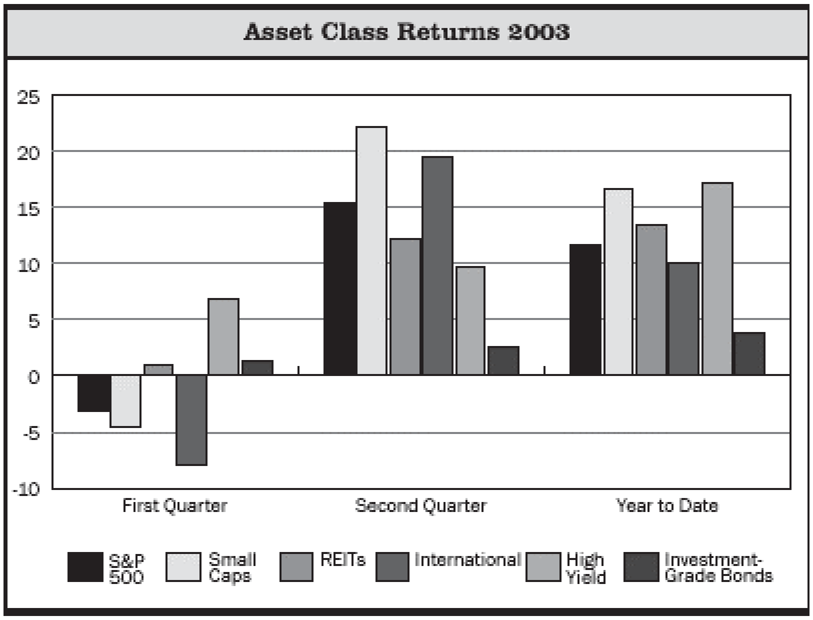
Monthly Investment Commentary | ***July 2003***

What a difference a quarter makes! The powerful second-quarter rebound more than offset a tough first quarter, rewarding investors with sizable returns during the first six months of 2003.

Three months ago we wrote about all the economic and geopolitical negatives. But after that rather depressing discourse we also wrote, **"…there are powerful positive forces at play which must not be forgotten at a time when the glass seems mostly empty."** Many times in the past we have written that investors should never underestimate the ability of the stock market to surprise. Our respect for the stock market's ability to humble investors over the short-term is part of the reason we rely so heavily on our diversification. So, despite economic and geopolitical worries, three months ago we believed that the stock market and other "equity-like" assets were clearly undervalued. For this reason, despite our big-picture worries we believed the odds were high that we would be rewarded either sooner or later for maintaining equity exposure. In essence we relied on that which we could confidently assess (stock market valuations) and were influenced less by factors that we could less confidently assess (geopolitics and the timing and strength of an economic turnaround). This allowed us to resist the temptation to get more defensive. Now, three months later the returns from equity asset classes have been impressive, and our portfolios have benefited from "staying the course".



We believe that Lido's value added to you is a function of the quality of our research and our completely independent and objective approach to investing. If we do not have the discipline to follow what our research tells us then the research loses its value. At times of extreme greed and fear this is particularly difficult because emotion clouds judgment. **And for that reason we view one of the most important parts of our job as helping you to deal with the same emotional challenges.**

It is worth addressing the question of why equity-type assets started taking off before the Iraq war even started (in mid-March) and have continued to rise despite continued economic uncertainty. There are three reasons:

- The stock market prices in expectations about the future. In times of fear or greed those expectations are often exaggerated, becoming overly optimistic or overly pessimistic. That leads to exaggerated actions in the form of excessive selling or buying. In March, investors were overly pessimistic, resulting in depressed prices for many financial assets. **This dynamic is why it is usually safest to buy when fear is high and why it often pays to be more cautious when investors are ignoring risk.**
- The economy continues to struggle; however it is not getting worse. Moreover, there is an increasing amount of stimulus with exceptionally low interest rates, a falling dollar (resulting in less competition from imports) and the tax cut. Areas of the economy are showing strength (housing) and the business sector has been able to take advantage of very low interest rates to refinance debt and lower debt service.
- Though great uncertainty about the post-war period remains, the Iraq-war disaster scenarios did not come to pass.

This all underscores once again the need to be forward-looking in assessing financial markets, rather than backward-looking or fixated on today's worries. And a critical part of the analysis is assessing what the financial markets are pricing in (or "discounting"). Sometimes the markets price in nirvana and sometimes they price in the end of the world. **Today, for the first time in years they seem to be doing a reasonably good job of pricing in reality.**

Have Stocks, REITs and Bonds Gone Too Far?

