
FREDERIC T. KUTSCHER ASSOCIATES, INC.

Comprehensive financial counsel for individuals, families and trusts

Due to significant market turmoil, our July 2002's letter took on special importance. It provides an exceptional opportunity to view our thinking and overall philosophy.

Frederic T. Kutscher Associates, Inc. serves 75 clients who have varying goals that are implemented employing individually tailored "investment policies." The July 2002 letter reminded each client of his or her investment policy, reviewed the 12-month investment returns and illustrated the returns of an unassisted investor with a similar policy.

The following is an example of a letter for a client with a policy allocation of 5% cash, 35% bonds and 60% equities.

July 18, 2002

June and July have been Ugly Months

In our discussions with clients, the most frequently asked question this July has been "Should I [we] do anything?" June and July have been so discouraging that even the most rugged investors have to be wondering if their faith in stocks is folly.

It wasn't just June and July, but also what preceded it, that has many folks shaken. Not since the 1930s has the US stock market experienced three consecutive negative calendar years. Unless the market rises by more than 25% over the next six months, that fate is in store for 2002.

With this backdrop, we have an ambitious agenda in writing this letter that includes:

- I. Providing you with an objective look at the markets' statistics, including some data on the less-publicized markets that are nonetheless represented in your asset allocation.
- II. Summarizing and revisiting your investment policy.
- III. Reviewing the total return of your combined investments – or at least those with your primary custodian – in your case, Charles Schwab. Here we note that you, like practically all of our clients, experienced significantly less of a decline in your portfolio than the average investor.
- IV. Providing commentary on the forces that are acting on the markets, how they affect our recommendations, and how your managers are adapting to those forces.

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We return to that very important question “Should I [we] do anything?”

Because we and your managers are continuously adapting to anticipated forces on the markets, we continue to expect your portfolio to experience better returns than the markets as a whole.

What you do, however, may be even more important than what we or your investment managers do. Often we think the greatest value we provide to our clients isn't in beating the market or bettering a blended index reflecting your specific portfolio, it's in helping you avoid big mistakes.

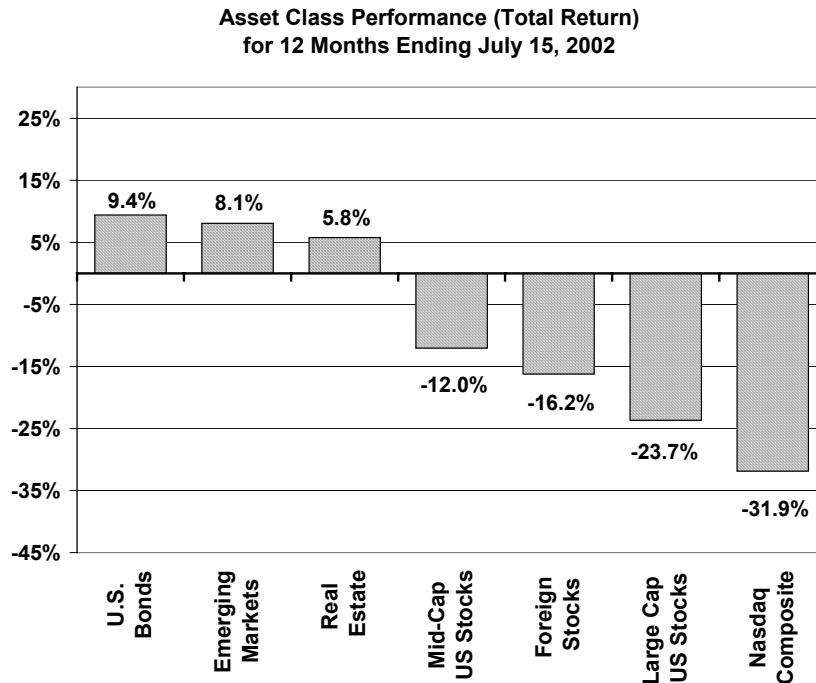
We may be at a point where this coaching is particularly important. You will recall that each year we have reviewed and discussed your “investment policy.” We've often commented that your policy would be tested in bad times, and we've probably told you that the last thing we wanted was to under-estimate the amount of negative return you could stomach. This would cause you to “whipsaw,” a classic move by unsophisticated market participants (note we don't call them “investors”) who bale out and lock in their poor performance at the low point in a pricing cycle.

