



Outlook for 2003

January 31, 2003

In referring to the world capital markets, to remark that 2002 was a difficult year is, in a very real sense, an understatement. Indeed, a year of revelation and controversy, the likes of which the investment community had not seen in nearly a century. 2002 arrived on the heels of an economy and markets whose growth appeared to have no end, ushering in a new economy; a growth that, at its peak in Spring of 2000, showed signs of overpricing relative to future earnings.

As we desperately searched for fair value through 2001, the world was shaken to its core, as it discovered a formidable and defiant adversary, who, in a metaphor of sorts, attempted to bring down the current economic and geo-political status quo, by destroying its formidable world towers.

We seemed to have caught our breaths during the beginning of 2002, only to then be witness to revelations that many had overstated the earnings we were desperately trying to fairly price in the first place. For an unrelenting five months, from the Enron story in February, through Xerox and Martha Stewart, and ending with WorldCom in June, we were subjected to the ultimate test of faith: can you trust a "fair" market system that has betrayed you? A massive response of, "*no way!*", between March and October of 2002, provoked a freefall, as the value of the shares of the world's largest companies was reduced by almost 30%. This, as a sequel to two years of an initial value lost of 20% .

It seemed as if this was the end of fair markets as we know them. How can you know what a company is really worth if you can't trust the mechanism by which it is priced? So investors simply walked away from the equity markets and left their assets in a holding pattern, in money markets and short-term Treasury debt instruments, bringing interest rates on Treasuries to historical lows. Some, given the massive uncertainty, shifted their monies to other, more tangible assets, like real estate and precious metals. Current estimates on the size of the move to the sidelines: \$1 trillion.

Over the summer, the markets' governing and regulatory bodies had no choice but to come forward with pronouncements and procedures that would help restore investor confidence. In particular, Standard and Poors and the stock exchanges themselves set the stage for new and stricter reporting and regulatory procedures going forward. The U.S. Congress voted unanimously to make certain corporate misdeeds a crime. These measures take time to cook, however, and as we entered the fourth and last quarter of 2002, a base was being built to support the next phase of the market cycle.

And then came Iraq. Just as we thought we had turned the corner of uncertainty, we are now faced with the probability of a military dispute between the U.S. (and the world?) and Iraq. Some think the issue is weapons of mass destruction. Others believe its really all about the oil. In the meantime, there is a swelling sensation that citizens' civil rights are being trampled on and that, as anti-American as it may sound, the enemy is within.

In any event, the world is now on military alert, with thousands of protesters in every major city, while official polls indicate that most Americans support military intervention. Happy New Year.

With a political tug-of-war between U.N. arms inspectors and the White House, we are, yet again, placed where markets dread the most: uncertainty. And, once again, the investors' place of choice becomes center-stage: the sidelines.

As strategic, long-term planners, its important to understand the issues that have, and will continue to, provoke the gyrations in market fluctuation, so as to react rationally to their immediate impact on market values. Such gyrations cause a "disconnect" between the value of a company and the competence of its product, strategy and management, and how it is priced in the open market. Fair value eludes us when there is uncertainty.

What is the long-term investor to do? "Long term" has become a bit of a cliché, a phrase that gets kicked around a lot by investment professionals, in an attempt to keep investors focused on their goals. So allow us to define the term.

In the investment arena, as we have learned, long-term refers to a time horizon of close to ten years. Intermediate-term places us in the five-year range. So, if an individual is planning his/her legacy, to materialize over

their life expectancy and beyond, they're usually thinking in ten-year terms, or longer. It is very important to place life or institutional goals in their proper time horizon, so as to minimize the risk of not achieving them, either by taking on too much or too little risk. Risk, in our world, means uncertainty of achieving one's goals, and usually translates to the probability of getting to where you want to go. And there is a direct correlation between the uncertainty of reaching your goals, and the uncertainty of market behavior.

Indeed, most of us, as individual investors or as fiduciaries for institutional funds, are long-term investors. This does not mean that there is no pains in watching portfolio values diminish, just because they are bound to recuperate "over the long term". As in setting our investment time horizon, it is equally imperative that we define and articulate our tolerance for volatility. As if anything has become materially clear over the last five years, it's that volatility doesn't hurt when the markets are rising. But equally clear is that nobody minds a smoother path to their ultimate goals.