We always get nervous when financial asset prices move sharply higher over a short time period. Contributing to our discomfort these days is the bullishness of financial advisors and investment strategists. **According to several polls of both groups, optimism is higher than it's been at any time since 1987.** Huge optimism is usually a bad sign because it suggests that if investors have acted on their optimism, stock prices will have been bid too high. However, investment sentiment is just one factor and a temporary one at that, so it rarely factors into our investment-decision-making process. To reiterate, most important is the valuation picture. And what is the picture now? The bad news is that there are no equity-type asset classes that appear to be huge bargains. The good news is that, based on our opinion, none are overvalued and some are still slightly undervalued. Our base-case assumption is that the economy recovers with interest rates increasing over the next few years so that the yield on the10-year Treasury backs up to 5%. This outlook assumes inflation between 2% and 3%. In that scenario the valuation picture is as follows:

Asset Class	Valuation Assessment
Investment-Grade Bonds	Overvalued
Large-Cap Stocks	Fairly Valued
Small-Cap Stocks	Fairly to Somewhat Undervalued

Foreign Stocks	Fairly to Somewhat Undervalued
REITs	Somewhat Undervalued
High-Yield Bonds	Fairly Valued

With most equity-type asset classes in a range between fairly valued and slightly undervalued, it's reasonable to wonder how current investment opportunities look relative to the risks. We've identified several risks over the past year:

- Structural risks including debt levels and the sizable U.S. dependence on foreign capital
- Deflation, which could be a by-product of high debt level
- Inflation, which could eventually be ignited by attempts to fight deflation
- Geopolitical risks including terrorism.

These risks have not gone away but in general most have subsided.

Debt levels are still high but on the corporate side stresses have eased considerably. That's because interest rates have dropped significantly for less-than-creditworthy borrowers. This has allowed many highly indebted companies to refinance their debt, significantly increasing their cash flow. On the household side, refinancing activity continued and hopefully this has helped stabilize and potentially reduce debt service (the most recent debt service data we have is as of March 31, 2003). However, household debt (credit cards, mortgage, etc.) has continued to accelerate, growing by over 10% in the 12 months ended May 31, 2003. The overall growth rate of debt is higher than it has been in over ten years and this increase may offset some or all of the benefit of lower interest rates. (Some of this increase in debt is probably explained by the increase in first-time home buyers.)

Deflation risk remains but we are less concerned than we were last year. Though some data continues to suggest deflation is a risk, the Fed has made it clear that it will not take chances and will err on the side of too much inflation. It has a variety of tools at its disposal but it may be able accomplish much of the job by simply stating what it "might" do. For example, there has been talk of buying Treasury bonds—this talk has no doubt helped keep bond prices high and interest rates (including mortgage rates) low. To date there has been no need to actually buy bonds because the threat of doing so has impacted the market's pricing of those bonds as if some of the buying had actually occurred. Aside from taking comfort in the Fed's focus, the economy remains on shaky footing but there are signs of stabilization in the labor market and the manufacturing sector. These signs are hardly conclusive but marginal improvement along with the increased fiscal stimulus soon to kick in suggest more reason to be optimistic than pessimistic. And as we wrote a quarter ago, the sluggishness of this recovery is surprisingly reminiscent of the recovery in the early 1990s.

Inflation risks are not significant in the near term. Even if deflation is avoided as seems quite likely, the risk will probably be around for a while, very probably into next year. However, the monetary and fiscal stimulus that is in place could ultimately overshoot the target and result in a spike in inflation. Though not a near-term concern it is something we think about as we think through return expectations over the next three to five years.

Geopolitical Risks remain, though the stress level has declined. So far the fear that a U.S. attack on Iraq would increase the risk of terrorism in the U.S. has not come to pass, but it remains a huge unknown. Most terrorist acts have little direct impact on broad economic behavior and thus affect financial markets only temporarily. However, the possibility exists for terrorist acts that could have real economic consequences, creating a wildcard for investors.

The world remains a risky place, as it has always been. And the risks continue to seem somewhat greater than in the past perhaps because the worst case is so scary. However, we are conscious of the tendency for "today's" risks to always seem much more alarming than "yesterday's" risks.

At present we believe equity asset classes are fairly valued and discount a "normal" level of risk. Are today's risks "normal"? That's a subjective assessment that is hard to make but it is no longer clear that big-picture risks are above average.

Reasonable Return Expectations and Ways to Add Value
Current asset prices suggest returns of 6% to 9% for equity-type assets on average, over the next five years. Of course that's a base-case forecast and assumes that assets are at about fair value at the end of the period. The reality is that returns could be significantly different if growth rates are abnormally high or low or if assets become over- or undervalued. So, though a most likely range is 6% to 9%, it's not hard to imagine returns being two percentage points higher or lower. And, along the way individual-year returns could be significantly higher or lower. Given our expectations, return potential relative to inflation is decent but on a nominal basis these returns may not seem exciting. After a horrible three years don't we deserve more? **The sad reality is that returns were so high in the 1990s that they effectively borrowed from the future.** The bear market brought things back to reality and beyond and now we've had a bounce back to fair value. So as we write this at the end of the second quarter, returns look likely to be okay but not spectacular. How can we do better, or at least ensure that we don't fall within the lower end of the broader range?

