

## Monthly Investment Commentary | January 2003

**I**t was a strong fourth quarter for stocks and high-yield bonds, though the stock rally fizzled out in December. But the fourth quarter was small consolation in a brutal year. For the first time since 1941 stock market investors have **experienced three straight down years, and 2002 saw the worst single-year loss since 1974**. Every single Standard & Poor's sector was in the red and eight of ten sectors experienced a double-digit loss.

### Blame the Bubble

Bad bear markets tend to be blamed on a variety of factors, depending on who is doing the blaming. In our opinion there are a number of factors that contributed to the bear market, but without question the biggest was the **stock market/tech bubble**. Terrorism and war fears didn't help, but these only contributed to the magnitude and length of the bear market. Corporate governance also contributed, but was not the driver—it was more of an outgrowth of the environment of bubble-driven greed.

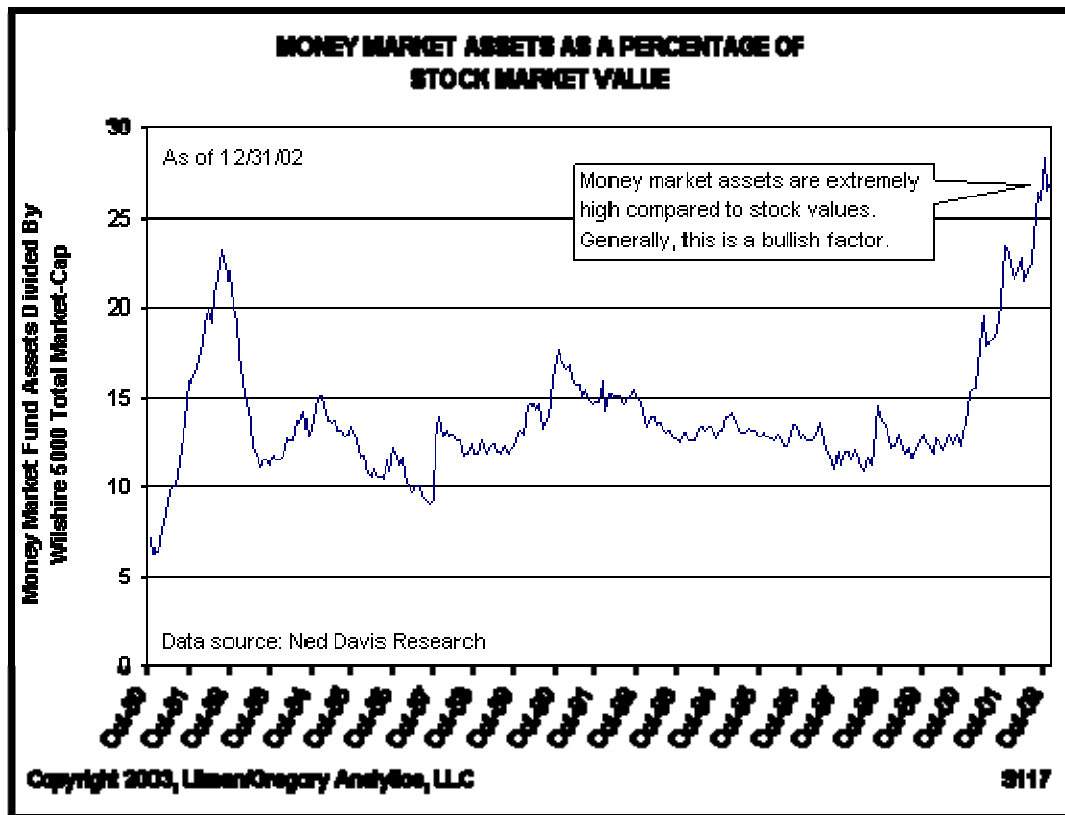
The bubble created three key problems. First, valuations got way out of line and while improved they are not in "screaming-buy" territory. Second, there was over-investment in the general economy as corporate management became overconfident in their growth expectations (this was particularly acute in the tech sector) and the resulting excess capacity has not yet been fully absorbed despite the fact that business capital spending is way down. Third, investors forgot about risk and were more heavily weighted to the technology sector, and stocks in general, than they had been in any prior bear market. The question we now face is whether it will take years for investors to regain their appetite for risk. In the past, investors have remained cautious for several years after the end of a major bear market.