OUTLOOK FOR 2003

If history repeats itself, and the unexpected always happens,
how incapable must Man be of learning from experience?

[George Bernard Shaw](#)

History Doesn't Repeat Itself, At Best It Rhymes.

[Mark Twain](#)

History never looks like history when you are living through it.

[John W. Gardner](#)

We learn from history that we do not learn from history.

[Georg Friedrich Wilhelm Hegel](#)

The future ain't what it used to be.

[Yogi Berra](#)

WHAT WE BELIEVE:

- Entering a potential environment of a slower pace of price appreciation, we should be most concerned with the concept of **total return** and its maximization. That is, we should pay more attention to

dividends and higher-yielding corporate bonds. In the event of lower price appreciation, dividends will be a larger piece of total return, and with lower taxation on dividends the case becomes even more compelling for individual investors and other taxable portfolios.

- Within domestic fixed income, the best total return possibilities exist in the **higher yields** of the corporate bond market. With a growing economy and continued low inflation, confidence will grow in corporate America's ability to repay its debt. (Note: high-yield corporate bonds are not suitable for all investors).
- As we have always emphasized in the past, **future return expectations must be realistic**. It is unlikely that we will return to the high levels of return seen in bull markets of the 1980's and 1990's. We would not be surprised if, historically, the 2000 – 2003 period is considered a soft landing for both the economy and the broad equity market.

Possible Scenarios

“Expected” Risk Premium

		Pessimistic Case*	Most Likely Case**	Optimistic Case***
Stocks	Initial Yield	1.3	1.3	1.3
	Growth in Earnings	4.5	7.4	8.0
	Change in Valuation	-5.3	0.0	2.5
	Average Annual Return	0.5	8.7	11.8
Bonds	Initial Yield	5.5	5.5	5.5
	Effect of increase(decrease) in interest rates	-2.0	-0.5	0.5
	Average Annual Return	3.5	5.0	6.0

Source: B. McKel

* Low to Moderate Economic Growth and Markets Expected Change in PE Multiple & Higher Interest Rates
 ** Moderate Economic Growth and Currently Close to Fair Valuation and Flat Rates
 *** Strong Economic Growth and Market Currently Undervalued and Lower Rates

	Expected ROR	3 Month	10 YR	ERP
	Equity	T-Bill	Treasury	
Equity Risk Premium (T-bill = Risk Free)	8.70	3.63	na	5.07
Equity Risk Premium (10 Yr Treas = Risk Free)	8.70	na	5.16	3.54

- There seems to be growing consensus that the economic drivers of growth will **shift from Consumer Spending to Corporate Spending** in 2003. Therefore, we will look out for sector choices that reflect this shift, especially mindful of any bias or over-weight towards the Industrial and Technology sectors and away from the consumer sectors.
- We also expect **increased value to be placed on actual earnings**, given the lack of confidence in forecast numbers.
- While some form of war with Iraq has already been discounted in the market, **a defeat or prolonged conflict has not**, and aside from its potential real impact these uncertainties will continue to dampen market sentiment. With these concerns **we expect high market volatility to continue throughout 2003.**

VALUATION

We must preface our expectations for the 2003 markets with an asterisk. While the market's price level may depend upon the interplay of only three variables (interest rates, expected earnings and market sentiment), their values can swing widely. Additionally, the only non-fundamental factor and that which is most volatile, investor sentiment or behavior, usually overshadows underlying business and market fundamentals. Additionally, earnings growth is now the most uncertain it has been in decades and last year's revelations of corporate malfeasance and liberal accounting continue to raise doubts with respect to earnings forecasts.

It is also unwise to put faith on a strong finish in 2003 solely based on the premise that we have had only one other period of four consecutive down years. This conclusion has little to do with economic and financial analysis. Playing the odds in this manner is simply, well, playing the odds. Its analogy is calling heads only because the coin toss has resulted in tails three times running: it is still a fifty/fifty venture. A safer approach would be to take a longer-term perspective and conservatively forecast 7.5% - 8.5% for the stock market and 5 - 5.5% for the bond market.

The following is some of our thinking. Our market valuation is based on **prevailing interest rates, the long-term earnings** as indicated by its long-

term trend, and to provide some plus/minus range to account **for variations in investor behavior**. Making reasonable assumptions regarding these factors, we herein provide some broad guidance for market expectations in 2003.

