LIDO ADVISORS, INC - MONTHLY INVESTMENT COMMENTARY
APRIL 2003

It was a difficult first quarter, with virtually every equity asset class showing losses. Uncertainty over the prospect of war with Iraq was a drag on the markets through most of the first two months, followed by further unrest over the progress of the war as the quarter came to a close, with a brief but strong rebound in between during the first week of the invasion. Most indexes showed losses in the single digits, with large-caps outperforming small caps, and growth stocks—led by the NASDAQ—outstripping value stocks across the market-cap spectrum. Junk bonds were the star performers for the quarter, besting both stocks and investment-grade bonds with a 6.9% gain (for the Merrill Lynch High Yield benchmark), compared to a 3.2% loss for the S&P 500 and a 1.4% gain for the Lehman Aggregate bond index. Our **overweightings** to both high yield (Payden & Rygel +4.8%, Pioneer High Yield +8.1%, Northeast Investors +0.60%, non-correlated investments (Merger Fund +0.30%, The Arbitrage Fund +2.0%, Caldwell & Orkin –1.8%, and Coast Fund of Funds +2.10%) have continued to help us stay ahead of our benchmarks so far this year.

March Benchmark Returns (Preliminary)

	Mar	YTD
Large-Cap Benchmarks		
Vanguard 500 Index	1.0%	-3.2%
Russell 1000 Growth iShares	1.6%	-1.2%
Russell 1000 Value iShares	-0.3%	-4.9%
Mid-Cap Benchmarks		
Russell Midcap iShares	1.5%	-2.2%
Russell Midcap Growth iShares	3.0%	0.9%
Russell Midcap Value iShares	0.7%	-3.4%
Small-Cap Benchmarks		
Vanguard Small Cap Index	1.2%	-4.5%
Russell 2000 Growth iShares	0.4%	-3.9%
Russell 2000 Value iShares	0.9%	-4.6%
Other Benchmarks		
Vanguard Total Intl Stock Index	-1.9%	-7.9%
Vanguard REIT Index	1.0%	0.0%
Vanguard Total Bond Mkt Index	-0.1%	1.3%
Merrill Lynch High-Yield Bonds	2.6%	6.9%

PSYCHOLOGY

It's no secret that investor psychology has a material impact on financial market volatility over the short run. Many stock pickers are fond of pointing out that the huge volatility in the prices of individual stocks over any given year doesn't reflect the actual change in value of the underlying business. **Stock prices are volatile; business values are much less so.** Stock price volatility does reflect change in what investors are willing to pay for a share of those businesses. What impacts these perceptions of value? In some cases there are developments that are material to the fundamental operations of the companies. **But more often it is emotion that impacts those perceptions.** When investors are driven by greed they tend to downplay risk. In periods of extreme greed many are incapable of acknowledging any risk. A glass filled halfway is not just seen as half full, it is seen as full. Conversely when investors are driven by fear, risks are

overblown and the positives are downplayed. The glass is beyond half empty and is seen as nearly empty.

The last five years have been among the most amazing in financial market history. Not only have we witnessed a greed-driven "bubble" environment on par with any in history, we've also watched its collapse. It is important to understand that the bubble was not simply a reflection of overvalued stocks. The greed that inflated stock prices permeated the economy in a variety of ways. Because rational thinking was not in evidence as the late 1990s moved toward the new millennium, it is not surprising that there were other excesses that developed and are also now being addressed. Corporate governance abuses, debt levels and the excess capacity present in many segments of the global economy are in various stages of reversal.

As we've watched this period unfold, the evolution of investor psychology has been fascinating. Emotion is alive and well and fueled not just by the financial media, but also by the Internet and e-mail. Unsubstantiated stories, rumors and analyses from sources lacking in credibility spread like wildfire.

In light of the events of the last few years this is a good time for all investors to be intellectually honest by thinking back to their view of risk and return in early 2000. If views were detached from reality back then, what does that suggest about the wisdom of trusting an emotional point of view today? **This is exactly why we believe it is so important for investment decisions to be made in the framework of a process that is consistently applied and is as far removed from emotion as possible.**

STAYING RATIONAL

Lido Advisor's investment process is intended to lead to decisions based on rational and realistic analysis. It doesn't ensure that all our decisions will add value but we believe, and our experience supports, that our process provides a framework for being right more than we are wrong thereby adding value over the long run. We have said many times "We always do what is right for our clients, however we may not always be right."

In theory any investment asset has a fair price or value. That price is the present value of the investment's expected cash flows. In theory, fair value sounds nice and clean. In practice it is anything but nice and clean. Because our asset-class decisions are largely influenced by fair-value assessments, it is worth addressing the key factors in this part of our analysis.

First there is the question of how accurately one can assess cash flows. This depends on the investment. For a 10-year U.S. Treasury note we can anticipate the cash flows with absolute accuracy if we assume that the U.S. government will not default. At the other end of the spectrum are earnings or cash flow estimates for single-product companies that operate in industries undergoing rapid change. For our purposes, we focus on the broader stock market (S&P 500), and in this case the uncertainty in the growth of cash earnings can be partly dealt with by looking at historical growth rates for the overall stock market relative to inflation. Over the long run common stock earnings have grown by about 2% more per year than the rate of inflation. There have been periods where growth was faster, but they were followed by periods of slower growth.

