ECONOMIC AND CAPITAL MARKETS COMMENTARY AND OUTLOOK

April 2002

MARKET REVIEW AND STRATEGY SUMMARY

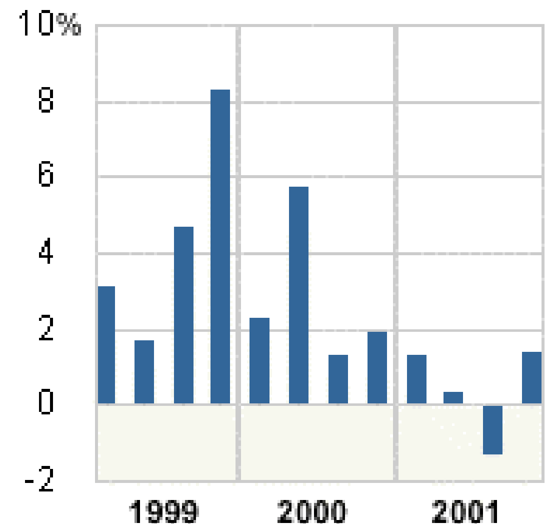
Middle East Violence, The War on Terror, A Nearly Bankrupt Japan – Where is the Good News? It is hard not to be discouraged or nervous about what is going on around the globe. The crisis in the Middle East between the Israelis and Palestinians has escalated into all-out war, the threat of future terrorist acts in America is all too real, and the Japanese economy continues to slide toward depression. Despite all the uncertainty surrounding investors, the U.S. economy has emerged out of what may be the shortest recession on record.

As we have mentioned in previous commentaries, this business cycle is different. Not only was the U.S. economy thrust into one of the shortest recessions in recent memory, the rest of the developed countries of the world have also suffered through various degrees of low-to-negative real growth. Rising excess capacity and profit compression have cut business confidence worldwide, resulting in large cutbacks in capital spending. All of this occurred while the consumer took advantage of a record 11 straight cuts by the Fed in 2001, a strong housing market and falling energy prices. The significant decline in interest rates spurred a record round of mortgage refinancings and a new spate of second mortgages. The consumer does not have the pent-up demand that usually occurs near the trough of the business cycle, but rather has accumulated significant levels of debt as a percentage of overall disposable income. Businesses are also concerned about sagging profits and are not expected to return to the levels of spending witnessed throughout most of the 1990s anytime soon.

In addition, this market has not discounted the rise in uncertainty usually associated with war. Even though the risk to the capital markets from the disruption of war in the Middle East is hard to quantify, most strategists are focused solely on the fundamentals within our own borders. Even the threat of additional terrorist attacks on U.S. turf has been slowly fading from the memory of most. Markets do not like uncertainty, and both the war on terror and the war in the Middle East do not yet have workable solutions. It is also surprising that more financial press has not been given to the potential global fallout of a banking system collapse or economic meltdown in Japan. Japan, the world's second-largest economy, is a major trade partner of both the U.S. and Asia (including China). Major disruptions of trade flows between these regions would most certainly threaten any sustained economic recovery in the U.S. and Asia.

Based on all this negative news, is there a light at the end of the tunnel? One needs only to look back over the last two decades. We live in a very different global community, where information flows more freely across borders and at lightning speeds. The global community has embraced free market capitalism in a big way. It was only a short time ago that communism was the evil force and the roadblock to true progress. China is a good example of a country that has embraced capitalism. Even though it is still a communist state, it has freely embraced all the principles of free trade and seen the benefits that the free flow of capital can provide. The rapid development of Shanghai is a testament to this new way of thinking. Even though the road ahead may look bleak to many, the lure and payoff of embracing free-market policies far outweighs the alternative. It is this new mind-set that will result in a more efficient and timely reallocation of resources. Even Japan can avert economic and financial disaster once it recognizes that the only solution is to abandon its old methods and embrace the strong medicine needed to put the dangerous banking debt problem behind it and halt the forces of deflation.

The Great Disconnect and The Double Dip. Many market watchers have recently focused on the surprising strength in the U.S. economy and, consequently, increased their corporate earnings growth forecasts for 2002 and 2003. This focus may be misguided in that economic growth and corporate earnings growth do not always move together. Recent indications suggest, however, that the manufacturing sector may be emerging from its two-year slump and that consumers have continued to spend freely on consumer durables. Even so, this does not exactly translate into higher corporate profit growth, nor does it suggest that this economic recovery is sustainable.



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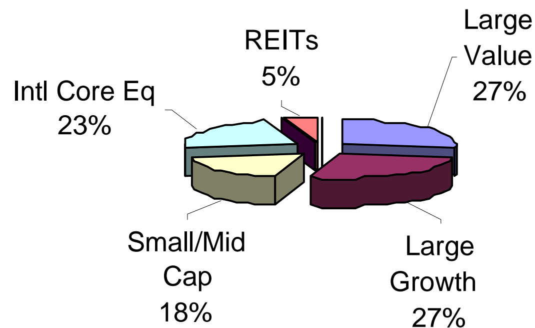
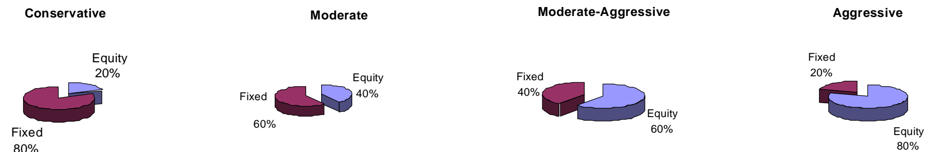
Tax Exempt Total Return Strategy

Current Equity Allocation Recommendation

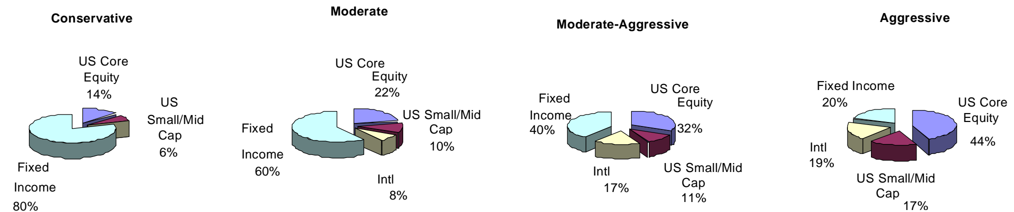


Taxable Allocation Recommendations

Strategic (Stock/Bond) Level



Style Level



Note: The "Tax-Exempt Total Return Strategy" refers to an equity-only portfolio for the non-taxable portion of an investor's portfolio. The "Taxable Allocation Recommendations" refer to a series of recommended diversified stock/bond portfolios covering a wide spectrum of potential market volatility. Please note that any portfolio changes in taxable portfolios are subject to capital gains taxes. Please review any possible tax impact before implementing portfolio changes.

