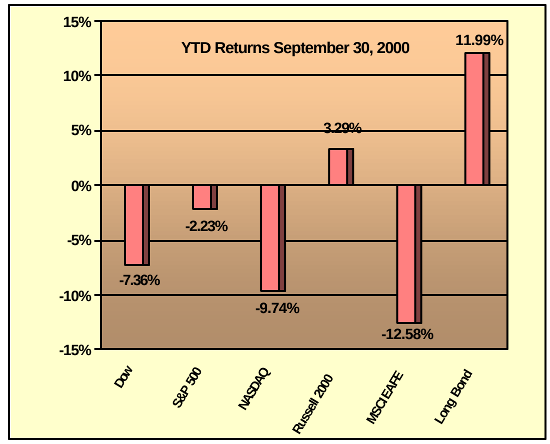
Flash. . .Congress proposes changes to complex IRA distribution rules. The current rules are a mess.

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

Bonds and Real Estate Helped This Quarter

Investors have gotten bad news for the third quarter for three years in a row, only to have their investments catch up in the fourth quarter. Only small stocks represented by the Russell 2000 index had a positive return of 3% for the year. The Dow stocks are still down 7%. Tech stocks are still in the dog house. The NASDAQ closed the quarter well below 4,000 after topping 5000 in March. The NASDAQ composite has lost just under 10% for the year to date. *(See details in graph)*



Small stocks, REITs and good performance in the bond market have helped mitigate the lousy large cap performance. Value investments have shown some signs of coming out of the doldrums. International stocks have suffered. The new Euro has lost significant ground. When the Euro was introduced it traded well above a dollar US. It closed the quarter at 88 cents, a loss of 18%.

The Fed opted not to raise rates last month. We doubt that there will be another hike in rates before the November elections. The economy appears to be slowing and corporate warnings have sent shares of those companies plummeting. *(see more in page 2 article)*

Star Ratings

★★★★★

Star Ratings from Morningstar™ are probably the most publicized part of their database and analysis tools. Fund companies are quick to highlight a 4 or 5 Star ratings from Morningstar as a testament to their investment prowess. But to the professional advisor, Star Ratings are of limited value, and we want our clients to understand its limitations.

With the Star Rating, Morningstar attempts to bring risk and return into a single measure by determining the fund's risk score and subtracting it from the return score. The top 10% receive a five Star Rating.

A major drawback of this rating is that only

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four broad asset classes are differentiated: domestic stock, international stock, taxable bond and municipal bond. This means that capital size and investment style are not measured. So, Morningstar is frequently comparing apples and oranges in their analysis of fruit. Problems arise when one asset class dramatically outperforms another, as we have recently seen with large company growth. More five star ratings appear in this asset class than any other.

Another problem lies with the formula used to calculate weightings. A fund with only a three-year track record will be evaluated on those three years and funds with longer records are measured on their full history. This would be a problem if a large cap growth fund, for example, has only a three year record, then a short track record would increase its stars because the past three years favored these funds. Thus funds are being evaluated over different time periods.

To address these problems, Morningstar developed Category Ratings. The Category Rating system compares apples to apples by assigning a three-year rating based upon how well risk and return are balanced relative to other funds with the same style and objective. This makes the Category Rating a better measure for investors looking to select the best funds within a specified asset class.

Quips for the Quarter

"investors repeatedly jump ship on a good strategy just because it hasn't worked so well lately, and , almost invariably , abandon it at precisely the wrong time." -David Dreman

Buy stocks when the market is depressed.

To create long term wealth - be an investor, not a speculator.

Big drops in the market are almost always great buying opportunities.

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

Spiders, Diamonds, Qs and iShares
ETF's are they right for you?

As we are evaluating the use of Exchange Traded Funds (ETFs) for our client's portfolios, we thought it would be beneficial to examine what they are and how they work. Exchange traded funds (ETFs) let you buy or sell shares of an entire portfolio of stocks in a single security. Each ETF share represents a portfolio of stocks designed to closely track one specific index or specialized industry. They are similar to a passively managed index fund except, investors can buy and sell shares throughout each trading day - just like stocks - paying normal brokerage commissions.

ETFs come in many different forms. Spiders, Diamonds, Qs, iShares, and HOLDRS are among the names you may have heard for ETFs . They have a number of advantages. Because they track indices, these securities are considerably cheaper than actively managed stock funds. We also like them for their tax efficiency as they tend not to make taxable capital gains distributions to shareholders.

ETFs are unit investment trusts (UITs) that have two markets. The primary market is where institutions swap "creation units" in block-multiples of 50,000 shares for in-kind securities and cash in the form of dividends. The secondary market is where individual investors can trade as little as a single share during trading hours on the exchange. This is different from open-end mutual funds that are traded after hours once the net asset value (NAV) is calculated.

Another advantage is that an ETF's underlying portfolio is shielded from investor trading of those fund shares since ETFs are usually traded in the secondary markets between shareholders. Redemptions are not an issue as they are with regular mutual funds because buying and selling of shares does not require selling investments and capital gains recognition. Further, ETFs are more efficient since no cash position is required for redemptions. Large institutional shareholders are able to buy and sell by depositing shares of the index or redeeming shares in-kind. Thus no capital event is triggered.

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ETFs, while they are designed to allow investors to move in and out of markets quickly and intra-day, in our practice are intended to be held for long term growth.

The cost advantage of ETFs over index mutual funds could be given up in situations with active traders since investors have to pay commission each time a buy and sell is executed.

ETFs work best in taxable accounts. They are a convenient, well-priced and tax efficient investment to use for core passive positions.

Eye on the Economy

The Federal Reserve's campaign to raise interest rates over the past year was designed to reduce U.S. domestic demand from its frantic pace. The Fed was trying to pre-empt inflationary pressures, moderate speculative growth in the stock market, and reduce the U.S. balance of trade.

Has the Fed been successful or will additional interest rate hikes be necessary? The Fed is still concerned about inflation, seeing historically low unemployment and tight labor markets. And in order to achieve a "soft landing", a reduction in domestic demand and a narrowing of the huge U.S.'s current account trade deficit is required.

Adding to the complexity of the situation is the run up in oil prices. A decline in energy prices could lead to a rebound in consumption which would increase inflationary pressures. But high energy prices are also inflationary as companies raise prices to cover the increased cost of production.

A "soft landing" is possible despite the fact that consumer confidence (and consumption) remains strong. Higher interest rates, combined with higher oil prices, have decreased consumer's purchasing power. The drop in the equity markets on a year to date basis have taken their toll on our perceived wealth. This should also slow domestic consumer demand.

In a Presidential election year, with both candidates expressing their willingness to spend the budget surpluses well in advance of receiving them, a "soft landing" might be in jeopardy. After the election, regardless of who wins, we believe more rational approaches will prevail.