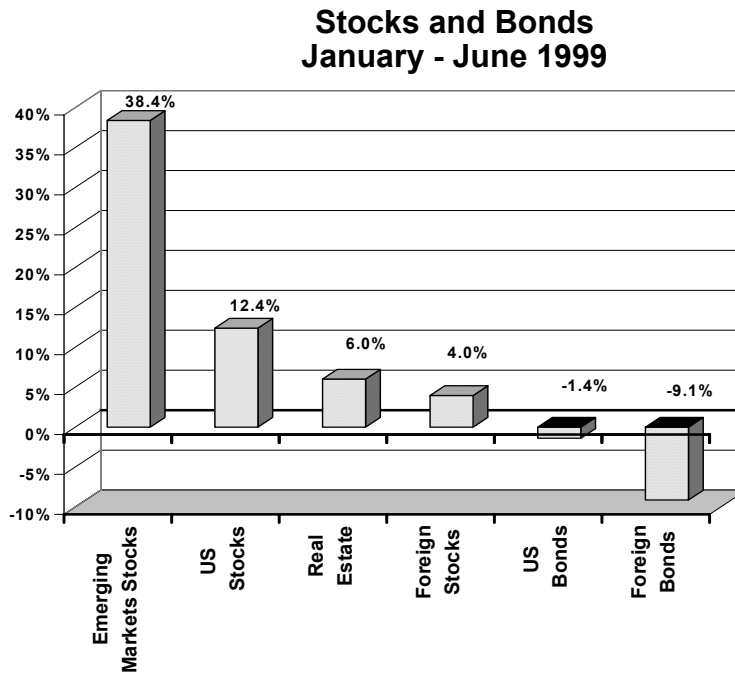


July 28, 1999

There can be little doubt that we live in exceptional economic times. And the continuing US market gains and world volatility of the last half and quarter confirm it. We think you'll find the enclosed copy "How real is the new economy" from this week's *Economist* thought provoking. It shows why we continue to recommend diversification among industries and asset classes.

**Volatility in US and Foreign Markets Continue**

With the first half of 1999 completed, the capital markets are showing varying personalities and contrasts to their 1998 performance.



The domestic and foreign bond markets, after a very respectable 1998, are down so far this year. Domestic bond markets reacted negatively when the Federal Reserve increased interest rates in June. Some sectors of the bond market went down almost 7% year-to-date (30 year US Treasuries), but the broader US bond market fared much better (as measured by the Lehman Brothers Aggregate Bond Index, which was off 1.4%).

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The US stock markets continue to roll on with good positive returns, although when defined by size and relative style, the leaders of 1998 have exchanged places with some of last year's laggards. Large and small value stocks performed better than growth stocks for the first half of 1999, after trailing for several years. For example, small value stocks returned over 8% so far this year compared to a 2% return for small growth stocks. US real estate and foreign emerging markets stocks have recovered most of what they lost last year.

In summary, while our bias continues to be toward managers who search for value, the markets remain potentially quite volatile, and we continue to find wisdom in long-term diversification using large and small, value and growth, US and foreign securities.

### **Planning for the Costs of Education**

The fact that education costs are rising more rapidly than the overall inflation rate is not big news. The rate of tuition increases at some private colleges has trended lower recently, but the total cost of education is truly staggering. To send a child born today to an average private college for four years is projected to cost \$218,000. That figure rises to \$270,000 at more expensive schools.

We routinely work with clients on planning for their children's education and have developed estimates regarding how much should be saved and invested to meet education costs. These cost estimates (available for both public and private colleges) are based upon studies done by *The Princeton Review*. We then apply what we believe to be reasonable assumptions for investment returns, inflation rates, and tax ramifications. If this information would help you in your education planning, or if this approach would be helpful in other areas of education planning, please let us know.

### **Lower Expense Ratios Contribute to Higher Returns**

In recommending managers to our clients, we've made low expenses one of our priorities. Recent research by Morningstar and Bloomberg (two investment research service bureaus) validates our approach. According to them, managers with the lowest expense ratios are most often the best performers. With the exception of funds focusing on smaller capitalized stocks, there appears to be a very high correlation between low expenses and high performance.