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On the economic front, a full recovery will require stepped-up spending in both the consumer and corporate sectors. Consumers have already leveraged their balance sheets, taking advantage of lower interest rates and zero-percent financing on autos, and securing additional discretionary funds from second mortgages. There is no more "pent-up" demand or capacity to keep buying at this current pace. At the same time, businesses have shed excess inventories (the primary reason for the higher-than-expected jump in real GDP recently). The large inventory adjustments in the fourth quarter of last year and the first quarter of this year have put a dent in excess capacity, but substantial excess capacity still exists, especially in the telecommunications and technology sectors. Global trade flows have also slowed sharply over the last year. The global economy will need more than a financially "strapped" consumer to pull it out of the trough. It will require a robust return to capital spending by businesses, a greater balance between supply and demand, and an increase in world trade flows.

Businesses have not been able to maintain pre-2000 profit margins due to a lack of pricing power; thus, they have had to focus on the expense side of the balance sheet. Greater attention to profits will require even further tightening on the cost side. Reductions on the cost side will continue to come in the form of personnel layoffs and measured capital spending. At the same time, corporate earnings expectations have risen, even on the heels of reduced capital spending and a tapped-out consumer. Where will the predicted 17%-plus earnings growth for 2002 come from? Even current stock price levels do not justify these optimistic profit forecasts. This is the "great disconnect."

Pockets of Opportunity. There are areas of opportunity, however, despite the questionable optimism on Wall Street, high overall market valuations and heightened global tensions due to violence in the Middle East. The difference in this market is that not everybody who jumps on the stock-market bandwagon is going to be a winner, as was the case throughout most of the 1980s and 1990s. Small- and mid-cap stocks are still attractive on a relative-value-basis versus large-cap stocks. This group is also attractive in terms of current p/e multiples relative to growth expectations. Certain sectors of the market should also benefit from the current environment. Undervalued areas, such as the financial services, health care and natural resource sectors, offer near-term opportunities. There are also opportunities for investors on a stock-specific basis. Many companies have managed their cash flow from operations quite well during the recent downturn, and have avoided the game of using accounting tactics to enhance shareholder value. Also, as we have said in the past, the current market environment is quite attractive for actively managed portfolio strategies due to the presence of a more diversified stock market. No one sector represents a lopsided portion of the market's total value, as was the case with technology in the late 1990s.

Stocks for the Long Run & Other Misconceptions. One popular delusion of the last two decades has been the mantra touted by many so-called market observers that longer-term investors are always better off holding an all-stock portfolio. First, what is long-term? And second, how many of these pundits actually experienced a significant loss in their own stock portfolios (prior to March of 2000)? Most people would agree that return volatility declines over long periods due to the effects of compounding. However, what most people do not realize is that the potential magnitude of financial loss (dollar wealth) 20 years from now could be substantial. The magnitude of dollar loss from an all-equity portfolio could certainly be greater than from a diversified stock and bond portfolio. Investors have also redefined what "long-term" means. Most followed the adage that stocks always rebound from their previous declines and that investors buy on dips, implying that stocks will always trend upward. Stocks are long-term investments with a longer duration than bonds (bonds have a stated maturity date).

Most investors assume that what happened in the past will happen in the future, with a pronounced emphasis on the most recent past. Investors have come to expect a 10%-12% annual return in stocks. Why? Because long-term historical returns have been in this range, biased by the extraordinary returns of the last two

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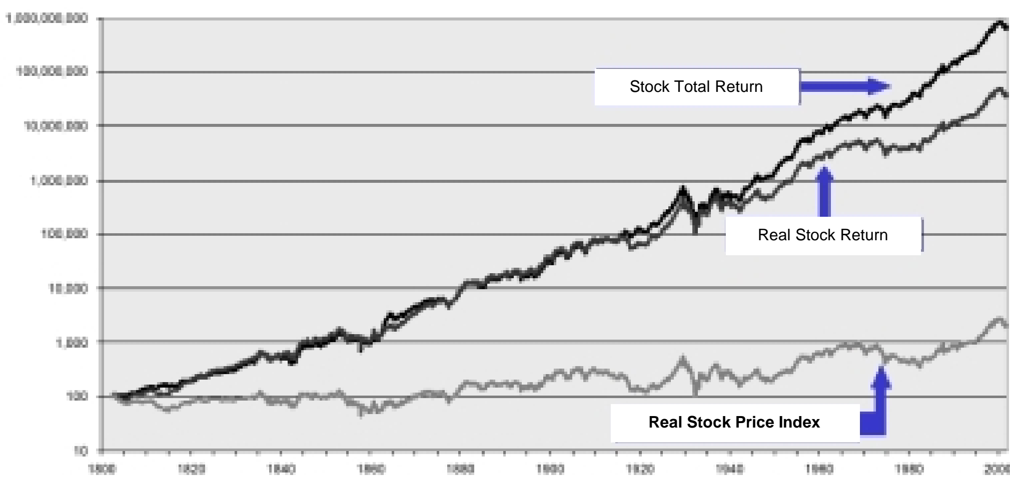
decades (18% annual returns for stocks in the 1980s and 1990s). The future will be different and returns will be lower because: (1) stocks are vastly overvalued with an average dividend of less than 1.5% and p/e multiple of 22 times forecasted earnings; and (2) long-term earnings growth for the aggregate stock market cannot grow faster than nominal GDP. We have already stated that real GDP is likely to grow at a 2%-3% annual growth rate near-term and possibly a 4%-4.5% annual rate longer-term, with an estimated long-term inflation forecast between 2% and 2.2%. It will take time for the stock market to revert to the valuation levels witnessed in the early 1980s, the beginning of one of the longest and deepest bull markets in history. Going forward, this suggests that prudent investors will have to better diversify their investment portfolios to include a mix of stocks, bonds and, possibly, nontraditional assets, abandoning the once popular "100% stocks, 100% of the time" strategy regardless of time horizon.

Current Asset Allocation: Long-Term Return Assumptions — Single-Digit Large-Cap Stock Returns, Favor Value vs. Growth, Opportunities in Small-Cap Stocks and Select Opportunities Overseas. Our asset allocation recommendation remains well-diversified with exposure to both stocks and bonds. All-equity portfolios (100% equity) are ill-advised at this time and are only appropriate for those who have some exposure to fixed assets and/or income-producing assets outside of their traditional investment portfolio. We still favor exposure to high-quality, undervalued issues in stocks and bonds. Our overall estimates of return for all asset classes have moved slightly lower and risk estimates have moved slightly higher. Even so, real return expectations for assets on a risk-adjusted basis remain attractive (based on a secular inflation forecast between 2% and 2.2%). Investors should focus on holding a well-diversified portfolio of stocks with the following characteristics: high credit ratings, low debt to total capital, large cash reserves, and a history of stable earnings growth during up and down markets. We would also suggest a slightly overweighted position in stocks that exhibit lower-than-market valuations and stable, market-like earnings growth. For equity-oriented accounts, we would also suggest a 15%-20% commitment to small-cap stocks and a 15%-25% commitment to international equities. The majority of the recommended allocation to international equities should be invested in companies that are in developed countries, with a continued emphasis on Europe and low exposure to Japan and the Far East. Specific allocation recommendations are based on each individual investor's unique financial objectives, circumstances and risk preferences. We also believe that the current market environment favors an active stock-picking approach based on lowered market expectations and the absence of concentrated sector risk.