HONEST RISK ASSESSMENT-WHAT COULD MAKE US WRONG?

Having high conviction isn't the same as being 100% confident in the outcome. **One hundred percent certainty does not exist in the investment business.** An important part of our investment process is thinking about what could make us wrong. This critical exercise helps us to assess risks and to maintain a high level of intellectual honesty. At any point in time there are

many risks present. Again this is the nature of the business. The world is unpredictable and we deal with incomplete information. As part of our job "to stay rational" we must be aware of as many of the potential risks as possible and assess their probability and magnitude and take them into account in our portfolio construction. **Our objective is to manage, not avoid, risk because avoiding risk also removes return potential.**

Following are some of the risks we see that could present problems over the next few years.

Valuations: There is a chance our analysis does not take into account the environment we will face in the coming years. We believe the financial markets and the economy have evolved over long time periods and that this evolution impacts risk levels, the perception of risk, the willingness to take risk and the ability to manage risk. For example, the advent of the computer provided investors with greatly improved access to data and information and increased the ability to analyze that data. This gives investors more confidence. Evolution of the financial services industry and a broadening of information sources made it easier for investors to diversify their investments and educate themselves. We believe these and other factors justify higher prices for stocks and stock-like assets than say, in the 1950s and 1960s because it is reasonable that the amount of extra return investors require to take on the risk inherent in stocks has declined. We believe this makes sense up to a point because risks and investors' understanding of risk have changed. But this trend went way too far when many stocks were grossly overvalued in the late 1990's. **We are increasingly cognizant of the possibility that the worst bear market in seven decades could have a long lasting effect on investors' risk appetites. Coupled with the perception (and quite possibly the reality) of increased risk due to terrorism and related geopolitical factors (the war on terrorism) investors may remain averse to risk for some time—resulting in lower stock prices than our analysis suggests**

Structural problems with the economy: The long period of declining inflation, the near 20-year secular bull market and the final greed-driven run contributed to high debt levels, large growth in manufacturing capacity and robust consumer spending. This now leaves us with a couple related concerns to go along with geopolitics:

- **Debt levels in the household sector** are extremely high relative to assets and income levels. Because interest rates are very low, debt service compared to income is not at all time highs, but it is close. With debt levels high, growth in debt may slow in coming years as investors rebuild their balance sheets. Sharply declining consumer confidence and continued weakening in the labor market add to this risk. Slower debt growth would likely result in slower consumer spending which would in turn lead to more muted economic growth. And the fact that consumer spending didn't slow as much as observed in past periods of economic weakness also suggests that the pent-up demand that typically helps establish an economic recovery may not be present. There are growing but not conclusive signs that the consumer is weakening, though we must also point out that debt levels have been a concern for many years and consumer spending has nevertheless remained robust.
- **Corporate debt levels** are also very high and businesses have already begun to repair their balance sheets (they have a ways to go yet). Concerns about consumer spending raise questions about demand growth, and this, coupled with sizable unused manufacturing capacity, suggests business may be incented to pay down debt rather than make new capital investments or expand their workforce. Corporate spending should grow from very depressed levels but it is not at all clear that the growth will be robust in 2003.
- **Geopolitical factors**: We all know that the risk of terrorism will remain with us for an extended period of time. The question is, will the fear of terrorism impact investors' willingness to take risk? And will there be individual incidents of terrorism that will impact economic behavior. Then there is Iraq. The war itself is unlikely to have a lasting negative impact on the economy unless there is a long-term impact on oil production and distribution. However, the ripple effects are difficult to analyze. There are a lot of moving parts. For example, will growing anti-Americanism stick and result in a grassroots boycott

of American goods? And will Americans react in kind? As of now this seems like a low-probability outcome but it's early.

Except for the geopolitical issues, most of these problems are somewhat related and have to do with huge consumption levels, mostly in the U.S. The question is whether we're likely to muddle through and then embark on a new healthy period of economic growth, or whether this is one of those rare periods when the collective problems lead to a protracted period of economic and market weakness. The evidence is fairly strongly in favor of muddling through, but we've become more concerned in recent months as the consumer increasingly appears tired. The environment we face is more fluid than most, with the unwinding of the bubble economy coupled with an increasingly hard-to-analyze geopolitical backdrop. And this impacts our thinking as mentioned below.

ANALYSIS

The problems cited above may seem to paint a grim picture. However, there are two very important points to keep in mind.