We've reviewed our favorite managers' expenses against the fund ratios in the study and found the vast majority of the funds we recommend have expenses well below the average fund ratios cited. Foreign stock funds generally have the highest expense ratios and bond funds the lowest. Although no reason was cited for the correlation between expenses and performance, one possible theory is that the funds charging higher expenses are pursuing exotic strategies (taking higher risks) that are not translating into higher returns; so the higher expense ratios are seldom justified.

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Next quarter we will be discussing another important criterion for selecting managers for taxable accounts: tax efficiency.

## **Indexing Versus Active Fund Management**

“Indexing” is a topic you’ve probably read about, discussed with us, and thought about when reviewing your customized annual reports. We’d like to summarize our thoughts on the matter.

The investment industry has adopted various benchmarks to measure performance of securities and managers. Each benchmark is a group of securities selected by firms such as Dow Jones, Standard & Poor’s, Morgan Stanley and so forth. The method of computing investment returns of the securities groups varies according to criteria set by the firm managing the benchmark. There are hundreds of different indexes, some measuring the broader markets and some measuring selected types of securities within a given market.

“Indexing” is the process of purchasing and selling securities to perform like an index. A manager of an index fund buys and sells investments to match the composition of the selected index. For example, Vanguard manages the well-known Vanguard Index 500 fund to contain substantially the same companies and amounts of securities as the S&P 500 Index.

“Active” management, in contrast to indexing, depends on the expertise and judgment of the manager to succeed. Actively managed funds typically have higher costs than index funds because the managers must research and investigate countless companies in many geographical areas, not merely imitate the composition of an index.

In recent years a debate has emerged about whether it is better to use indexing or active management.

Where we stand:

First, we differentiate between the concepts of benchmarking and indexing. We believe in benchmarking to an index because it provides a context to judge a manager. For example, when the Morgan Stanley EAFE Index (measuring international stocks) is up 5.84% year-to-date and Hakan Castegren’s Harbor International is up 9.5% year-to-date (one of our preferred international managers), then we are pleased. In this instance, the index provides an apples-to-apples comparison, and without it we wouldn’t know whether to be happy with Mr. Castegren.

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Indexes are not always “apples-to-apples.” As noted above, an index can provide a good benchmark, but this isn’t always so. A case in point is the Russell 2000 Index, which is intended to measure the performance of small US companies. Until June 30 of this year, this index held America Online (AOL), which became a very popular stock and one of the largest capitalized companies as its price reached 600 times earnings! Because Russell’s policy is to reconstitute the index yearly on June 30 and not before, the index became less and less representative of the performance of small companies as AOL grew.

While the term “indexing” connotes inactivity, and while it implies the fund is on autopilot, it is important to note that the index creator periodically changes the securities in the index. Funds that follow an index must purchase or sell securities based upon the index’s changes. The index firm is the decision maker. This is not necessarily bad, but the previous example about the Russell 2000 illustrates the point. An active manager whose mandate requires the purchase of small company stocks and who was measured by the Russell 2000 (for example Marty Whitman who runs Third Avenue Value) would probably not have continued to hold AOL.

In conclusion, there is a time and place for index funds – in general, it’s when an investor can’t effectively choose funds that outperform indexes. (You also must have the appropriate index fund available for purchase, and many indexes don’t have mutual funds that efficiently track them.) But on the whole our experience and research shows the active managers we recommend usually outperform their respective benchmarks (and comparable index funds) *after expenses*.

Your annual report provides a comparison of your managers and their benchmarks. The goal is to employ active management which beats the collective benchmarks. This isn’t achievable every year after we factor in our overall comprehensive planning costs and Schwab’s transactional costs, but we frequently do reach our goal of exceeding benchmark returns.

Please contact us if we can assist you in planning for education, questions about the markets, or any other matter involving financial issues. We hope you’re having a great summer.

Sincerely,



Frederic T. Kutscher