Source: Arnott & Bernstein (2002)

We do not believe in market timing and will only make recommended changes if we believe structural changes have occurred in the economy or markets that could impact long-term returns and the relationship between stocks and bonds. We continue to recommend that the core bond portion of portfolios be invested in the highest-quality and most liquid segment of the market, preferably Treasury securities. For more risk-tolerant investors, we also recommend that a portion of their bond portfolios be invested in higher-grade corporate bonds.

THE ECONOMY AND INTEREST RATES

The U.S.

Consensus forecasts for economic growth in the U.S. in 2002 recently moved significantly higher due to better-than-expected economic announcements. The recent rise in growth numbers has largely been influenced by a big adjustment in inventory levels. Economic forecasters now expect growth to move 2.1% higher in 2002, up from a 1.6% forecast just one month ago and 0.9% three months ago. In fact, most forecasts for many economic indicators have been revised upward. Personal consumption is now expected to grow 2.7% in 2002 versus 2.1%

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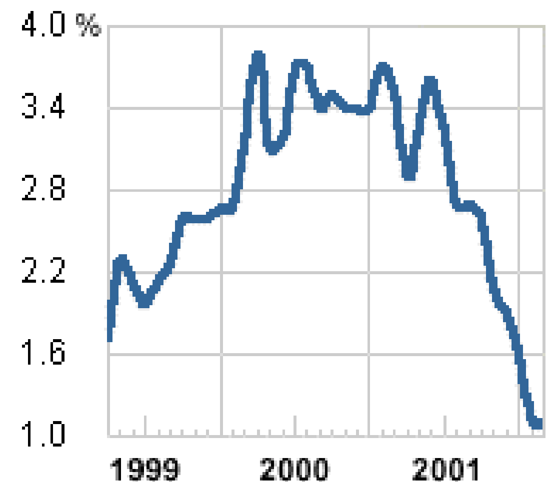
just one month ago. Business investment is still expected to decline 3.7% on a year-over-year basis versus a forecasted 4.6% decline just a month ago. Pre-tax corporate profits for the U.S. economy are expected to grow at a 5.3% annual rate in 2002, a big jump from just one month ago (+2.2%).

There are signs of real economic growth, but there are still questions as to whether this growth is sustainable or whether economic forecasters are being a bit too optimistic. The jury is still out with respect to whether consumers can continue to spend at the level most are predicting for 2002. Business investment forecasts are also a bit too optimistic in terms of the magnitude and timing of recovery. The consumer can afford, or be willing to purchase, only so many more autos and large appliances. The dividends from lower interest rates and lower energy prices are gone. The Fed is more likely to keep rates steady or possibly raise them in the next nine months rather than cut them from their current levels. Rising commodity prices (for most commodities) and improvement in the manufacturing sector suggest that the recovery is intact, but that it may take longer than most expect to return to a 4% annual real rate of growth. Consumers are more likely to slow their purchases over the next 12 months as debt levels (as a perentage of disposable income) rise and as more companies announce job layoffs. The housing market, the one bright spot in the last two years, is also likely to cool off. There are already indications of rising vacancies in the commercial office space sector of the real estate market. Businesses have a long way to go before returning to profit levels of the 1990s. Balance sheets are being squeezed on both sides, as lower revenues face off with rising operating costs. Due to the lack of pricing power in most sectors, companies have only one alternative to improve profit margins and that is to focus on the cost-side of the balance sheet. The largest operating costs, such as overhead, are the first to be slashed, as are expenditures on capital items. Even though inventories have declined in many sectors of the U.S. economy, there exists a large amount of unused capacity in many sectors around the world. Telecommunications and retail are just two of the sectors where excess capacity still exists.

The job market holds the key to recovery in the U.S. and the magnitude of that recovery. Recent employment statistics suggest that the national job numbers will worsen before they get better. The current unemployment rate is at 5.7%, a slight increase from previous levels. The current employment statistics still point to layoffs in the goods-producing sector and some improvement in the services sector. Most of the job increases in the services sector have been in the area of temporary employment and not full-time hires. This data suggests that companies are still not committed to hiring full-time employees until evidence of higher sales revenues is firmly in place. The biggest job losses have been in the transportation, construction and retail sectors. With corporate profits expected to be under continued pressure over the foreseeable future, it is more likely that operating-cost cuts will continue to come in the form of personnel layoffs. Consensus forecasters predict that the national unemployment rate will end the year at 5.8%, only a fraction higher than where it now stands. Estimates range from a low of 5.1% to a high of 6.2%. We side with the higher estimate.

Inflation remains in check, even as commodity prices have reversed their two-year slide. Energy prices and various metal prices have moved higher on the news of Middle East uncertainty. The overall trend in commodity prices is lower. Lower commodity prices are a reflection of the weak global economic situation and a lack of pricing power at the wholesale and retail levels. The outlook for price direction remains on the downside. There are sectors of the global economy where prices have crept higher, such as energy, medical services, housing and education. The rapid growth in the money supply is also a concern for the Fed, as is the possibility of a longer-term rise in inflation. We continue to believe that the long-term secular trend for inflation is on the downside. The consensus of economic forecasters predict a 1.4% rate of inflation in 2002 and 2.4% in 2003, with the trend moving higher in 2004 and beyond. Our current forecast of



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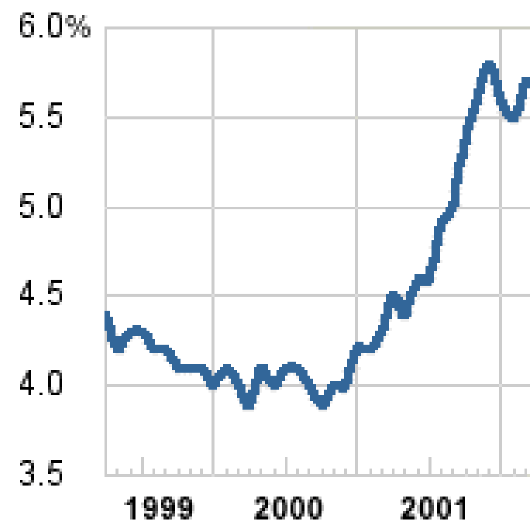
long-term inflation is 2.2% (10+ years). We agree that inflation should trend near the consensus in 2002 and remain in the same range in 2003. Beyond 2002, we differ from the consensus for the following reasons: (1) fierce global competition and cheap overseas labor will continue to place downward pressure on prices well beyond 2002; (2) a financially tapped-out consumer will not be the primary driver of growth in 2003 and beyond; (3) it will take time for the global economy to emerge from recession; (4) a subdued profit outlook will continue to place pressure on capital expenditures; and (5) excess capacity still exists worldwide in several sectors, such as telecommunications.



Shorter-term interest rates are expected to move slightly higher as inflation expectations move higher on the heels of rapid money growth and the expected upturn in commodity prices. Short-term interest rates may inch slightly higher over the next two years as the economy resumes a steadier rate of real growth. The market expects short-term rates to remain near 2%, at least through the second quarter of this year, and to move to a level near 3.3% by March 2003. At the same time, longer-term bond yields are expected to end this year near 5.25% and next year at 5.5%. It is likely that interest rates have bottomed and will move higher from current levels. However, the rise may be limited due to the excess capacity issues mentioned earlier and the weak demand expected from both the household and business sectors.