Earnings: In seeking an earnings figure to plug into our calculation, we have a few options. We could select some single year's number based on historical figures. We could also employ a consensus forecast figure. Or, as we have done, we could input a figure derived from the historical growth pattern. This figure, 6.3%, has been fairly consistent since 1935. We believe these trend earnings are more reliable than any single year's numbers or unreliable and unrealistic analysts' forecasts.

Interest rates: For interest rates, we can only go by the consensus. Indications for the 10-year Treasury rate remains in the 4% - 5% range for 2003. It is unlikely that we will see further cuts this year having run out of room to ease monetary policy, and some economists predict a slight tightening towards the second half.

Investor behavior/sentiment: This factor remains the wild card. Our sense, and that of others, is that market volatility will continue throughout 2003, especially in light of a potential conflict with Iraq and weakened confidence in the market and corporate management. To account for this we foresee a trading range (+/- 100 points for the S&P 500) away from fair value.

The relationship between stock prices and earnings is analogous to that between bond prices and their coupons. Bond prices are determined by prevailing interest rates and the coupon they payout, a fixed payment. Company shares return a variable amount, whether measured by the dividend or more appropriately as their profit or cash flow. Similar to bonds, taking this profit number and the prevailing interest rates we can back into intrinsic value.

A P/E ratio of 20 on a stock (or index) means that for every \$20 you pay you receive \$1 of earnings. Whether you own one share or the entire company, your return would be 5%: $1 \div 20 = 5\%$. This is the earnings yield. This yield can be compared with the return from bonds and is often compared to the yield on 10-year Treasuries, and while unlike stocks, government bonds have no credit risk they also have no potential for growth. Stocks, on the other hand, do offer the potential for earnings

(yield) growth. If these two yields are both 5% we have reached equilibrium.

If the bond yield increases, yields on stocks should also increase to maintain this equilibrium, thus P/E ratios will fall (e.g. yield of 8% equals P/E of 12.5). Conversely, if yields fall, the P/E should rise.

In practice, there is no exact correlation between P/E and interest rates, but over the long-run falling interest rates have resulted in higher P/E's and vice versa.

As explained above, the P/E level is driven by interest rates and earnings expectations. One should also be aware that normal swings in investor behavior or emotion will often move the market up or down by 10% around intrinsic or fair value, and 20-30% swings although less seldom have occurred. Again, we remind you that long-term trends can be sidetracked by short-term market sentiment.

So with long-term rates between 4 and 5 percent, the fair value P/E is between 20 and 25 times earnings. In the current less risk-tolerant environment, we feel 20x is more appropriate. Over the summer of 2002, prices were as low as 15x. If we take the earnings range of between 45 and 55, we get a fair value range for the S&P of between 900 (20 x 45) and 1100 (20 x 55). We would add another 100-point swing as a trading range, the result being 800 to 1200. This is, precisely how the markets have been priced since March of 2002.

BOND MARKET OUTLOOK

The story for bonds in 2003 relates to credit risk and economic recovery. Corporate profitability is showing signs of improving, and if this occurs, increased capital expenditures should follow. In light of this scenario, Treasury bonds are expected to relatively under-perform. Rising budgets will force an increase in the supply of Treasury debt, and as Treasury issuances increase and confidence in economic recovery grows, Treasury yields may rise slightly. The table below shows the sensitivity of total return from a 10-year T-note (currently yielding 4%) to movements in its yield. As you can see, at levels above 4.5% investor income is more than offset by capital losses.

10-Year Treasury after One Year*

Yield	Total Return	
3.5%	7.7%	
3.75%	6.2%	
4.0%	4.0%	← Current Level
4.25%	2.6%	
4.5%	0.5%	
4.75%	-1.0%	
5.0%	-3.0%	

- 4% coupon assumed. Does not represent actual investment of specific security.

Source: Wachovia Securities, Inc.

All quality categories of Corporate bonds are expected to outperform as companies strengthen their balance sheets and default risk falls. In this challenging economic and business environment, the spread between corporates and Treasuries is as high as it has been in decades. Moody's Baa bond index is yielding 2.65 percentage points above long-term-treasuries with an overall yield of roughly 6.65 percent. The normal spread has been about 2 percent. Hypothetically, if the spread were to narrow as Treasury yields rise, the return on corporates could remain close to their current yield, shielding one from the full effect of the increase in rates. Furthermore, it is possible for returns of high-yield bonds to compare closely with those of stocks, with yields in excess of 10% and spreads expected to narrow as the economy improves and default risk contracts.