There are no guarantees but as we focus on the important question of how Lido Advisors can continue to add value we would like to point out the following:

Tactical asset class plays are limited *today*: For much of the last five years we've been pounding the table about opportunities in REITs, high-yield bonds, value stocks alternative investments and small-cap stocks. **Today, we see no table-pounding opportunities.** REITs and high-yield bonds are borderline fat-pitch opportunities (more on this later) but after strong recent performance they don't offer the potential they did up until recently.

Taking advantage of market overreactions is one of two primary ways we expect to add value**. With no market overreactions are we left to fight with one hand tied behind our backs?** This is a fair question and in response there are two points we'd like to make. First, though no area is hugely compelling, there is one area of overreaction. **Investment-grade bonds are clearly unattractive.** We believe that bonds will probably return less than their yield over the next three to five years, which means very low single-digit returns are likely. We are looking hard at opportunities to build in exposure to assets that allow us to maintain the portfolio-level risk that we want but with better return potential. We continue to view our alternative investment class (market neutral products) as an asset class that might allow us to somewhat reduce exposure to both equities and bonds in a way that will maintain the risk level in the portfolio while at the same time raising the portfolio's return potential. The second and more important point is that just because there are no great opportunities today, does not mean there will not be any tomorrow. In fact we can guarantee that there will be some great opportunities in the future because they always come and go as a byproduct of investors' ongoing swings between fear and greed. We will be patiently awaiting opportunities we can take advantage of.

Adding Value via Manager Selection: The second way we add value over time is through manager selection. Over the long run this has been a material factor in our performance. Our manager research is an ongoing major focus of our Firm. Although there are no guarantees, and there will be periods of underperformance, we believe that our managers as a group will continue to add value by generating better returns than the markets. And just as we take advantage at the asset class level of the over or under valuations arising from fear and greed-driven volatility, our managers similarly benefit at the security selection level. Volatility is the long-term investor's friend.

June Benchmark Returns (Preliminary)		
	June	**YTD**
Large-Cap Benchmarks		
Vanguard 500 Index	1.3%	11.7%
Russell 1000 Growth iShares	1.1%	12.7%
Russell 1000 Value iShares	0.7%	10.9%
Mid-Cap Benchmarks		
Russell Midcap iShares	0.7%	15.0%
Russell Midcap Growth iShares	1.4%	18.6%
Russell Midcap Value iShares	0.2%	12.4%
Small-Cap Benchmarks		
Russell 2000 iShares	1.6%	17.6%
Russell 2000 Growth iShares	1.8%	19.1%
Russell 2000 Value iShares	1.4%	16.0%
Other Benchmarks		
Vanguard Total Intl Stock Index	2.7%	10.1%
Vanguard REIT Index	2.3%	13.4%
Vanguard Total Bond Market Index	-0.1%	3.9%
Merrill Lynch High-Yield Bonds	2.7%	17.2%

Decisions, Decisions

As all financial assets have moved higher we've been debating three tough decisions:

What to do with bonds? Given our very low return expectations for investment-grade bonds it's fair to ask why we own them. The reason is that economic risk has not gone away and bonds will be the best-performing asset class if the economy weakens again. Returns wouldn't be great but from current levels positive returns of 6% or 7% over a year would provide important portfolio ballast for our balanced portfolios if equities were declining across the board. So some exposure to bonds is necessary as a risk-management strategy.

Are high-yield bonds still a fat pitch? High-yield bonds are still quite competitive with stocks but they no longer qualify as a clearly superior alternative. However, everything—including high-yield bonds—is a fat pitch compared to investment-grade bonds and that's why high-yield bonds continue to be interesting. We expect high-yield bonds to return around 7.5% over the next five years, somewhat higher than stocks on a pre-tax basis, but potentially somewhat lower than stocks on an after-tax basis. However, high-yield bonds are somewhat less risky than stocks. Their risk is similar to the risk of an equal mix of stocks and investment-grade bonds. For that reason it makes sense to compare return expectations to a blended return of stocks and investment-grade bonds.

Over the next five years pre-tax return expectations for the stock/bond blend is about 5% compared to 7.5% for high-yield bonds. After-tax return expectations are about 4.5% compared to about 3.7% (assuming maximum tax rates on interest and assuming a high tax state). Investors who hold their high-yield bonds in retirement accounts have the potential to have even better comparative returns on an after-tax basis. For this reason, most of our high-yield exposure is in tax-deferred accounts.