Europe

The economy of the Euro region continues to languish with some signs of recovery evident in the large inventory adjustments and improved business expectations in Germany and France. Consumer expenditures and exports have been weak in both markets, but many expect some improvement in these areas by the third quarter of this year. Unlike the U.S. economy, most of Europe has a high rate of unemployment. This has placed more pressure on the household sector and its ability to sustain expenditures. The Euro region has also felt the effects of lower business spending. This statistic has trended in negative territory over the last year and isn't expected to improve until well into 2003. Any return to healthy real economic growth in the region is unlikely this year and into the first half of next year. Demand forces are weak at home in both the consumer and business sectors and the labor market continues to worsen. High rates of unemployment in the region and moderate export growth are likely to dampen any significant outbreak in real economic growth in the foreseeable future.

The questionable prospects for a significant pick-up in real growth in Europe suggest that pressure on the Euro relative to the dollar will continue. While most expect the Euro to gain strength over the next 12 months relative to the dollar, we believe that the currency will continue to trade in its current range of 0.87-0.89 per U.S. dollar. The increase in uncertainty in the world due to terror and war in the Middle East and a slower-than-expected, but sustainable, recovery in the U.S. will continue to attract foreign capital to the U.S. capital markets.

In Germany, real GDP growth contracted in the fourth quarter of 2001, the second consecutive decline in real growth and the first time this has occurred since 1993. The two positive contributors to economic growth over the last few quarters have been the large adjustment in inventories (decline) and increase in government expenditures. Real economic growth is expected to move 0.8% higher in 2002 and 2.5% higher over the period from 2003 to 2006. Personal consumption expenditures are expected to grow at only a 2% annual rate in 2003 and 2004. These forecasts are muted by the fact that the unemployment rate remains high, near 9.6%, and is only expected to improve to an annual rate of 9.4% in 2003. Most of the improvement in economic output in Germany is expected to come from a pick-up in business spending and export growth. The local economies of both Germany and France (the largest economies in the Euro region) are poised to move higher at rates of real growth that will probably lag the U.S., but that have the potential to surprise on the upside if local officials effectively address the unemployment issue through deregulation and more tax incentives.

The U.K. has been one of the stronger economies outside of the U.S. The same forces that have slowed growth in the rest of the world have been felt in the U.K. Real growth during the fourth quarter was flat in the U.K., the

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lowest rate since the second quarter of 1992. The U.K. consumer continued to keep the economy afloat with household consumption growing 1.2% in the fourth quarter (mostly in the durable goods sector). The sharpest declines in the U.K. economy have been in the business sector, where gross fixed investment dropped 3.2% during the fourth quarter of last year, the biggest decline in this area since 1991. Both exports and imports declined in the fourth quarter in most categories. Recent statistics indicate that export growth has improved with gains in January, especially in auto exports to the U.S. As the U.S. economy improves, the export sector should continue to benefit. The U.S. is still the U.K.'s largest export market, representing 14.7% of total exports. Real economic growth is expected to grow at a 2% real rate of growth in 2002 and 2.9% in 2003. The biggest improvements are expected to come in the areas of business investments and corporate profits. Little improvement is predicted in the area of household expenditures.

Interest Rates

	Dec 01	Jan 02	Feb 02
Federal Funds Rate	1.82	1.73	1.74
Discount Rate	1.33	1.25	1.25
Prime Rate	4.84	4.75	4.75
Conventional Mortgage Rate	7.07	7.00	6.89
Treasury Yields:			
3-month constant maturity	1.72	1.68	1.76
6-month constant maturity	1.82	1.77	1.86
1-year constant maturity	2.22	2.16	2.23
3-year constant maturity	3.62	3.56	3.55
5-year constant maturity	4.39	4.34	4.30
10-year constant maturity	5.09	5.04	4.91

Source: Federal Bank of St. Louis

Japan

Real economic growth declined 1.2% during the fourth quarter of last year, the third consecutive quarter of negative growth. Private consumption actually grew 1.9% in the fourth quarter, while business investment dropped over 12% during the quarter. Even though some economic forecasters expect the Japanese economy to return to a positive annual rate of real growth in 2003, there are far more indications that this forecast is too optimistic. The statistics clearly show that the local economy continues to suffer from lack of demand, falling prices, and alarmingly high levels of public debt. Statistics aside, there are far more pressing problems in Japan that the current political leaders have failed to effectively address. Falling prices, zero interest rates, weak domestic demand, rising national debt and a worsening banking debt problem are all impediments to Japan's recovery.

It is hard to believe that, slightly over a decade ago, Japan contributed over 12% of world growth. Japan's fall from a global economic power to a distant second behind the U.S. economy has been significant and painful. The decline from the peak in stock market and real estate prices has been substantial. Unfortunately, Japan has applied its old methods in an attempt to jump-start the local economy, ranging from monetary easing to large government spending packages. The end result is that the economy is now confronted with excessive levels of outstanding debt, no room on the monetary side for stimulus (interest rates remain near zero), weak domestic demand, and falling prices. The aggressive banking policies that were practiced during the boom years resulted in a large percentage of bad loans that have not been written down to this day. As prices decline and real interest rates move higher, the price tag of the banking debt problem continues to grow. Bankruptcies have accelerated in most all sectors of the Japanese economy, and the banking system is all but insolvent.

The future of Japan's economy looks quite grim. As debts mount, the population continues to grow older and many continue to save what they earn. This places future pressure on any sustainable recovery and continues to place downward pressure on prices. The immediate question should be how does this grim scenario impact the U.S. and the rest of the world. Problems that could certainly arise and impact economies around the globe are: (1) less direct investments by Japan overseas will place another constraint on global growth; (2) it could cause a repayment of Japanese funds from U.S. banks and insurance companies; (3) Japan owns nearly one-fifth of all U.S.-traded Treasury securities; and (4) lower trade flows would dampen growth around the globe (Asia, including China, accounts for 42% of total Japanese imports).

What, if anything, should be done to avert a global economic crisis? To avoid further economic deterioration in Japan and a spillover into the rest of the economies around the world, the Japanese political establishment has to make radical reforms. The government recently announced a plan to combat the deflation problem plaguing Japan. The proposal on the table is aimed at promoting the disposal of non-performing loans, stabilizing the financial system, supporting the stock market, and insuring against a credit crunch. The problem with this proposal is that the approach is not new and few specifics have been given. If this approach has not worked in the past, why do local officials insist on taking this approach? The answer is part cultural and part politics. Even if the Prime Minister could

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force the write-down of bad banking loans at a more accelerated pace and reinflate the local economy by printing more money, he still needs the full support of the majority political party. The political leadership in Japan has shown little indication that they are willing to change. The major rating agencies of Japan's sovereign debt are growing impatient. Moody's put Japan's sovereign debt rating on a negative outlook in February. This only increases Japan's interest costs and extends the pain.

