

May 19, 2000

Mixed Economic Signals And Valuation Concerns Produce Volatile Stock Market

The stock markets' roller-coaster ride since the first of the year has caused investors to hold their breath and experience a variety of other emotional responses. While Nasdaq is down 14% for the year, it's down 30% from its high in March. Some individual stocks in the Nasdaq have fallen harder - many have lost more than 50% of their value.

In our estimation, the reasons for the dramatic drop in the market are at least twofold: (1) investors' correct perception that the Fed's interest rate hikes hurt companies' ability to grow and generate future profits and (2) an increasing concern that "new economy" stocks may become subject to old-fashioned securities pricing conventions (i.e., cash flow and profits do matter). We see both a vibrant economy and some inflation concerns. We believe there are companies at both ends of the valuation spectrum (some very cheap and some still overpriced after the recent downturn). Given the mixed signals, we aren't convinced this is "just a dip" or the beginning of a widespread bear market.

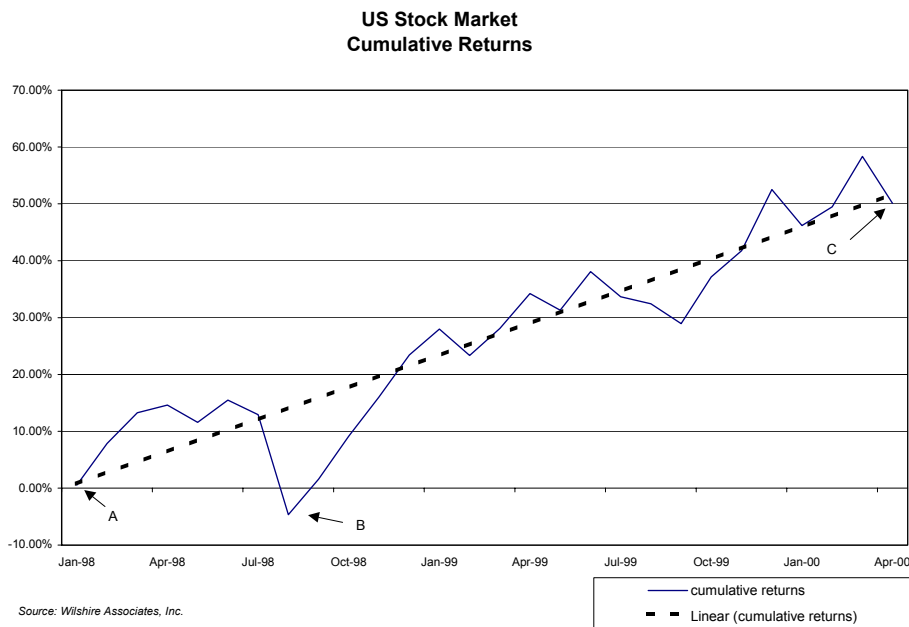
We continue to recommend broad diversification. While the beginning of the year has been rough, virtually all of our clients, ranging from conservative to growth-oriented, have experienced positive returns over the twelve-month period.

Hoge Building
Suite 800
705 Second Avenue
Seattle, Washington
98104-1711
Phone 206/382-4414
Fax 206/382-4412

Straight Line Projections Versus a Volatile Reality

Most investors understand intuitively that short-term returns vary from average long-term returns, and the “peaks” and “valleys” can dramatically affect the outcome of investing. There is no way to predict when this volatility will happen and in which direction it will occur. The chart below reflects cumulative returns for the broad US stock market since January 1998. The straight dotted line shows a linear regression of those same returns.

The solid line representing actual returns in the chart below shows that the beginning and ending points can have a dramatic effect on returns. If you invested at point A and evaluated performance at point C, your cumulative return of 50% would have been quite different than if you measured from point A to point B (negative 4.7%).



Financial projections we provide our clients are generally based on “stochastic” modeling techniques, meaning that a consistent rate of return, net investment (deposits less withdrawals), and inflation rates are used. Yet we know the actual experience in our clients’ portfolios will vary from the projections.

Does the stochastic modeling have merit? Yes, we think so. We are convinced an investor must understand the upward long-term *linear* trend of the markets. If you believe in the upward trend you can have the discipline to sacrifice by saving more and spending less. As the chart indicates, early investment of a dollar yields better results than later investment of a dollar over the long-term, but you may need to be patient.

The stochastic model is not the only way to make projections. We will discuss the merits of “Monte Carlo” simulation in a future newsletter.

Tax Efficiency and Manager Selection

In June 1999 we promised you an article about tax efficiency and manager selection but postponed it until a time when we knew the issue would peak your interest (right after tax time). You can't escape taxes, but we would like you to know that we keep taxes in mind when making investment recommendations.

In taxable accounts, what counts is not only what risks you are taking to generate higher returns but what your returns are after adjusting for taxes. Managing a taxable account tax efficiently can add between one half of a percent to one percent a year to the returns of the taxable portion of your portfolio. Over time, due to compounding, the extra return provided by tax efficiency can really add-up. Generally, the more passive a manager is (the less he buys and sells stocks), the more tax efficient the portfolio since selling a security creates tax liability if the stock's price has increased. Other processes portfolio managers use to make portfolios tax efficient are: realizing off-setting losses when realizing gains, evaluating and selling certain securities in favor of others with the cost of taxes in mind, and specific identification of certificates to time profits and losses better.

Statistics about returns adjusted for tax impacts are available for most portfolio managers and mutual funds. We consider these statistics when selecting investments for the taxable portion of your portfolio and periodically evaluate each manager's performance in light of important tax considerations.

We hope paying attention to details such as these will generate better than average returns for our clients over the long-run.

A handwritten signature in black ink, appearing to read "Scott Rhodes", with a large, stylized initial "S" and "R".

SCOTT RHODES