REITs are having another great year; do they still offer better return potential than stocks? Yes, REITs still sell at a historical yield premium compared to stocks (comparing their dividend yield to stock's earnings yield). However, they also continue to sell at a premium to their underlying net asset value of nearly 10%. This isn't an alarming level but it is nearing a point that suggests future appreciation may be limited. However, even if we assume REITs simply capture their dividend yield and the yield grows with inflation (as they have over the long run) returns would be 8.5% to 9.5%. If there is further appreciation, which would probably require underlying property values to appreciate faster than inflation, returns could be even better. We are not betting on faster property appreciation over the long run but it wouldn't surprise us. That's because for some time we've stated our belief that real estate is undervalued compared to stocks. The solid performance of the property sector recently, in the face of shaky fundamentals, suggests that investors agree. So, on a pre-tax basis REITs look very attractive compared to stocks. Based on our analysis, on an after-tax basis REITs currently (and conservatively) offer a long-term expected return premium over stocks of about 50 basis points (one half percent), with, we believe, more long-term potential upside and somewhat lower risk. As is the case with high-yield bonds, REITs are much more attractive if held in a tax-deferred account.

For taxable investors both high-yield bonds and REITs remain attractive; however are they attractive enough to be considered a fat-pitch? We still put them in that category but it would not take too much relative out-performance to force a change in our opinion regarding their fat-pitch status.

In other areas, we are sticking with our small-cap and foreign equity positions. Both are areas that we believe offer somewhat better value than U.S. large-cap stocks. And, small-caps usually outperform early in the economic cycle when they tend to exhibit superior earnings growth. Although we believe there is a good chance that returns will be higher over the next several years, the advantage is not so clear-cut to make either small-caps or foreign stocks a fat pitch.

We see no compelling investment advantage in U.S. large-caps for either the growth or value style, at least on a statistical basis. There is an argument that is somewhat appealing that value stocks could experience a secular period of out-performance as an after-effect of the growth/tech stock bubble. However, we are not betting on this. In small-caps, growth has a slight statistical advantage but not one that is clear-cut enough to bet on.

Thoughts on the Tax Bill

The impact of the tax bill was a positive one for investors and it will have some ramifications on asset allocation and portfolio management decisions. By lowering the tax rate on capital gains and most dividends, investors will receive higher after-tax returns. This justifies higher prices for stocks and helps explain some of the upward move in the stock market. Lower tax rates in general also benefit investors who hold interest bearing assets and REITs (which do not benefit from the lower rate on dividends). However, though rates have effectively dropped for all investments, they dropped more for capital gains and qualifying dividends thus benefiting stocks more than most other assets. **This means that for high-tax-bracket investors, high-yield bonds and REITs will fall from fat-pitch territory faster than they otherwise would have.**

At this point we do not view the tax changes as reasons to pursue certain types of investments over others. The market tends to adjust fairly quickly to relative opportunities. And while it's possible that high-dividend-paying stocks might outperform because of their tax-advantaged status we're not so sure that this alone makes them more attractive. After all, all stocks are now on more of a level playing field when it comes to taxes. So taxes alone are not necessarily a reason to prefer a dividend payer to a high grower.

From a portfolio-strategy standpoint, now more than ever, investors with both taxable and retirement plan portfolios will benefit from emphasizing investments that throw off income taxed at high ordinary rates in their retirement plans. That means that portfolios will be much more tax efficient if bonds, REITs and investments that throw off lots of short-term capital gains are in retirement plan accounts.

The tax plan also somewhat reduces the appeal of separate accounts. One of the big selling points for separate accounts is that they are more tax efficient and you don't buy into embedded mutual fund capital gains. With lower tax rates this argument is somewhat lessened. Moreover, the bear market has left many well-managed funds with capital loss carryovers and/or unrealized depreciation, thus undermining the argument that separate accounts will be more tax efficient (mutual funds are required to distribute annually all capital gains but can carryover losses to future years.) In fact, since many mutual funds will not be distributing taxable capital gains for the next few years due to these loss carryovers, we would argue that mutual funds will likely be more tax efficient than separate accounts over the next three-to-five years.

Conclusion

Unlike most of the last five years, financial asset values are not currently disconnected from reality. So in this environment we rely on

1. Our ability to identify exceptionally skilled stock pickers who continue to add value, and
2. Our ability to be patient in waiting for the next fat-pitch (tactical asset allocation) opportunity.

Over the years we think we have developed a clear understanding of our circle of competence and we have learned the importance of staying there. And part of that circle of competence involves focusing on that which we can confidently analyze, such as valuations, and staying away from the type of big-picture analysis that is so hard to get right. Lets see what the next quarter and the rest of the year brings!

Lido Advisors Investment Team (7/3/2003)