### Intellectual Integrity, One-Year Forecasts and the Future

It's almost a tradition for investment professionals and the financial media to issue a forecast at the beginning of each year. But in any particular year there are many factors that may play out differently than expected, and other potential issues that simply can't be foreseen. This makes accurate forecasting very difficult. **Of greater importance, it makes it dangerous to base any investment strategy on a one-year market forecast.** Take 2003: it's relatively easy to play either side of the fence with respect to the general investment environment.

Arguing along with the bulls we'd say that monetary and fiscal policy is stimulative and should allow the economy to build on its slow recovery. The recent economic news is becoming increasingly positive. Inventories are lean so corporate spending should rise. Moreover, capital investment has been cut so far that the capital stock (the non-depreciated portion of capital assets at work in the business sector) is actually declining. A rebound in capital spending is inevitable and appears imminent and that will combine with continued consumer spending to put the economy on sound footing. This will encourage investors who are sitting on a mountain of cash and have an opportunity to buy stocks at a discount. As for war with Iraq, if a war starts soon investors will begin to look past the uncertainty. And, there is a real possibility that there will be no war. Saddam Hussein has a strong incentive to avoid war and if pushed into a corner he is likely to be able to do enough to make other countries uncomfortable supporting a U.S. military response.

► **Money Market Assets as a Percentage of Stock Market Value**



The bears would respond that investor sentiment has been seriously damaged and therefore investors will not pile back into stocks anytime soon. In the past, stocks were much more undervalued after a serious bear market than they are now. Moreover, falling interest rates have fueled refinancing and auto purchases, helping to support the economy. But with rates so low it is likely that we've seen the last major wave of refinancing for some time. Without more refinancing opportunities and little pent-up demand (unlike other post-recession periods), this will probably mean that consumer spending will grow more slowly. And capital spending will not save the day because even though it might seem primed for a rebound, existing excess capacity and uncertainty over consumer demand will keep businesses from aggressively expanding. Even if capital spending did improve, it constitutes far less of final demand than consumer spending and can't carry the economy alone.

Then there is the risk of war and the unknown of the ultimate cost of waging the war. On top of that is the terrorism wildcard and increased security costs, which weigh on the economy. Uncertainty leads investors to demand a high risk premium as compensation. That suggests a cap on stock prices.

There is truth in both the bullish and the bearish arguments. With respect to the economy the key questions are the strength of the consumer and the timing and strength of the next cycle of corporate spending. The short-term impact and timing of the Iraq situation is also a factor, as is the wildcard of terrorism. **From where we sit it is not realistic to be confident in assessing whether these factors will net out positive, negative or mixed over the next 12 months.**

