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*Comprehensive financial counsel to individuals, families and trusts*

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January 12, 2002

By normal standards, the -13% return for the US stock market<sup>1</sup> in 2001 was dismal, and the continuing decline of the technology laden NASDAQ stock index, with its -21% (after falling -39% the prior year), was extraordinarily so. But 2001 was not a normal year, and with the traumatic shock of September 11th and the events that followed, it seems that last year will probably not be remembered primarily for its financial events.

As financial counselors who participate in financial events with our clients, we can't help but note that what we witnessed in 2001 was the probable culmination of one of the great pricing cycles of modern times. It showed what happens when investors become transfixed on one type of investment (US growth stocks) and forget about risk and the need for diversification. Hopes and dreams of riches that went unchecked for too long distorted investors' views of what was sustainable. The longer prices stayed up, the more investors thought they would stay up infinitely (or at least indefinitely). Such a manic pricing cycle occurs perhaps once every 30 to 40 years. It appears that investors of each generation – who have neither lived through a momentous market event nor studied its lessons – are destined to repeat the mistakes of the prior generation in one manner or another.

It's now time to look ahead, and so in the enclosed summary we share our thoughts about how to approach the current investment environment. As always, we invite you to contact us if you would like to discuss the implications of any of our observations on your financial plan.

Sincerely,



FREDERIC T. KUTSCHER

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1 As measured by the Standard & Poor's 500 Index, representing the largest 500 domestic companies by capitalization.

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**SUMMARY:**

Traditional asset classes such as the S&P 500 are likely to see single-digit returns in coming years.

Style-based investing is unlikely to work as well in coming years as it has in recent years. We think manager skill will be better rewarded than broad style calls.

Better returns are available outside the traditional asset classes. Currently we favor REITs, High-Yield and Small-Caps.

While the long run of great returns is likely over, the bear market is probably behind us and flexible, smart investors will still be able to earn decent returns.

When we last wrote to you, in the immediate aftermath of September 11<sup>th</sup>, we made the case for not abandoning your investment policy because we believed there were good long-term values in the stock market and in several other asset classes. We also said that we've learned to respect the financial markets' ability to surprise investors in the face of lots of pessimism. As it turned out, stocks delivered double-digit returns in the fourth quarter of 2001. Our clients' portfolios participated strongly in the rally (admittedly, returns varied with the aggressiveness of their portfolio objectives.)

As you know, we try to give our clients an objective measure of their portfolios' performance - called a weighted benchmark - reflecting the individual characteristics of their holdings. For the full year 2001, most client portfolios significantly outperformed their benchmarks. And, while it's hard to get too excited about losing less than the other guy, we're pleased that most of our clients managed to stay in the black or close to it (depending on the aggressiveness of their portfolios) over the two years that ended in December, despite the worst bear market in a quarter century.

Looking forward, we see an investment environment that is significantly different from what we saw in several of the last 20 years. You'll note, however, that many of the themes we describe do not represent a change in our thinking, but some points have evolved. Our ideas have three key points:

**1. Large-Cap U.S. Stocks and Investment-Grade Bonds Are Likely To Deliver Single-Digit Returns**

**Stocks:** Large-company-oriented stock market benchmarks such as the S&P 500 are likely to deliver single-digit returns. Unlike many past bear markets, the market in the last year and a half did not drive stocks down to bargain basement levels. On average - remembering that some years may be better or worse - we expect returns to fall short of 10% per year over the next five years or longer. So while the stock market recovery is likely to continue, it is unlikely to turn into a multi-year double-digit bull run.

**Bonds:** Investment-grade bonds are currently yielding 5% to 6%. It is highly unlikely that total returns will exceed yields by much over the next five years, and they could be lower.

## **2. Style-Based Investing Won't Work As Well As It Did During The Last Few Years**

Although we're not "market timers," we do recommend adjustments in portfolios if fat opportunities appear or, on the flip side, if dangers clearly lurk. Some managers were rewarded for correctly selecting the hottest style over the past four years (for example growth stocks in 1996-98 then value stocks in 2000-01). Looking to the near future, however, we can't detect an advantage to any specific style of investing (growth or value) since both styles appear to be in a fair-value range relative to each other. The opposite was the case in 1996-98 and 2000-01 – first with growth and then value. We also believe that the aftermath of this last market cycle will lead investors to a more traditional fundamental approach toward investing. We are pursuing an essentially a style-neutral approach with an emphasis on highly skilled managers who are not constrained by a one-style mentality but instead look for good companies.

## **3. Better Returns May Be Found by Looking Beyond Traditional Areas**

In the 1990s large-cap US stocks, which account for the biggest slice of the global equity markets, dominated all other equity asset classes including small-caps, foreign stocks and securitized real estate such as REITs. Investors were rewarded for narrowing their focus. Given our expectation of much lower returns from traditional sources, we're inclined to anticipate the exact opposite may occur in the coming years. In other words, investors may be less herd-like and instead will be compelled to look at other asset classes such as:

- ◆ **High-Yield Bonds:** High-yield bonds rallied in the fourth quarter but they continue to be priced at levels only seen in recessions. Traditionally bonds do not perform better than stocks, but in the near and intermediate future we expect that high-yield bonds may garner better returns than stocks. If we had to hazard a guess, we wouldn't be surprised if the return range for the asset class over the next three years may be 12% to 14% (annually) after considering yield spreads and likely losses due to defaults. We continue to recommend a 10% to 20% weighting to this asset class depending on the portfolio type. Investors should note that high-yield bonds are likely to lag stocks if the stock market experiences a powerful, short-term rally. But they will probably outperform stocks if there is a sizable stock market decline. We view high-yield bonds as a respectable alternative to stocks and employ them as a substitute for some investment-grade bonds in balanced portfolios.

- ◆ **Real Estate and REITs:** Real estate is an attractively priced asset class when compared to investment-grade bonds or large-cap stocks. This is true even in light of the strong showing from REITs over the past 21 months. Based on yields currently being in the 7% range and using a conservative estimate of expected growth, real estate securities may also significantly outperform common stocks and investment grade bonds over the next three years, particularly if investors get excited about the potential in real estate.
  
- ◆ **Small-Cap Stocks:** Small-cap stocks have out-performed large-caps by a healthy margin over the past three years. They still sell at a sizable discount to large-caps, however. Small-caps almost always outperform coming out of recessions and for a few years into a recovery. After massive under-performance during the five years ended 1998, small-caps may be on their way to a multi-year run of out-performance, as suggested by their relative valuations and the current economic cycle. By emphasizing managers who tend to buy mid-cap and small-cap stocks, we continue to recommend larger than normal percentages in the small cap area.

## Final Perspective

If we're right about the next few years, the bad news will be that the days of easy money are over (the 1980s and 1990s). We've commented before that we detected that the bear was loose in 1998 and 1999 roaming in the broader market, and the media only discovered him in 2000 and 2001 as large-caps finally fell. The good news is that we think the bear is yawning and showing signs of hibernation. Consequently, decent returns are attainable for those willing to think about other asset classes besides US large company growth stock. And thinking is the key. The past cycle ended badly with investors intoxicated with greed. Now we think investors are likely to stay sober for the foreseeable future and thinking will be once again rewarded.