Emerging Markets

Investors should not be fooled by strong returns in the emerging markets over the last three months. Despite this jump in security prices, economic fundamentals are still weak in both the Latin American and Asian regions. The global recession has dampened capital investment in much of this region, making it difficult for these local economies to emerge out of recession. The economic news is mixed in Asia and more on the downside in Latin America. In both regions, a resurgence in economic growth will depend largely on the health of the U.S. economy and, to a lesser degree, on the Japanese economy.

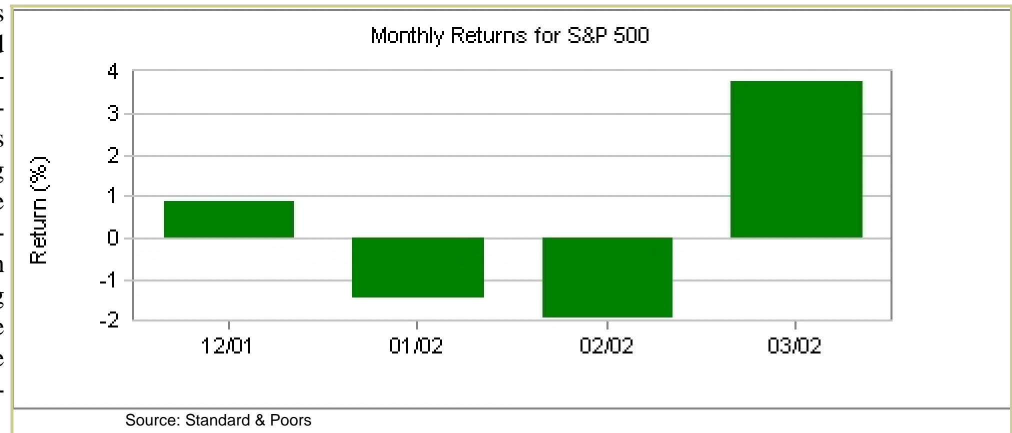
In Asia, the economies of Hong Kong and Singapore continue to decline. Both regions have suffered through a painful round of economic contraction. In Hong Kong, real growth declined 1.6% during the fourth quarter and retail prices moved 2.3% lower. The same forces afflicting Japan are impacting the local economies in Hong Kong and Singapore. Real growth declined over 7% during the fourth quarter in Singapore, with a negative consumer price index (CPI) as well. The strongest economy in Asia is China, where growth moved 6.6% higher in the fourth quarter of last year. It is not clear whether these figures are accurate, given China's method of national accounting. One thing is clear, the flow of both investment and intellectual capital from Hong Kong into China is significant. Shanghai has become the new Hong Kong, with a flow of entrepreneurs from Hong Kong into the region who are investing in major real estate and technology projects. There has also been some economic improvement in Thailand, as domestic demand shows signs of resurgence. Other markets in the region are susceptible to a drop in foreign investment due to the increase in political and religious tensions in countries such as Indonesia, Malaysia and India.

In Latin America, economic and social problems continue to mount, exacerbated by the record levels of people leaving the region. The region is currently suffering from its second-largest economic downturn since 1998. Economic problems in Argentina and Brazil have led to social unrest and lack of confidence in local leadership. In Argentina, the government has defaulted on over $155 billion in debt, the largest such default in history. Savings accounts were frozen in December of last year and imports have all but evaporated. The four-year recession in Argentina is expected to continue this year, with a predicted 4.9% decline in economic output. The unemployment rate hovers near 25%. The existing currency board has made it difficult to react to external shocks and the high government-spending rate far overshadows the amount of tax revenue collections. Even Mexico, one of the largest economies in the region, has suffered economic decline on the heels of slower economic growth in the U.S. In Mexico, real GDP fell 1% during the fourth quarter of last year, industrial production declined 3.3%, and consumer prices moved 4.8% higher. In Argentina, real growth declined 10.7% during the fourth quarter, industrial production was down 16.5% in February of this year, and consumer prices moved 4% higher on a year-over-year basis through February. In Brazil, the story is the same except that, while real growth in the economy is negative, inflation is rapidly moving higher (+10.4% year-over-year through February).

PERFORMANCE

U.S. Equity

U.S. stock prices finished the first quarter close to where they began the year. Value stocks continued to outperform growth stocks and small/mid-cap stocks continued to post higher returns during the quarter relative to their large-cap counterparts. Investors appear to be focusing on stocks that are not as expensive as the overall market. Stocks also moved slightly higher on news that the U.S. economy grew at a faster rate during the first few months of the year than most had predicted. Despite this optimism, corporate profits continued to decline and stock valuations remained high. Big gains were posted during the quarter in the transport and energy sectors, as a profit recovery in the airline industry seemed within reach



Source: Standard & Poors

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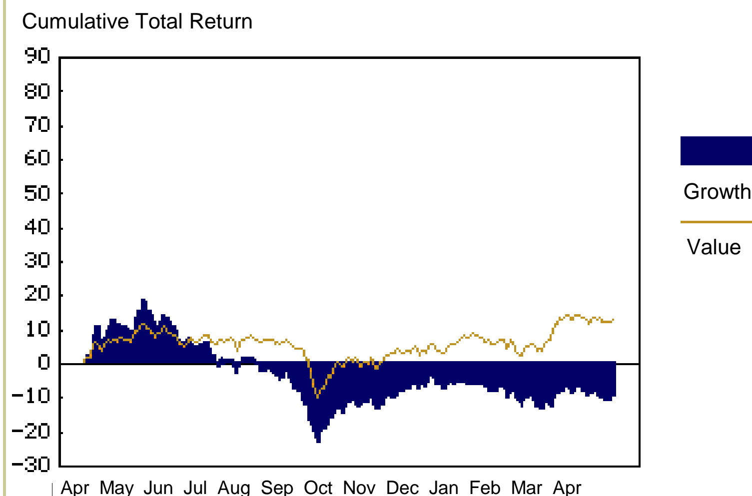
despite higher energy prices. The most prominent attribute of the last three months' activity in the stock market has been the pull on expectations between better-than-expected economics news and high stock valuations (based on current p/e multiples and future growth estimates). Investors continued to shun technology stocks, which were the darlings of the new economy just two years ago. Venture capital has all but evaporated in the sector, with some signs of rising interest in the biotech area.

Even areas that have recently outperformed the overall market, such as REITs, look stretched now in terms of valuations. Recent news on the geopolitical front has also contributed to an increase in uncertainty. The escalation of war in the Middle East and the continued war on terror in Afghanistan have distracted many investors and increased the level of uneasiness. While the overall volatility in the stock market may appear to be lower than the historical average, individual stock risk has increased. Many companies not only face squeezed profit margins, but also closer scrutiny of accounting statements by regulators and investors. Mitigating this risk has meant that investors have held portfolios with a greater number of individual stocks than was the case throughout most of the 1980s and 1990s. This trend is likely to continue as many more companies come under pressure to account for stock options, goodwill and pension fund liabilities.