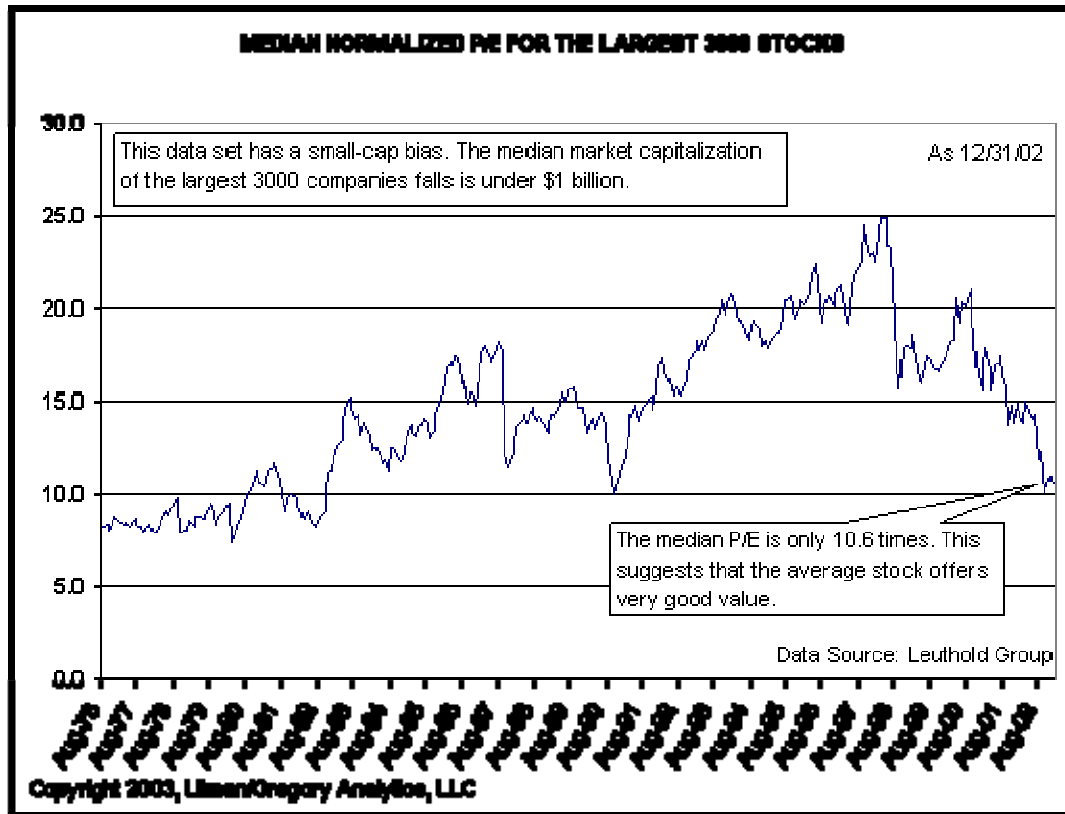
### **An Investment Strategy Based on Confidence, Not Hope or Speculation**

This leads us back to our basic philosophy. To achieve long-term investment success we believe it is essential that we base our strategy only on analysis that we are highly confident in. This necessitates a relatively long-term time horizon, since we have a much higher level of confidence in our ability to assess long-term factors but little confidence in our ability to determine how these might play out over the short term. The following are our comments about each asset class.

**U.S. Equities:** The volatility in the stock market in 2002 caused our view on valuations to shift around as the year progressed. The rebound since the July market bottom has not been large enough to eliminate the undervaluation. But it has cut in to the degree of undervaluation.

We've become very sensitive to the real possibility that current interest rates are unsustainably low. The deflation risk in the economy has contributed to low bond yields. But over the intermediate term deflation seems like a low risk. Our confidence that sustained deflation is unlikely has increased over the past two months because the Fed has been very vocal in expressing that it has many tools, including printing money, that it is willing to use to fight deflation. The tools for fighting deflation are, by definition, inflationary, and therefore any short-term increase in deflation risk equates to a longer-term increase in inflation risk. So we think it is likely that over the next three to five years interest rates will be higher than they are now. We believe equity asset will return between 8 and 10% over the next 5 years, with continued volatility both on the upside and downside.

