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Commentary
Fall 2002

The Market

The stock market finished the third quarter of 2002 with its worst performance since the "crash" of 1987. The S&P 500 Index of blue chip companies was down 15 percent in the third quarter alone and it is now down 29 percent for the first nine months of this year. The NASDAQ is down 40 percent so far in 2002.

The Rikoon-Carret US large company stocks declined 25 percent during the first nine months of 2002. The corporate bond market index has risen 4.4 percent while Rikoon-Carret's taxable bonds have gained 5.84 percent. The tax-free bond market has gone up 7.28 percent versus our municipal bonds which advanced 5.26 percent.

Due to the continuing challenges of this market environment, we are publishing and including herein a special report called "Investment Outlook - Fall 2002." The cover page of this special supplement has a short summary which gives an overview of our market outlook.

War and the Stock Market

Current events are roiling the stock market and for good reason. Unsettling events seem to be leading our country inextricably towards military action in the Middle East. This has led many observers to conclude that until there is a clear resolution to our country's political uncertainties, investors will remain on the sidelines.

At this point in a normal economic cycle, one would expect to see consumer confidence and business activity recovering. The reason this is not so has as much to do with politics as it does with economics. There is a direct relationship, I believe, between the dearth of honest leadership on the part of politicians and the continued weakness in the stock market. Both factors play into the high level of malaise that is driving the market downwards.

Our market system runs on faith in the future. When business leaders and elected representatives are more responsive to corporate donations than to public opinion, we have a very serious problem. The disparity between corporate and political public relations pronouncements and the reality we see with our own eyes is too wide to ignore. Corporate management interests have diverged so much from the interests of common

stock shareholders that even the august Federal Reserve has taken note. Recently, New York Federal Reserve Bank President William McDonald spoke about the disparity between CEO compensation and the average worker's pay. He challenged executives and boards to voluntarily cut their pay. McDonald said, "The policy of vastly increasing executive compensation was . . . at least with the brilliant vision of hindsight, terribly bad social policy and perhaps even bad morals. If the best companies lead the way, the market economy, through the stock market, will force other companies to follow."

Jack Welch, former head of G.E., the U.S.'s largest company, responded by publicly renouncing some of his tens of millions of dollars in severance, but at the same time, he described these millions as being "justified". The evening news is replete with revelations of novel accounting methods that served to enhance managerial compensation by the executive actions that manipulated their company's stock values. This is further evidenced by the fact that over 1000 public companies have restated their earnings over the last year.

In the political sphere, a politician's desire to be re-elected is similar to a corporate chieftain's efforts to enhance his or her own compensation. Both involve a manipulation of the information presented to the public so as to confuse and distract attention from the underlying issues of personal greed, selfishness, and egotism.

The question now is how can ordinary citizens and individual investors express their preferences? The general disillusionment I see amongst shareholders and voters does not bode well for the future of the equity markets or for a functioning democracy. The goal here is to get both the stock market and the political process back on track.

The stock market hates uncertainty. Many Americans worry about the Bush Administration's current military policy. The unknown repercussions of a U.S. - British strike is to what extent it may possibly galvanize the radical, fundamentalist and economically desperate segment of the world's Islamic population. Action taken without UN auspices increases the likelihood of future disruptions to the U.S. economic system. People assume that war is good for the economy, but a prolonged war could be a further blow to a precarious recovery.

Politicians have exhausted the traditional tools available to stimulate growth over the last two years. We have seen lower interest rates, increased money supply, cuts in taxes, and heavy government spending. By and large, these government actions have not worked. In order for the market to improve, there has to be a strong belief on the part of individuals that saving, investing, and working hard will have their eventual benefits. The natural tendency right now is for investors to want to get out of the stock market and sit in cash. Since bond rates are at their lowest level in 40 years, investors cannot achieve an income above 5% unless they are willing to take on a high degree of risk.

Stocks may now be undervalued in a long-term sense but given the current level of anxiety and uncertainty, they are unlikely to move upward until there are long-term resolutions to the "faith" problems described above. There is a siege mentality in the markets right now, and it could last a while. It may take more than the passage of time for the public's distrust on corporate America to pass. Helpful actions would be for true reforms to take place in corporate compensation, the reversal of tax policies that favor international companies over local communities, and an end to the influence of corporate money on politics at all levels. These complex and largely taboo issues need to be addressed for the markets to thrive again.