After reading the discussion that follows, if you'd like to address any of these issues, we encourage you to contact us. We feel it's important you understand that we and your specialized investment managers are continuously employing judgment based on experience and skill to produce long-term results for you that will be superior to those realized by the average unassisted market participant.

I. MARKET PERFORMANCE – VARIOUS CLASSES

Over the last 12 months ending July 15, 2002, the stock markets of developed countries, both US and international, took a beating. Emerging market stocks, however, produced a positive 8% total return. Large-cap US stocks markets¹ declined -24%, and the technology heavy NASDAQ composite trailed eight percent lower with a -32% loss. Some individual sectors have fared worse with telecommunications down -64% and biotech -49%.

¹ Unless noted otherwise, we'll measure the performance of the US stock market by using the S&P 500 Index, which measures the performance weighted for capitalization of the 500 largest companies in the US.



There were a few bright spots domestically. In the US markets, bonds did well, returning over 9%, and with real estate stocks returning almost 6% for the twelve months.

These are not all the asset classes represented in our clients' portfolios, but the results provide a flavor of the market forces at work. Since the US large company stock market (which lost -24%) gets most of the media attention, it's easy to fall into the trap of forgetting other markets did moderately well.

II. A SUMMARY OF YOUR PORTFOLIO'S GOALS , INVESTMENT POLICY AND WHAT A COMPARABLE INVESTOR HAS EXPERIENCED OVER THE LAST 12-MONTHS

Perhaps we're *discipline* nuts, but we think this characteristic has saved our clients a great deal of anguish in these hard markets. You will recall that our practice is to start by establishing your "investment policy" based on your goals and tolerance for market volatility. We make a point of reviewing the policy every year.

Your investment policy embodies long-term guiding principles that, once established, should be retained unless your long-term investment goals change. It usually remains consistent from year to year, unlike the tactical aspects of your portfolio that we adjust intermittently in response to your financial needs and market opportunities.

Your primary investment goal has been to **achieve long-term growth focusing on investment performance over five years or more. You will accept volatility.** Your long-term investment policy allocation between major types of assets has been approximately **5% in cash, 35% in bonds, and 60% in stocks** and other equities. From

time to time we adjust the policy guideline to accommodate your cash needs for the short term, but the policy guideline provides a fairly reasonable picture of how we could expect your portfolio to have done over the last twelve months. For example, we know that for the twelve months ending July 15, 2002, cash investments generally returned about 1.6%, bond investments returned about 9.41% and the stock market returned about -23.66%. **So we would expect an average unassisted investor who invested with a similar allocation of cash, bonds and stocks would have realized a return of -11% for the same twelve months.**

III. A REVIEW OF YOUR PERFORMANCE

Your actual total return for the same twelve months on all your investments at Charles Schwab was -8% net of all costs including our fees. While the expected return described in the previous paragraph is not derived with the precision that we employ when we draft your annual report benchmark, it does provide you with a sense of how your results compare against those of a hypothetical investor with a similar long-term investment policy.

One other point is worth mentioning here. Many of our clients have asked how bad things can get. In your last annual report we estimated that the worst one-year performance in 50 years for a hypothetical investor with an investment policy fairly similar to yours was -13%.

At the risk of tempting fate, we note that neither you nor any of our other clients who has a diversified portfolio has reached or exceeded the losses of a hypothetical investor (without financial counsel) or your worst-case number, even though by several

² These figures are based on the following index returns for the 12 months ending July 15, 2002: Thomson Financial Money Market Index (for cash); Lehman Brothers Aggregate Bond Index (for bonds); and Standard & Poor's 500 Index (for stocks).

³ This figure is a total return after considering all costs including our fees. It does not factor in, however, any additions or withdrawals you may have made to your accounts. It is also important to note it excludes the results of investments held outside Schwab, if any.

⁴ This worst-case estimate is adjusted for short-term reserves of cash so it may be more conservative in a given year when you have extra cash that reduces volatility. This one-year negative return limit has a 95% probability based on a historically comparable diversified portfolio (using statistics from 1946 through 1999). To the extent a portfolio contains a concentration in one security or an economic sector, the historical data have less relevance and volatility will be higher. This figure does not represent an absolute "worst case" scenario in the future, but it is believed to represent likely outcomes. Of course, on any given day or for any given month the markets can be more volatile.

measurements this market has been the second worst in living memory. This reinforces our assessment that you've been on the right path. If you are spooked by the worst-case number, now that you've had some experience with negative markets, we'd like to revisit the topic of how much patience and risk tolerance you may actually possess.