► **Median Normalized P/E for the Largest 3000 Stocks**

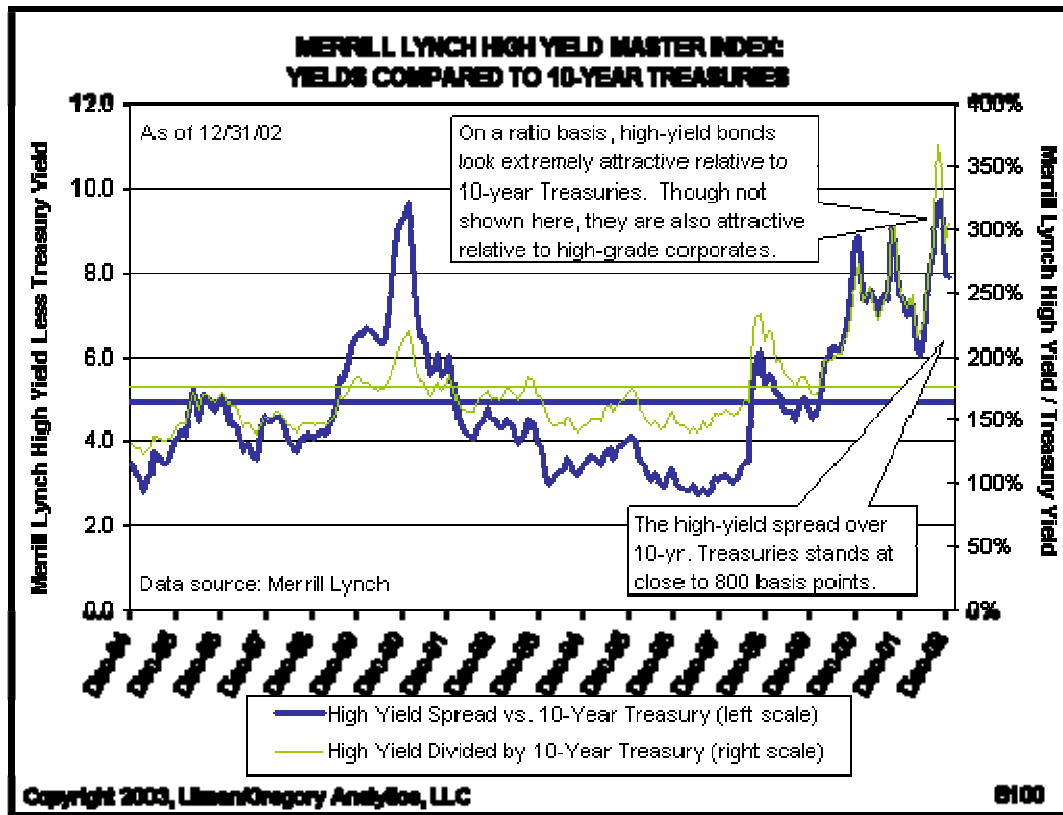


**High-Yield Bonds:** High-yield bonds had an excellent fourth quarter, returning 6.7%. The rally drove yields down from over 13% to a still-healthy level of 11.7% as we write this. The default rate, though high, has been steadily declining in recent months as the economy has shown some signs of improvement. Balance sheets are generally improving as net new borrowing has declined sharply and more companies are generating higher free cash flow, selling assets and finding other ways to reduce debt. Flows into high-yield mutual funds have been steady and healthy while high-yield fund managers have been cautious and recently held a sizable cash reserve of about 9% of assets. On the negative side, the improvement in default rates has been excruciatingly slow. If the default-rate improvement continues to be gradual as expected, it is unlikely that we will see an explosive snap-back in prices. Still, looking out over the next several years, high-yield bonds are still priced at recession-type levels. This is true whether we compare yields to Treasuries, high quality corporates or inflation. As the economy gradually improves so should prices of these bonds. Current price levels suggest that low double-digit return expectations are realistic. In 2002, high-yield bond returns were slightly negative (however our two largest high yield bond funds, Payden High Income +2.1% and Northeast Investors +3.2% were positive on the year), and though this was disappointing it amounted to a huge performance advantage compared to stocks. If the economy and financial markets have a strong 2003, high-yield bonds should do quite well, though not as well as stocks. If things deteriorate, they are again likely to hold up much better than stocks. But stretching out our horizon over a few years, we believe high-yield bond returns can be competitive with stock returns and have the potential to do somewhat better than stocks.