INTERNATIONAL OUTLOOK

The primary reason for holding international investment, low correlation to the U.S. markets, has declined somewhat over recent years, especially with regard to Europe. The large cap, global companies in the European markets are now more correlated with the global companies in other markets. Although at first glance European companies appear more attractively priced, there are several reasons for this discount:

- Profitability for US companies is expected to improve as sales recover, and more so than European companies. Looking at unit labor costs, productivity and corporate layoff announcements, the US, with more flexible labor costs, appears to have restructured more vigorously.
- European economic policy makers have been less proactive with regard to stimulating growth. The European Central Bank is more focused on fighting inflation, as opposed to the US where the concern is deflation. On the fiscal side, they are constrained by the restrictions of the European Monetary Union and are forced to raise taxes at exactly the wrong time.

European markets are down as much as their US counterparts (even more so in local currency terms) and there is no compelling reason for this to change.

Japan remains in a deflationary recession. Of the Asian countries, Japan seems to be the weakest. Indeed, China recently supplanted Japan to become the leading exporter to the United States. Japan's problems stem from its banking system and the absence of the political conviction to confront the issues head on.

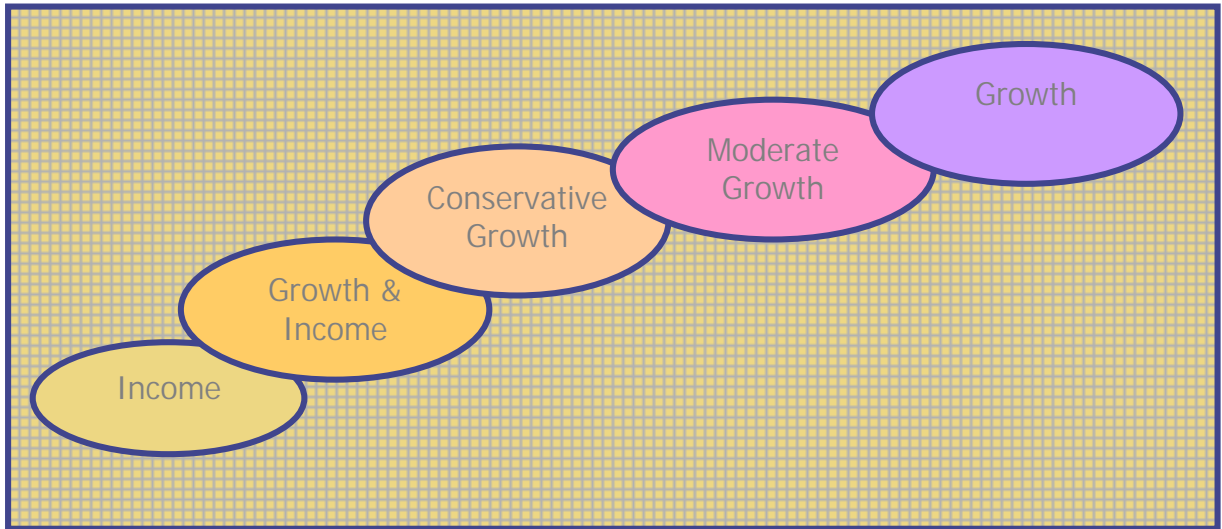
We look towards the yen as the leading indicator and there is said to be technical weakness in the currency. A decline relative to the euro and dollar could be sufficient stimulus to jump start the economy and stock market.

In Asia ex-Japan, the story is China. In the twelve months ended September 2002, the three-month moving average of China's exports to the U.S. was up 33.6%. Exports to Europe and the Pacific Rim countries were also up a similar amount. The flipside to this is that China is now generating demand. The three-month average for imports into China from other Pacific Rim countries was up nearly 40% year-over-year, and the same figure was up 7.3 and 18.1 for the U.S. and Europe, respectively.

