
FREDERIC T. KUTSCHER ASSOCIATES, INC.

Comprehensive financial counsel to individuals, families and trusts

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Over two weeks have passed since the tragic events of September 11th. We've borne witness to acts of horrendous barbarity and to responses of courage, shock, kindness and grief. We've seen our nation united. And now we're seeing the civilized world reassessing policies and formulating appropriate strategies and effective tactics to combat this most recent worldwide scourge.

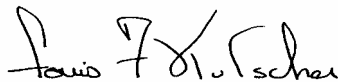
We've spoken with many of our clients, and we know of no losses to close family or friends. For this we are most thankful.

As we write this letter, it appears that the turmoil in the stock markets, which dropped record percentage amounts (at least for the week of September 17-21), may have found their footing this week. The nation and the markets have taken a hit, but they are largely sound. In light of the events of September 11th and their effect on all of us, we would like to share our thoughts about the investment environment and investing in these demanding times. We've enclosed our summary.

On an emotional level it's hard to deal with what we have witnessed. There are so many thoughts and so many questions. There are tremendous challenges on all levels. But hasn't that been true throughout our nation's history? Each generation of Americans, it would seem, has a "rendezvous with destiny."

We wish you, your family and friends safety and health. As always, we welcome your calls and your comments.

Sincerely,



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Prior to September 11th we characterized the investment environment as follows:

- Both the US and global economies were in recession or near recession though some statistics were beginning to signal a trough.
- Corporate earnings were weak...especially compared against the stratospheric expectations of two years ago...and were probably headed somewhat lower.
- In the broader markets, stock prices were in a fair-value range, neither cheap nor expensive.

While we had no opinion in the outlook for stocks over the short-term, we believed that returns over the future 12 months would be decent-to-good. We believed this because:

- We expected the economy to begin to recover (especially knowing that the longest recession during the past 50 years was 16 months).
- With a recovery beginning, earnings comparisons in 2002 would be strong compared to depressed 2001 levels.
- The stock market, being “forward looking” had, in the past, typically (almost always) rebounded three to nine months before the end of each recession.
- Stocks were already almost down 20%. In the past, declines of this magnitude had provided an excellent entry point (buying opportunity) for long-term investors.
- Although we believed returns would be decent or better over the next year, because stocks were only fairly valued (not a bargain), we thought longer-term returns would be okay but not great. If asked to guess what total stock market returns would average over the ensuing three years, we would have said: “in single digits” meaning not more than 9%. In other words, compared with the torrid returns of the middle 1990’s we were expecting modest returns (but not negative returns)

What has changed since September 11th?

- First, over the near-term the economic slump will almost certainly be more severe than it would have been. Business activity slowed dramatically for several days and the aftermath is likely to dampen consumer spending, business spending and capital investment. Other factors to watch are the U.S. dollar and oil prices (although OPEC has said they will increase production if necessary to stabilize prices). Corporate earnings will be hurt over the short term.
- Monetary and fiscal policy is likely to be significantly more supportive than it otherwise would be. Liquidity is at a 41-year high and the Federal Reserve's discount rate is at a 42-year low. The political landscape has changed dramatically so that, in the near-term, concern about depleting the surplus will take a back seat to supporting the economy. It is likely that we will see significantly higher government spending that will help support the economy.
- For the vast majority of publicly traded companies, we don't believe September 11th changed their *long-term* business prospects. *Clearly the short-term has changed, but it is the long-term business prospects that drive long-term business values.* If the tech bubble taught investors one thing over the past 18 months it is that stock prices ultimately are driven by long-term business values. Greed and fear drive prices over the short-term, but these emotions are not sustainable.
- Stock prices are down sharply around the world. As we write this, the Dow is down about 8% since September 10th (and over 15% since early July). For the first time in three years stocks are undervalued based on valuation models. What is important to point out is that if stocks decline much further they will be bargains. At the very least, we believe global stock values now suggest very acceptable intermediate (three-year) returns relative to inflation.

Performance

- While our clients' portfolios have outperformed their respective benchmark indexes by a wide margin through most of this bear market, so far this month we may have under-performed somewhat as many of the areas that did well earlier in the year have weakened. For example, Longleaf Partners - this management team did so well during 2000 and through August 2001 compared to the overall market - has fallen further than the market since September 11th due to its large ownership of hotels in the portfolio. Small-caps and mid-caps have begun to under-perform. And high-yield bonds have lagged outperforming investment-grade bonds (but have held up better than equities).

Conclusions—The Most Important Things To Understand Now

- The economy will recover. There will be layoffs, consumers will spend less for a time and companies will invest more cautiously. However, this is how economic cycles always end and new cycles start. Just as recessions are ultimately the result of over-expansion (excessive optimism relative to business opportunities), recoveries occur because businesses hunker down too much in bad times. Ultimately this causes businesses to begin expanding again to meet demand - and when consumers slow down their spending, this ultimately leads to pent-up demand. We've had wars, assassinations, political upheaval, energy crises, financial crises, terrorist acts, the break-up of a military super-power and double-digit inflation. September 11th probably has far-reaching implications in how we view ourselves and the world, but the global economy has in the past always proven resilient. We're confident it will again. But we wouldn't pretend to know how or when the recovery will occur in the near term.
- The market is unpredictable over the short-term. We've learned to respect this rule of investing. The markets often do the opposite of what people expect. Though it is hard to imagine a rally now, it is not out of the question. First, cash on the sidelines is at a 20-year high. This suggests that a lot of investors have already hunkered down and that some of this money will make it back into the market eventually. Investor pessimism is extremely high and this is a good contrary indicator because when investors are extremely pessimistic they have usually already done most of their selling. We don't expect a rally but the point is that we don't know what will happen over the short-term. It makes sense to approach long term investing with an abiding faith you will be rewarded for staying invested, accepting uncertainty in the short term, and positioning your portfolio accordingly.
- The financial markets are forward looking. That's why stocks are always a good buy in a recession. It may be comforting to reflect that "when things are really bad, they can only get better." Experienced, smart investors know that the best time to buy is when there is maximum pessimism because that is when stocks are on sale. Yet the reality is that we can't precisely identify the point of maximum pessimism. Still, it's our opinion that things don't have to go too far south from here to be at an extremely pessimistic point.
- In the short run things may get worse still. We don't know what additional short-run shocks to the economy may occur as we work our way out of the damage done on the 11th.
- Emotionally, the feelings of devastation remain, and will for a while. While they remain, as investors we must force ourselves to remove the emotional overlay and continue to make sound rational decisions.