Value stocks continued their leadership role in the stock market during the first quarter, a trend we would expect to continue throughout the remainder of the year, especially in the small-cap value sector. Investors have finally been forced to invest in stocks based on fundamentals such as price-to-cash flow and fiscally sound balance sheets. The focus has shifted from reported and estimated earnings to sales revenues, cash from operations and balance sheet quality. This seismic shift is both long overdue and probably here to stay. It may be awhile before the momentum players return to the glory days of the late 1990s, when anyone could make money by just investing in the overall market. Small stocks continued to outperform the overall market due to attractive valuations relative to large-cap stocks and relative to estimated earnings growth. The cycle favoring small-cap stocks is intact and, compared to previous cycles, probably has several years left before hitting a peak.

The best-performing sectors during the quarter were consumer durables, transportation, raw materials and energy. For the 12 months ending March 2002, the best-performing sectors were business equipment & services, consumer non-durables, raw materials and retail. Strong gains in the consumer durables sector were primarily the result of record sales in the auto industry due to zero-financing incentives. Those sales did not necessarily translate into higher profits for the major auto companies. In fact, the auto companies have recently announced major job layoffs in an effort to resuscitate earnings growth. The jury is still out for the major transports as customers slowly return to the friendly skies and fuel prices move higher on the heels of higher oil prices. The jump in performance is also a result of these stocks being severely depressed shortly after the attacks of 9/11. Air traffic is still down over 20% from the same period last year. Violence in the Middle East and stepped-up security have also forced many to rethink their air travel plans. Strength in the raw materials sector was due to higher prices in the metals and natural resources areas. Gold prices have also moved higher on future inflation expectations and a pick-up in gold purchases in Asia. Investors in the region have increased their purchases of safe-haven assets, such as gold and U.S. Treasury securities, as return prospects in the region remain quite muted. The energy sector moved higher during the quarter, as higher energy prices translated into higher revenues for the major U.S. energy companies.

The worst-performing sectors during the quarter were capital goods, utilities, technology and multi-industry. For the 12-month period ending in March 2002, the worst performers were utilities, consumer services, technology and multi-industry. The poor performance in the capital goods sector during the quarter was largely due to the negative results of one company–Tyco International.



Source: Vestek Systems

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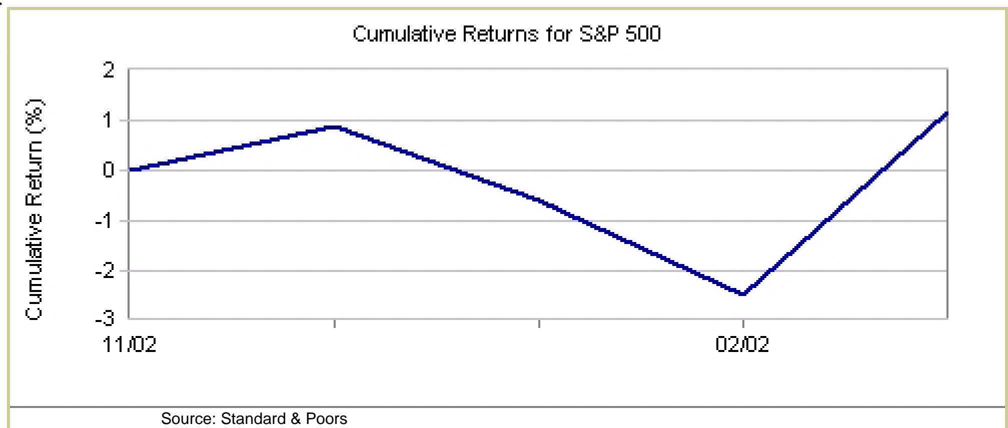
Tyco accounts for over 40% of the sector based on market capitalization. The stock plummeted during the first quarter, as the company came under fire from regulators for accounting inconsistencies and was forced to restate its earnings. Negative performance results for the major telecommunication providers, both land-based and wireless, helped push the utilities sector lower. Major companies in the sector, such as AT&T, AT&T Wireless, SBC Communications and Verizon Communications, posted negative returns for the quarter. Most of the technology sector continues to struggle with lower profit margins, a decrease in IT spending by corporate America and high relative valuations. The big three in the sector, Microsoft, Intel and IBM, posted negative returns during the quarter. The multi-industry sector came under fire during the quarter due to the troubles affecting the earnings prospects of GE--specifically, questions regarding the validity of reported earnings. The company represents over 82% of the sector on a market-weighted basis and finished the quarter with negative results.

U.S. Bonds

While bonds were one of the best performers during 2001 (the Federal Reserve lowered the fed funds target rate 11 times from a level of 6% in January to 1.75% in December), this trend reversed during the first quarter of 2002, as signs of recent robust economic activity fed higher inflation expectations. The Fed ended its policy of easing interest rates, as signs of recovery became evident, especially in the manufacturing sector. As bond yields moved higher in anticipation of recovery and because of the longer-term threat of higher inflation, most all sectors of the bond market declined during the first quarter, with the exception of high-yield bonds and mortgage-backed bonds. Yield spreads for most corporate-grade bonds over Treasury securities widened over most of the quarter, with some evidence of narrowing during the last few weeks in March. Mortgage-backed bondholders benefited from a slowdown in prepayment speeds, as mortgage rates bottomed during the quarter.

For the first time in over 15 months, the Fed kept rates unchanged during the quarter. Signs of economic strength in the first few months of the year prompted the Fed to hold steady on rates even though the outlook still appears vulnerable to weakness, especially in the corporate profit area. Core inflation, ex-energy and food, remained subdued with most forecasters expecting little change through the remainder of the year. Higher crude oil prices and some price creep in other hard commodities have also sparked inflation fears. The jury is still out as to whether this is a temporary or permanent phenomenon.

Even though it may appear to many that interest rates have hit the bottom of the cycle, it does not mean that rates are poised to move dramatically higher from their current levels. Long-term inflation expectations are still low. This is consistent with most of history, with the exception of wartime and the oil and credit crunch of the 1970s. Real returns for bonds are currently quite attractive, especially relative to real earnings yields on stocks and the high valuation levels in the stock market. Add to this the increase in investor anxiety and uncertainty due to the escalation of violence in the Middle East, the possible disruption in crude oil production, and a global recovery. In times of heightened uncertainty, investors worldwide still tend to view the U.S. as the safe haven, specifically U.S. Treasury securities.



Source: Standard & Poors

The best-performing sectors of the bond market during the first quarter of 2002 were the high-yield and mortgage sectors and the worst were the long-dated U.S. Treasury sector. Most other sectors of the bond market posted losses during the quarter, including short-term securities and cash equivalents. The yield curve shifted higher during the quarter with spot rates for the two-year Treasury note trading with a yield of 3.91% at year-end 2001, rising to 3.84% by the end of first quarter 2002. Longer bond yields, represented by the 10-year Treasury bond, began the year at 5.62% and ended the first quarter at 5.95%. Yield spreads for most corporate and agency-issued bonds moved higher early in the quarter, only to reverse that trend in the last two months of the quarter. Investment-grade corporate spreads in the 10-year maturity part of the yield curve moved from 0.79% over Treasury securities at the end of last year to 0.82% at the end of March 2002. At quarter-end, the yield on the government bond sector of the market stood at 5.76% vs. 9.93% for the high-yield bond sector.