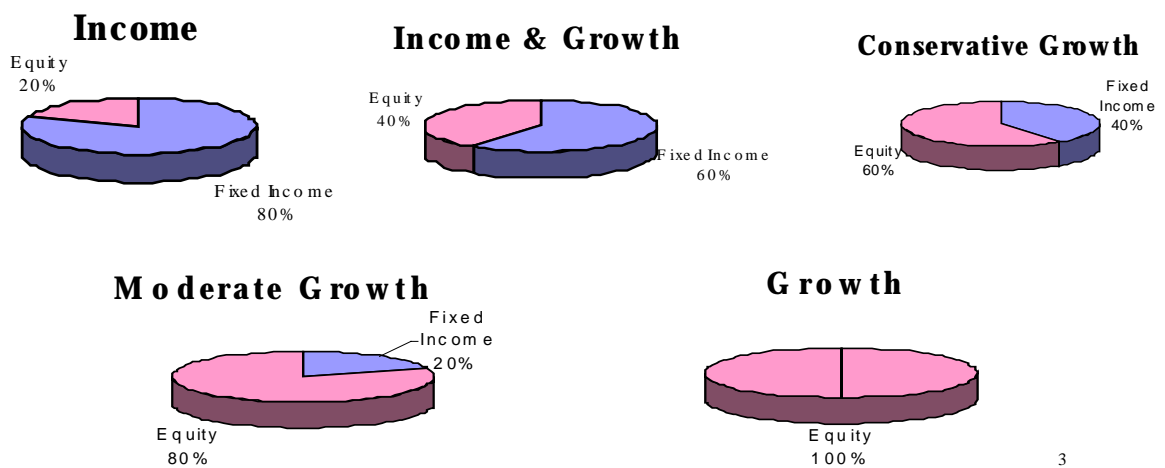
In the long-term, we find optimism about the region and recognize its potential as an attractive investment, especially in consideration of its attractive valuations.

ASSET ALLOCATION AND STYLE DIVERSIFICATION

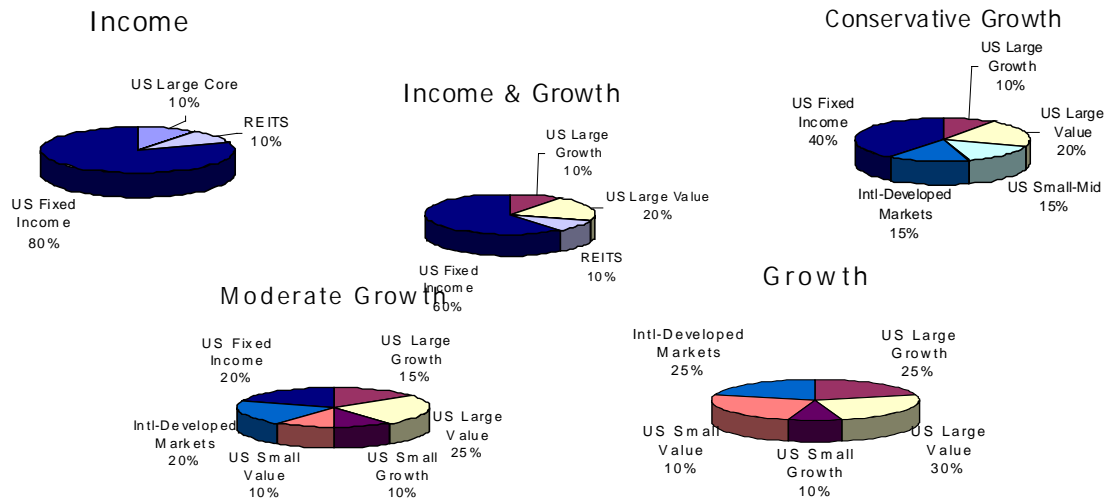
Resulting from these beliefs, and considering that 2003 is only the first year of the next cycle, we include our five portfolio strategies:



Asset Allocation



Style Distribution



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OUR COMMITMENT

As we begin the New Year at Consultiva, we are once again reviewing each client's investment goals and corresponding investment strategy, in an effort to assure that portfolios only take on that risk which is commensurate to their objectives. Wherever possible, we will continue to employ appropriate and available risk management strategies in order to seek out a "smoothing" effect on portfolio market values from quarter to quarter.

Finally, we intend to continue to seek out and drill investment management firms about their strategies, portfolio construction and current holdings, to assure consistency with current mandates, to uncover any material qualitative issues that we may believe are relevant to their management abilities and to identify superior investment strategies and manager teams.

Above all, we will lift our hearts, day by day, and pray for a year of peace.