The first point is that there are always risks and worries, though years later it is not easy to remember how troubling they were at the time. As an example, it is somewhat surprising to look at data from the early 1990s and see the similarities between then and now. The Leuthold Group recently pointed this out quite effectively:

- Business confidence was very weak. Corporate executives were very negative well into 1992 (the recession ended in the first quarter of 1991). Sounds like 2003.
- Consumer confidence didn't bottom until a year after the recession ended—another similarity. (An interesting aside—low consumer confidence has been an indicator of excessive investor pessimism and has strongly correlated with good entry points into the stock market).
- There was a lot of concern about debt levels in the early 1990s and consumers supported that concern as they decreased debt through the end of 1992, almost two years after the recession ended. Yet the economy was able to recover as consumer spending still rose.
- Employment (payrolls) didn't improve until a year after the end of the recession.

It is also important to point out that there were other concerns in the early 1990s. A major concern was that the U.S. economy was simply not competitive and would continue to give up ground to the Europeans and especially the Japanese, who were viewed as the world's future economic power. That was obviously way off base. There were serious concerns about our budget deficit. And there was the Savings and Loan crisis and what was viewed as a sizable bailout. And as 1991 started we faced a war with Iraq that, in retrospect, was anticipated with a remarkable lack of confidence. Weak stock markets always coincide with multiple worries.

We remain seriously concerned about the points cited above and we acknowledge that not everything about 2003 is comparable to the early 1990s. Most disturbing is the unprecedented weakness in the stock market despite a post-recession period of positive (albeit mild) economic growth. But we also must remember that there are powerful positive forces at play which must not be forgotten at a time when the glass seems mostly empty. Low competing returns from non-equity assets, sizable amounts of cash on the sidelines, significantly reduced allocations to stocks, stimulative monetary policy that has been helping (primarily through mortgage refinancings and the housing market) and the potential for more fiscal stimulation are among the positives. Also, the fact that consumer confidence is low, profit margins are near a 50-year low and five-year real earnings growth is also near a 50-year low suggest that upside surprises could be strong. Finally, the magnitude and length of the stock market decline, from a historical standpoint, suggests that it is unwise to bet against stocks looking out over the next few years.

PORTFOLIO STRATEGIES IN AN UNCERTAIN WORLD

Our valuation analysis is the primary driver behind our asset-allocation mix. However, we also look at risk to our portfolios in various economic scenarios. As we sort out the relevant information we come up with several key factors that influence our views:

- Based on our valuation analysis we believe stocks, high-yield bonds and real estate investment trusts are each likely to deliver high single-digit to low double-digit returns over the next five years.
- Stocks are the most volatile of the three asset classes.
- Because of very low interest rates, investment-grade bond returns are likely to fall in a range of 5% or (probably) less over the next three to five years unless we have sustained deflation, in which case returns will be slightly higher.
- We will continue to overweight Non-Correlated assets in our portfolios.
- The upside potential for mainstream financial asset classes over the next three to five years is not what it was in the early 1990s. Equities offer more return potential than bonds, but returns into the mid-teens, while possible over the next five years, are not very probable.
- Given the geopolitical environment, post-bubble risk aversion and vulnerable economy we believe market volatility (upside and downside) is likely to continue for an extended time period.

Our strategic conclusions with respect to the opportunities and risks are as follows:

- **As we have said many times in the past, diversification is especially important in this environment.** Our exposure to high-yield bonds and REITs allow us to hold assets with equity-like return expectations but with somewhat lower risk (though these assets are not immune to the same risks). Primarily because of our assessment of risks, we are likely to maintain exposure to these asset classes until we believe they offer inferior returns to equities. We will continue to assess the diversification mix between these asset classes.
- Our assessment of the risks discussed above also lead us to maintain portfolios that are approximately risk-neutral relative to our benchmarks. Normally at this point in an economic cycle we would want above-average risk exposure. This suggests that if we do have a normal cyclical economic recovery our ability to outperform our benchmarks will be less than it would otherwise be.
- Our continued belief and allocation to alternative investment classes (non-correlated investments) have provided similar expected returns but with some hedge or reduced exposure to the economic risks and substantially less volatility then the traditional asset classes. These strategies have proven to build some additional diversification into our portfolios, protect capital in a negative stock market environment and still offer upside potential. However, it is important to remember our main objective for investing in this asset class is not for performance, but it’s low correlation to the traditional asset classes. Because prospective bond yields are so low and stock return potential is good but not spectacular over several years, the potential opportunity cost of having lower-than-average exposure to mainstream asset classes is not as great as it was coming out of the last recession.
- If we are right about market volatility, **rebalancing will be an important strategy for increasing returns.** When equity allocations fall a few percent below targets in down market periods, bringing allocations back up to targets will allow investors to fully participate in the rebound. Likewise when the rebound comes and equities outperform, rebalancing down to targets will allow locking in some of these profits. If the pattern of negative correlation between stocks and bonds that we've seen recently continues, rebalancing could add nicely to returns.

Despite the risks we see we are quite confident that the odds for at least decent returns relative to inflation are high over the next few years. Our confidence in the ability of our investment

managers adds to our expectations. We don't expect to re-live the 1990s but we also know the worst of the bear market is probably behind us.

—LIDO ADVISORS INVESTMENT TEAM (4/1/2003)