International Equity

The overseas equity markets finished the first quarter slightly higher then year-end 2001 levels (on a USD basis). Local market returns were marginally higher than

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dollar-based returns during the quarter, as the dollar continued its position of strength relative to both the Euro and the Yen. The biggest jump came in the Asian markets as investors reacted to positive economic events in the U.S. and the potential longer-term impact on growth in the region. Results were mixed in Europe as earnings continued to come under pressure from lower exports, weak domestic demand and an overall sluggish economy. Some of the biggest gains during the quarter were posted in the emerging equity markets, spurred by low valuations and optimistic earnings-growth estimates. Lower interest rates and an upturn in institutional interest in the region also accounted for an influx of new capital.

In the Euro region, stocks moved lower on a U.S.-dollar basis and were essentially flat on a local-currency basis. Two of the three largest markets in Europe, Germany and Italy, posted single-digit gains during the quarter, as investors took advantage of lower valuations and an improved earnings outlook as a result of improved business conditions and export growth. In France, stock prices declined as economic conditions worsened during the first quarter. Weak business conditions, highlighted by a sharp contraction in business investment and softer consumer spending, were the primary culprits. The once fastest-growing countries in the region were the hardest hit during the quarter--such as Ireland, where investors avoided a stock market characterized by inflated stock valuations and a deteriorating earnings outlook.

Stocks in the U.K. finished the quarter nearly flat. Local returns were dampened for U.S.-based investors due to a stronger U.S. dollar relative to the British pound. Export-driven companies provided some of the best returns during the quarter, as goods exports rose 4.1% in January, improving the overall merchandise goods deficit. As in the U.S., British consumers continued to direct their purchases toward the consumer durables sector. Companies in the sector continued to benefit from a 4.6% year-over-year rate of growth in household expenditures. Low interest rates, low inflation and an expected return to stronger economic growth in the second half of this year have raised corporate earnings growth expectations.

Japanese stocks moved higher during the quarter on optimism that positive economic news in the U.S. would eventually benefit Japanese export growth. The stock market return in Japan for U.S.-based investors was slightly lower than the local market return during the quarter, as the dollar continued to gain strength relative to the Yen. Results during the quarter masked the true underlying fundamentals of the stock market. Many companies, especially those in the banking sector, propped up share prices in March in anticipation of Japan's fiscal year-end of March 31, 2002. The government also stepped in to bolster share prices. Valuations remain rich in Japan and corporate profits are non-existent. The elimination of short-selling by the Japanese government also artificially boosted stock prices during the first quarter, as investors rushed to cover their short positions.

The top-performing markets during the quarter on a U.S.-currency basis were Singapore, Austria, New Zealand and Norway. The worst-performing markets on a U.S.-currency basis for the quarter were Ireland, Greece, Finland and Spain. The top-performing markets on a local-currency basis during the quarter were Singapore, Austria, the Netherlands and Norway. The worst-performing during the quarter on a local-currency basis were Ireland, Greece, Finland and Sweden.

Some of the best-performing markets around the globe during the quarter were in the emerging markets. As a group, the emerging markets posted a double-digit gain during the quarter. This high beta group bounced off their lows of last year, as institutional investors slowly began to put capital back to work in the region, tempted by low valuations and hopes that a U.S. recovery would increase the flow of capital to these markets. Shorter-term, investors are betting on an expansion of p/e multiples from current levels as capital flows to the region and earnings growth improve. The region now trades at a p/e multiple of 11 times estimated earnings (12 months forward) versus a forward p/e multiple of 22 for U.S. stocks. Many investors are relying on the U.S. recovery to help improve prospects for the region, as it is a major trading partner. Longer-term, investors in the region are banking on a shift in demographics, improvements in corporate governance and the fact that many countries are moving toward adopting a national pension system. The downside of this optimism is: (1) many of these markets are undervalued for a reason (earnings estimates are suspect); and (2) the increased level of uncertainty surrounding the capital markets worldwide, due to tensions in the Middle East and higher oil prices, is likely to generate a flight to safety away from these markets into U.S. Treasury securities and hard assets.

In the emerging markets, the top-performing markets during the quarter on a U.S.-currency basis were Pakistan, Indonesia, Korea and Thailand. The worst-performing markets for the quarter on a U.S.-currency basis were Argentina, Israel, Greece and Morocco.

MARKET VALUATION & EARNINGS

The U.S.

Investors seem to be ignoring the fact that stock-market valuations are expensive and that p/e multiples are more likely to contract than expand over the next 12 months. Better-than-expected economic news has fed the fires of the stock market bulls, as many revise their growth estimates higher for 2002 and 2003. Even if stocks are "fair-valued" and multiples stay at their current levels, the upside in earnings growth looks quite limited as global demand remains weak and excess capacity still

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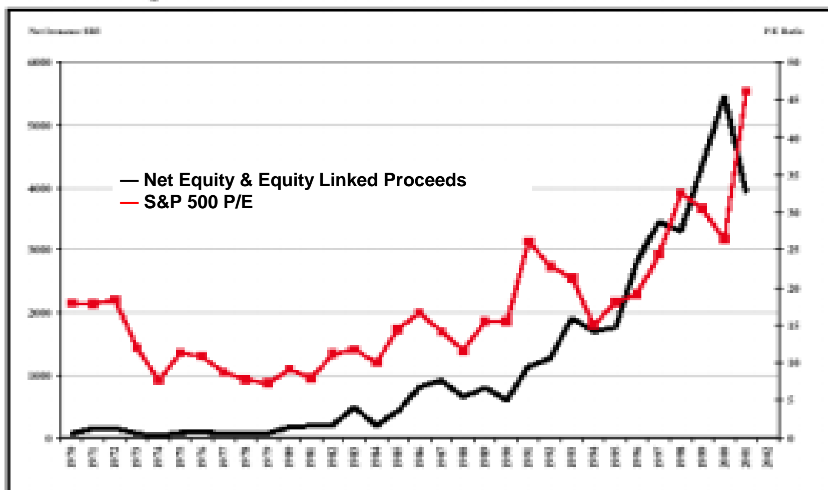
exists. Current valuation levels are not sustainable longer-term. With dividend yields at record low levels, p/e multiples near record highs and future earnings growth limited, it is difficult to see where the bulls can make a case for double-digit returns in stocks. In addition, the increase in uncertainty due to worldwide tensions surrounding the Middle East and the war on terror could have more of a negative impact on stocks than bonds. Real yields on bonds are quite attractive considering all the uncertainty surrounding future expectations for stock market returns. There are pockets of opportunity in the stock market, but they are few and hard to find. In terms of valuation and earnings potential, the most attractive groups in the U.S. stock market are small/mid-cap value stocks, and select stocks in the capital goods and consumer non-durables sectors. Individual stocks that have the fundamental characteristics of lower-than-market valuations, solid free cash flow from operations, low debt to equity, high credit quality and strong sales revenue are also attractive.