IV. REFLECTIONS ON THE MARKET

June ended a wretched quarter for the US stock market, leaving the market down -13.1% for the year through June. As of July 15th stocks had receded further, closing down a bit more than -20% for the year, meaning that it would take more than a +25% increase over the next five and half months to avoid the fate of the market's return being negative for three years in a row (in terms of the math, remember it takes a 100% gain to offset a 50% loss).

With all the attention and media on the stock market in general, and specifically on news-making companies like Enron, Worldcom, and Merck, it's easy to forget you have an investment policy with a component of bonds and cash that make your portfolio less volatile than the stock market as a whole.

There is no denying, however, that stocks have had the dominant influence on your portfolio, so we'll devote the remainder of this newsletter mostly to stocks. We're more than ready for something better, and we badly want to believe the stock market is set up for a great run. If you've known us for any time, you know that we are basically hardwired as contrarians. This means we usually recommend staying the course, thinking of big spikes, up or down, as potential overreactions. After three consecutive years of rotten performance for the stock market it would be easy to think the stock market is positioned for a huge new bull market. So how does this decline stack up as a buying opportunity?

The recent sell-off of the US stock market means there could be a short-term rebound, but we'll stick with our outlook of single-digit returns over the next few years.

You will recall in our last newsletter we spoke about the excesses of the "greater fool" or "castle in the air" theory, meaning it would take some time, perhaps many years, for the markets to digest these excesses. As we write this, however, the US stock market has declined to a level that is beginning to look somewhat attractive. From here (with the S&P 500 at 917) we wouldn't be surprised to see a run that could take stocks 10% to 15% higher from current levels in the near term. But if that happens stocks would probably no longer be undervalued. From a longer-term standpoint this is the problem we keep coming back to. Most stock managers and consultants we respect are expressing a lack of enthusiasm about the opportunities they are seeing, supporting our view that stocks look okay but not great from a valuation standpoint.

⁵ Incidentally, it bears repeating that we think, at least conceptually, of real estate and high-yield bonds as stocks because they share many of the characteristics of common stocks both in returns and volatility.

In looking backward to assess the potential for another bull market, it is crucial to realize that the huge bull run of the 1980s and 1990s was largely driven by falling interest rates—a scenario that won't be repeated without a sustained rise in interest rates that would first depress prices.

One thing we know – and this was the substance of the Warren Buffet piece from *Forbes* we sent you in April – the valuation of the market is negatively correlated with interest rates. In fact there is a logical reason for this. When investors price a stock, they look at the value of expected profits for the company in the future and what those profits are worth to them in today's dollars. When interest rates are high, those future profits are worth less presently than they would be if interest rates are low. This is one reason you want inflation rates to be low. Interest rates are low now (ten-year Treasury yields are at 4.58%), and it is this low rate that supports higher prices for stocks. It wouldn't take much of a blip up in rates to make stocks look expensive again.

Buffet and others have pointed out that the amount investors were willing to pay for a dollar of company earnings, which is mathematically tied to interest rates, expanded massively with the falling interest rates of the 1980s and 1990s. In short, falling interest rates provided a massive tail wind for the stock market. But now, with rates low, there may be no tail wind at all. And while a stable, low interest rate environment would be beneficial for the market, it won't drive it to lofty levels.

Valuations and the lack of an interest rate tail wind are the basis for our general view that stock returns will be in the single-digit range for a number of years to come (on average).

Other factors besides interest rates also inhibit the stock market from turning bullish (and could drag it down further)

Besides the valuation/interest rate argument, it seems to us that there is a longer-than-average list of problems for the US stock market that are difficult to brush aside, including:

- ***A scale-back or reversal of foreign capital inflows.*** Foreigners invested \$386 billion into US stocks in the three years that ended with 2001. This year the pace of flows has dropped by about 50%. With the US image somewhat tarnished relative to other markets and foreign investors already heavily invested in the US as a safe haven, there is the risk that foreign investment will slow further or reverse. We don't know if this will happen but it's worthy of mention.
- ***Unethical corporate management.*** Whether the actions of specific individuals or companies were criminal will need to be determined, and if criminal, then the perpetrators should receive sentencing that reflects upon the crimes. At the same time a different type of trial is underway – a media and public opinion trial where the rules are quite different. We believe there is some overreaction, but there is no question that we were in an environment where far too many management teams were at least “ethically challenged.” Regulation, prosecutions, embarrassments and investors generally paying attention (they

weren't during the bubble) will all drive change in behavior and will address the corporate governance issue, potentially making this a temporary phenomenon. Our guess is that there is probably another shoe, or two, or three yet to drop, but to put things into broader perspective, we believe that management at the vast majority of public companies is honest. We say this mostly based on feedback from fund managers we know and whose judgment we trust. Still, regardless of our expectation that corporate governance will improve, the headlines will be another factor that will contribute to a general lack of confidence that could chip away at the "equity culture" and lead to lower price/earnings multiples.