### Moody's 12 Month Trailing Default Rates

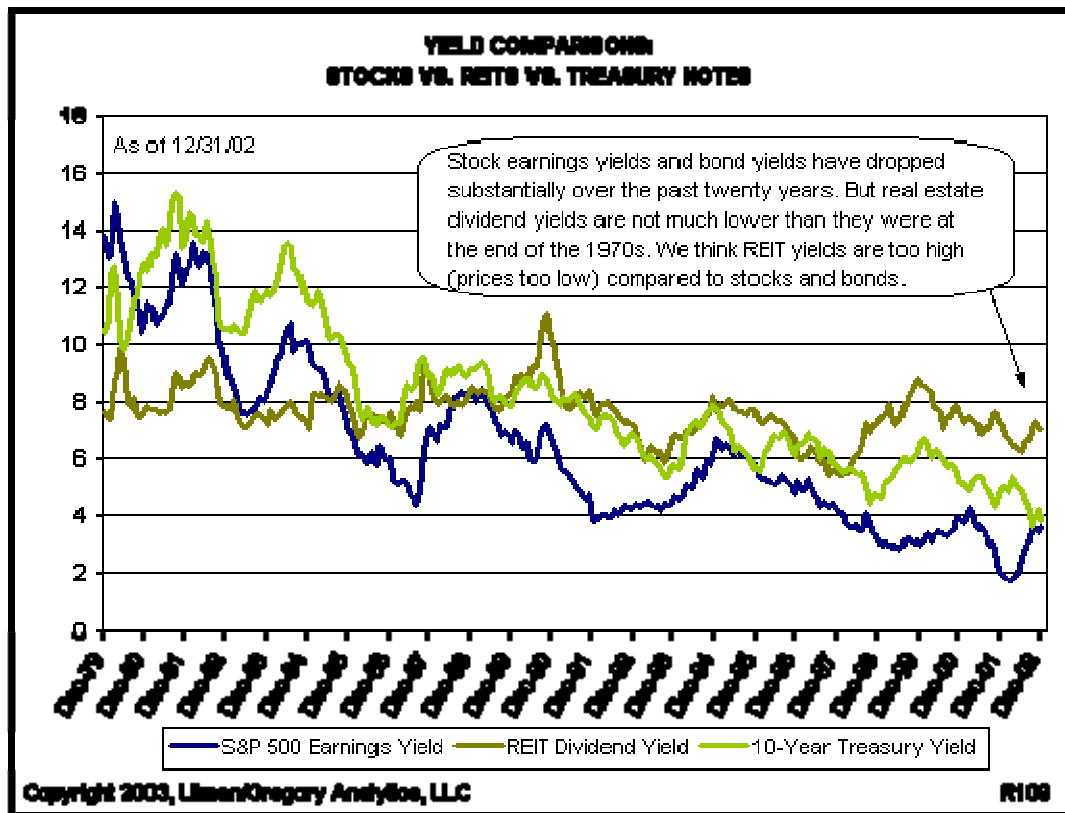
|                  |       |
|------------------|-------|
| As of 12/31/2001 | 10.5% |
| As of 7/31/02    | 10.1% |
| As of 11/30/02   | 8.7%  |

### ► Merrill Lynch High Yield Master Index: Yields Compared to 10-Year Treasuries



**REITs:** Real estate fundamentals are weak (not including single family homes, which are not represented in the REIT universe), especially in the office and apartment sectors. However, prices of REITs are still very attractive relative to other financial assets (stocks and bonds). Even taking into account the likelihood of little cash-flow growth (and possibly a decline) in 2003 and a few scattered dividend cuts, REITs and their 7%-plus dividend yields are one of the cheaper financial asset groups. There is much talk these days about dividend cuts in REIT world, however it appears quite likely that cuts will not be widespread and the overall impact to the dividend yield of a diversified REIT portfolio will not be material. There is also concern that a dividend tax cut for regular corporations will be a disadvantage to REITs. That may be true at the margin if REITs are not included in the cut (since they are already exempt from taxes at the corporate level), but REITs will continue to have higher pre-tax and after-tax dividend yields even if some or all of corporate dividends are exempt from individual taxes. We continue to believe that the income yields that real estate offers indicate that it was an under-owned asset class during much of the past decade. We believe lower return expectations from stocks could gradually draw more money to real estate, though this is not necessary for REITs to do well. But this year could be a challenge. Real estate tends to lag the economy and if the economy continues to improve investors may temporarily ignore REITs in favor of stocks. **However, we can't say for sure that this will happen and we continue to believe that at current prices REITs offer somewhat better return potential and lower risk over a longer horizon of three to five years.**