Stocks in the S&P 500 currently trade at an average p/e multiple of 22 times the next 12 months' estimated earnings growth and nearly 40 times trailing earnings. Historically, stocks have traded at an average p/e multiple of 14 to 15. Most current stock market investors have never experienced any extended downturns in their stock portfolios (more than two years). Many were introduced to stock investments during the great bull market run of the 1980s and 1990s. Few realize that the lofty returns in the past stemmed from rising valuations (expanding p/e's) and high-dividend yields that have since disappeared. Investors tend to believe that the equity risk premium (expected return on stocks less expected return on bonds) falls somewhere between 5% and 8%. This belief is based on past behavior (past performance) without regard for current investment fundamentals, such as current dividend yield, real earnings growth and its relationship to real GDP growth, and change in valuation. A more likely estimate of the expected equity risk premium, based on current yields, valuations and earnings growth potential, falls somewhere between 2.5% and 3.5%.



The problem with earnings forecasts is that they are too short-term in nature, subject to numerous revisions by Wall Street, suspect in terms of accuracy (what about accounting for stock options and unfunded pension liabilities?) and too optimistic. Some suggest that the corporate profit forecast for all U.S. companies on a national-account basis is a more valid proxy of future profit growth than forecasts from Wall Street analysts. The national account number properly accounts for stock options, taxes, etc. On this basis, corporate earnings are expected to grow 5.3% over the next 12 months versus the 17.6% growth rate predicted by Wall Street analysts. Aggregate stock market earnings growth can never grow faster than the nominal rate of GDP growth. Only long-term earnings growth rates that correlate to nominal GDP and real corporate profits that correlate closely to real GDP per capita are useful in developing realistic expected returns for stocks. Bottom-up analyst consensus growth forecasts are only useful for understanding the potential direction of stocks over shorter intervals (6-12 months). Valuation changes can have a significant impact on future returns and historical data confirms this. The period between 1982 and 1999 is a good example of what can happen to market returns when valuation levels are extreme. Most of the performance during this period was a function of expanding valuations (a dividend yield that contracted from 5% to 1% and a p/e multiple that expanded from 11-12 times earnings to 20-22 times earnings), and not of a significant rise in earnings growth relative to the long-term average growth rate.

The consensus forecast of earnings growth over the next 12 months is 17% with a long-term growth rate of 13%. Stocks currently trade with a dividend yield slightly less than 1.5%. The long-term average yield for stocks is 4%-5% and earnings growth is 3.5%-5%. Current dividend yields and earnings forecasts are substantially different from both next year's growth forecast of 17% and the long-term median forecast of 13%! The recent

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trend in earnings growth estimates has been positive to the tune of 1.2% over the last three months, meaning that analysts have begun the process of raising their already optimistic growth forecasts over the next 12 months. More companies have positive earnings revisions now than downgrades, another sign of unwarranted optimism. Investors may be concerned with the future potential of their stock holdings given the bad news regarding valuations, the earnings outlook and increased volatility in the stock market. However, what is of greater import is how this assessment compares to other assets. Inflation-adjusted returns and comparing expected real returns on stocks and on bonds are what matters. On a go-forward basis, stocks still look to provide a 2.5%-3% return over bonds. A positive relationships, yes!--but nowhere near what investors have come to expect over the last 15 years.

Europe and the U.K.

The potential for positive real returns in stocks over bonds in the Euro region and the U.K. is still present and slightly higher than what can be expected in the U.S. Future earnings growth will depend on several factors, ranging from the timing of a sustained economic recovery both at home and in the U.S. to the magnitude of that recovery. On a valuation basis, stocks in both the Euro region and the U.K. are as or more expensive than stocks in the U.S. Growth estimates for the next 12 months are much higher in Germany, Europe's largest market, with an 84% predicted growth rate! Analysts also expect growth to move 21% higher over the next 12 months in the U.K. These growth rates are abnormally high based on the negative base of profits posted over the last 12 months and due to an overly optimistic forecast of economic growth over the next 12 months. While stocks are trading at inflated multiples, current dividend yields in the region are markedly higher than those in the U.S. Earnings growth should grow at a rate higher than in the U.S., as markets benefit from higher real economic growth, low inflation and record low interest rates.

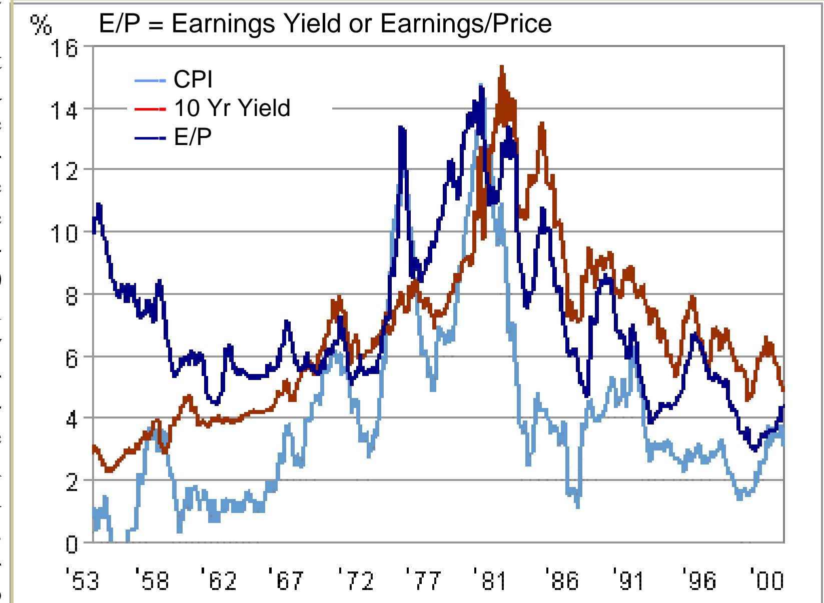
Japan

Investment fundamentals are currently irrelevant in Japan, overshadowed by the overwhelming structural problems that still exist in the local economy, especially the banking sector. Deflationary forces have also destroyed the potential for positive returns in stocks as real interest rates have soared. Real yields are higher than nominal yields, thus making it even more difficult for debt reduction to occur in the banking sector. Real economic growth continues to decline, making it difficult for those attempting to forecast corporate profits over the next 12 to 24 months. Consensus growth forecasts for the next 12 months are so large (coming off such a negative growth base) that forward p/e multiples are deemed unusable and irrelevant. The real opportunities in Japan are for those venture capital investors who are willing to invest directly in distressed situations as a long-term play, paying 30-50 cents on the dollar for shares of local companies with a local focus. There may be select individual multinational export-oriented companies that are good long-term buys in Japan, but those situations are harder to find. Given all the uncertainty in the global capital markets today, coupled with the dire economic situation in Japan, now is not the time to commit any significant portion of investment portfolios to Japanese stocks.

Emerging Markets

We generate risk and return estimates in each of the emerging markets, but have little faith in the output, as data is less than reliable. In many of the emerging markets, analyst coverage is sporadic or nonexistent. Systematic or market risk will probably continue to dominate the direction of most individual stocks in the emerging markets, many of which rely on outside capital for growth.

Recent debate on the emerging markets has focused on whether they should be considered as a separate asset class. At Lockwood, we believe the most prudent approach is to consolidate developed and emerging foreign markets into one asset class, and most recent mandates for international equity exposure have been fulfilled by hiring an active manager to run a hybrid portfolio with investments in both developed and developing markets.



Source: Shiller (Yale)

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