- ***Accounting practices (crooked number-crunchers or a policy debate?)***
When investors aren't sure of the numbers they are given by corporations, they lack conviction about how much any company is worth. This is clearly a root cause of the market's woes. Uncertainty about the numbers derives from lack of trust in management integrity and accounting practices. We don't know the degree of shenanigans that have been going on, but having discussed corporate ethics above, we turn now to accounting practices. This is an area where the grown ups need to be in charge – or at least people with experience who can separate reality from hyperbole and apply good judgment. Marty Whitman, whose firm manages the Third Avenue funds that are represented in many of our clients' portfolios, contends that US accounting standards are excellent. He goes further to point out that accounting cannot be all things to all people. In his words:

“The Securities Acts Amendments of 1964 sparked a disclosure revolution that is still ongoing. Today, for trained bottom-up fundamentalists, [generally accepted accounting practices have] never been better, provided more information or been more reliable, the Enrons of this world notwithstanding.”

“It is much more important for the U. S. economy to have its accounting systems geared toward informing creditors in a meaningful fashion than it is to have accounting systems directed toward meeting the perceived needs of outside passive minor investors.”

We think Whitman's points are at the heart of the important policy debate about how to account for stock options. This is a healthy debate, but it should be noted by everyone who is willing to listen that an honest policy debate should not be confused with issues of corruption and integrity à la Arthur Andersen, Enron, and (probably) Worldcom.

- ***Terrorism.*** Then there is the terrorism wildcard. Many potential terrorist acts that worry us as citizens would probably not have a far-reaching economic effect. If, on the other hand, worst-case scenarios involving weapons of mass destruction ever come to pass they would probably be accompanied by severe economic impacts. This is not priced into the market (nor should it be—it is far too uncertain). Worst-case scenarios rarely happen and we've always tended to discount them. Five or ten years from now we all hope to look back and say our

fears of a worst-case scenario were only fears that did not materialize. But there are many credible non-alarmist types who believe the risk is disturbingly high. At the very least the risk will lead to more defense and homeland security spending. These are not productivity-enhancing activities.

So Where Does This Leave Us?

First, there are important positive features about US stocks that shouldn't be forgotten.

Stocks are generally much cheaper than they were two years ago, and we are very likely to see a decent company earnings rebound over the next year. The economy is clearly recovering, and that's what could drive a rebound in the stock market. We don't make short-term bets but we'd put the odds on such a rebound as high. And it could be temporarily powerful. There is a lot of cash being held on the sidelines that could fuel a market recovery.

But given all the risks, many investors are probably wondering if stocks will become a screaming buy or whether they will fall more. And that begs the next question: Should we gamble one way or the other by increasing or decreasing stock allocations? Our answer is "no." Most of our clients are currently a bit under-weighted in stocks, because we've placed a tactical emphasis on real estate and high-yield bonds. Also, if stock returns are disappointing (low single digits), they are still likely to compete well against cash and bonds that are defensive alternatives.

At two-and-a-quarter years into a bear market, it is worth noting this period of market weakness is already very long from an historic perspective. The compounded five-year return on stocks is now only 3.6%. History and valuations suggest the odds are heavily stacked toward decent returns over the next few years after such an extended period of lousy performance. These decent returns could very well be front-end loaded with above-average returns over the next six months to a year. If it is likely that we can capture decent returns in the stock market, why get defensive by selling stocks and keeping the cash or using the cash to buy bonds in a gamble that these bonds will do better than stocks? Doing so risks missing out on full participation when the market does rebound. Of course it is possible that stocks could fall more, maybe even another 25% in what we would think of as the worst-case scenario. But, this is unlikely, and if the market does sell off further, then stocks are very likely to be positioned for a very powerful rebound.

Second, we believe you are invested with superior managers who will continue, on average, to provide higher returns than their benchmarks.