► **Yield Comparisons: Stocks vs. REITs vs. Treasury Notes**

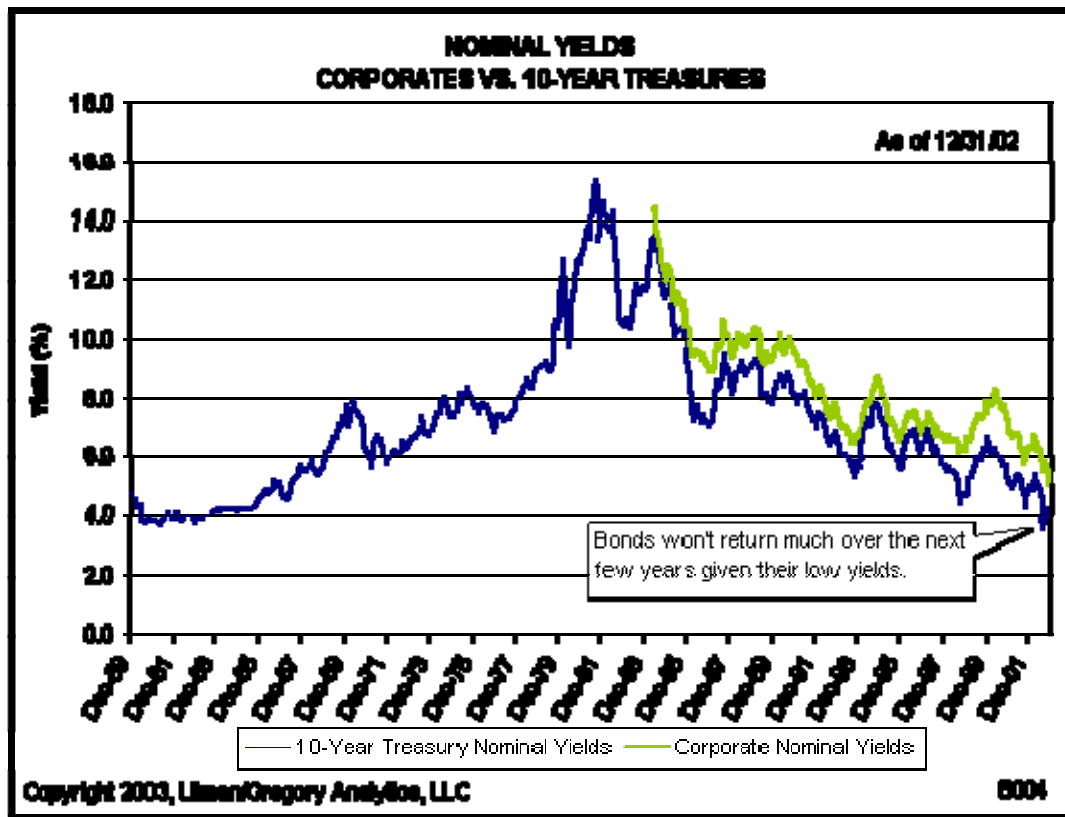


**Alternative Investment Class / Non - Correlated Funds:** We continue to be very bullish on this asset class. Our Non Correlated Investment class had strong relative performance in comparison to the traditional equity markets. Caldwell & Orkin +2.93%, Boston Partners L/S -.51%, Merger -5.67% and the ARK Fund of Funds -2.58% preserved capital in this most treacherous year. We will continue to overweight these managers as their ability to raise cash and short the market give them a tremendous advantage over traditional long only managers. We must reiterate we invest in this asset class more for their low correlation to the traditional markets than for their superior return characteristics. However, this asset class has proven over time to deliver healthy returns with substantially less risk than traditional asset classes.