So while we focus our market assessments on the market averages, we expect our managers to outperform those averages. It's worth mentioning that the brief love affair with individual stocks at the expense of mutual funds at the latter end of the bull market seems to be reversing. The diversification offered by funds and the realization that *good* professional management can make a difference has again underscored the common-

sense appeal of funds. And while there are only a handful of great funds out there, we believe finding them is one of our strengths.

We believe high-yield bonds and real estate (meaning real estate investment trusts and stocks of companies holding real estate) offer quite attractive long-term return potential. They are in our “fat pitch” categories, which means they have a significant chance of outperforming the stock market. As we rebalance client accounts we are also increasing the amount of foreign stocks, which we think, while not a fat-pitch, offer a somewhat better risk/reward relationship than US stocks. We address each category in a little more depth below:

- 1. Real Estate:** We have decided to stick with our real estate allocations (we had been reassessing this after their big runs in 2000 and 2001). The fact that real estate fundamentals are weakening and that real estate has had a fantastic run could suggest that real estate exposure should be reduced. But we’ve concluded that real estate remains a fat-pitch. It’s true that fundamentals are weakening and have been for a while (as we expected) but the deterioration is cyclical. From a long-term standpoint we believe fundamentals for real estate are solid. As for valuations, real estate funds are no longer cheap compared to underlying real estate values. But, we believe underlying real estate values are very cheap compared to financial assets. And unlike most of the 1990s, today’s expectations for low returns from financial assets give investors an incentive to search for investment alternatives that offer a decent risk/reward trade-off. Real estate offers a high level of income and an asset that should deliver moderate growth. High single-digit returns seem very realistic with some possibility of doing a bit better. We believe this will appeal to investors and support moderate appreciation to go along with a healthy yield.
- 2. Foreign stocks:** We think foreign stocks offer somewhat better return potential overall compared to US stocks. There are several reasons to be optimistic, including an overvalued dollar (foreign stocks are benefiting from currency gains, though these will be offset in some cases by a reduction in export competitiveness), better valuations (European stocks recently sold at a 28% discount to US stocks and for emerging-markets stocks the discount is even higher), fewer economic excesses to be worked off relative to the US, the tarnished US image (see corporate governance above), and the risk associated with the large US current account deficit.
- 3. High-Yield Bonds:** High yield bond managers have had a rough quarter too. Has our emphasis on high-yield been a mistake? This move has not yet added value for you, though it has not been too costly. The asset class has done better than US stocks. We remain patient. We are still highly confident that borrower defaults on bonds will decline, as they always do coming out of a recession, and when that happens investors will come back to high-yield bonds, as they always do. That will lead to rises in the price of these bonds, which coupled with the double-digit interest yields (and fewer defaults), should result in solid returns. We continue to be convinced that, in the near and intermediate term, high-yield bonds’ potential returns are superior to stocks or investment-grade bonds and that the risk of investing in high-yield bonds is lower than for stocks.

Growth v. Value and Large v. Small: evolution continues.

Over the past two years value stocks have moved from under-valued levels up closer to fair-value levels, while growth stocks have moved from massive over-valuation down to fair value.

With respect to market capitalization, we favor small and mid-cap stocks over large caps, as we have for some time. This advantage is not as good as it was, but some advantage remains and smaller-cap stocks almost always outperform larger cap early in the economic cycle, which is an important reason to keep small and mid-cap stocks in your portfolio now.

In Closing

This is the toughest investment environment we've experienced in our eleven years as an independent firm. Nevertheless, our philosophy, our emphasis on superior independent managers, and discipline in executing your investment goals give us a high level of confidence that you should have outcomes better than the markets as a whole. We remain focused, disciplined, and diligent in our research. We continue to assess risk based on a one-year time horizon and base our decisions on a three-to-five year horizon.

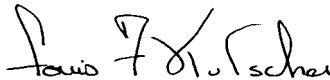
Looking forward we believe we are continuing a transition to an environment that will be characterized by a return to common sense. Value and good fundamental analysis will be rewarded, as will honesty, integrity and accountability. These are traits we've never lost sight of and any environment that emphasizes these is one that we believe plays to our strengths. Our ability to look at a broad spectrum of asset classes, search for the most skilled managers to implement our asset class tactics, and to do so absent any conflicts of interest, puts us in a strong position to add value.

These are the same attributes that helped us mitigate the damage the market has dished out over the past few years, and we believe these same strengths will serve you well in the investment climate we expect to see over the next few years.

—Frederic T. Kutscher Associates Inc.
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