**Foreign Stocks:** Europe continues to look somewhat underpriced relative to its historical relationship with the U.S. Europe's price-to-cash earnings ratios are 36% below the U.S. on a trailing and forward basis (based on Morgan Stanley data). The average historical discount has been about 25% over the last 20 years. In addition, the large U.S. current account deficit continues to suggest the odds favor a weakening U.S. dollar over the next few years relative to the euro. Finally, Europe has the potential to provide more new marginal stimulation from monetary policy than in the United States. Emerging markets, as a group, also look extremely undervalued with Asia offering more political stability now than Latin America

**Investment-Grade Bonds:** With a yield of 4%, 10-year Treasuries appear overvalued relative to trailing inflation. Whether they are overvalued compared to future inflation is yet to be seen but with the likelihood of continued sizable fiscal and monetary stimulus we believe the odds are high that Treasury yields will be higher, on average, in coming years than they are now. Other sectors of the investment-grade bond market offer better value but not great absolute value. And with rates very low, it doesn't take much of a move up in interest rates to wipe out a whole year's worth of interest (about a 1% back-up in rates would do it). It is highly unlikely that investment-grade bonds will deliver attractive absolute returns over the next few years unless we fall into a deflationary environment and stay there. The purpose they should serve in a portfolio in this environment is as a hedge against deflation/recession. Investors who can look beyond these risks have less need for investment-grade bonds than do investors who are more sensitive to short-term risk.

► Nominal Yields Corporates vs. 10-Year Treasuries



### Return Potential

As we look out over the next five years we believe financial markets are likely to deliver decent returns relative to inflation. However, there are two risks that we must mention:

1. Terrorism remains an unknown. We already know there are security costs which will have a marginally negative impact on productivity. What remains to be seen is the impact of terrorism on economic behavior. This will be determined by whether there are terrorist attacks that alter consumer and business behavior in a lasting way. This may or may not happen. The fear that it could happen is a secondary factor that could well result in a somewhat higher risk premium (lower prices) for equities and other equity-type assets.
2. Inflation and interest rates. We continue to view deflation as a risk. With excess capacity, a very competitive global economy, and lots of debt we are not ready to say that it couldn't happen. But we think the odds of sustained deflation are quite low—lower than a few months ago now that there has been further marginal improvement in the economy and since the Fed has made it clear it will be aggressive in using all its inflationary tools if needed. So the longer-term risk is that there will be some increase in inflation. While this bodes well for earnings growth it would not be good for P/E multiples. The risk is that a decline in multiples more than offsets the increase in earnings growth.

In spite of these concerns we are moderately optimistic. There remains lots of liquidity that at some point will begin to move out of cash. And in general valuations provide some cushion. The fact that companies have rediscovered spending discipline is very important and is likely to result in improving returns on capital in coming years. And, we also think it is likely that a higher level of earnings will gradually be paid out in dividends as investors show a preference for dividend-paying stocks, regardless of whether taxes on dividends are cut (this preference is already happening). This will enhance equity returns because, somewhat surprisingly, earnings growth (in general) has a strong tendency to rise when payout ratios rise—something of a free lunch. Generally, we believe returns from equity-type asset classes (stocks, real estate and high-yield bonds) will fall between the mid single-digits to the very low double-digits over the next five years. While this is our expected range we believe it is likely that returns will fall in the upper half of this range with low double-digit returns very possible. Returns from investment-grade bonds are likely to fall between 4% and 5% on average.

—Lido Advisors Investment Team (1/13/03)