There is a palpable fear level present in the minds of most investors, and it will not pass with a regime change in Iraq. The move on the part of many investors to liquefy their holdings, already in progress, could intensify with a long-term conflict or if additional terrorist activity occurs. These deplorable things would, no doubt, adversely affect real estate values and consumer spending as well.

The foundation of our investment system is the belief that if one works hard, eventually one can retire and enjoy a reasonably good life. If business and political leaders don't step up to the plate and tell the truth, it is unlikely that retirement for most people will be comfortable or secure.

Sacrificing some of our personal conveniences and comforts is one way we have of expressing our desire for change. Simple steps such as refusing to buy goods produced by national and international corporations in favor of locally produced goods would severely challenge the economic structure and force change in the political process.

Thoughtful questions, such as those posed by Texas Republican Congressman Ron Paul on his website, www.house.gov/paul, need to be addressed. The mainstream media and Paul's colleagues in the House of Representatives have all but ignored the important issues raised in his speeches. In the end, it will be up to you and I as the true owners of public companies to exert our influence on the mutual funds and pension organizations who in turn can insist on changes in how companies act. A complete revamping of political and executive privileges are in order so that the public's confidence and faith can be earned back by those to whom we have delegated our collective future.

The Economy and Ethics

How much money should the corporate executives of the stocks we own earn? Do they deserve millions of dollars per year? Pearl Myer and Partners, a consulting firm, said that the average head of a U.S. publicly traded company made 4.3 million dollars per year during the 1990's, counting all aspects of corporate compensation. Over the course of that decade, the average CEO of all U.S. companies saw 20 to 40 percent increases each year while the average employees of these companies were barely staying even with inflation. Corporate CEO's in the U.S. now earn approximately 209 times the pay of an average employee. This is in stark contrast with Japanese CEO's, who make nine times as much as a typical worker in their companies.

The enactment of the new "Truth in Accounting Reports" law went into effect in August, but it entirely failed to address the underlying dilemma of the salary inequities. There is a real lack of access to information about corporate chieftans pay, and this leaves investors with a feeling of unfairness about the markets. CEO's are still, in many people's minds, a kind of hero and they evoke envy due to their privileged lifestyle. It is disheartening to individual investors who are stuck with moribund stock prices. Since the mid-1980's, it has been individuals at the top of the corporate ladder who have prospered while the rest of working America have struggled to put their children through college and keep pace with increased cost of basic living. The tax rates on personal income of the very rich are lower in our country than in any other industrialized nation. Executives here also have found ways to shield much of their income from taxes, thanks to complex

stock options and company owned life insurance. Since executives and the top 1% of earners in the U.S. own much of the stocks and bonds in this country, the super wealthy should have been hurt the most by the recent declines in the stock market. Yet I believe the consequence of the market downturn has affected middle-income wage earners more acutely because people dependant on their profit-sharing or 401(k) plans to ensure a secure retirement have little else to fall back upon.

Since the mid-1970's, the purchasing power of workers in the United States has fallen. This includes the plight of middle managers, salespeople, and workers in most service industries. This is one reason why so many Americans are now in debt and why personal bankruptcies have risen by 30 percent. Gary Burtless, an economist at the Brookings Institute in Washington, says that for 60 percent of American families, the current combined incomes of two wage earners buys less now than what one person's wages could purchase 20 years ago.

Japan's cultural policy of top management getting only nine times the pay of an average employee's wages may not ever be emulated by our system. Implementing a change in this direction would free up capital that companies could use to invest in the long-term future of the local communities in which they operate. An increase in the minimum wage to a living wage would be another step towards a more equitable pay scale for corporate employees.

History has shown us that when people in power ignore the problems of widespread inequality and dissatisfaction the consequences can be severe. Curtailing excessive executive compensation, installing taxes on short-term profits generated from speculative trading activities, and providing protections for natural resources are a precondition for sustainable growth. These are important issues and they are not likely to be solved merely through an act of Congress.

Other Asset Classes: The Search For Income

Many investors are asking us about alternatives to stocks and bonds. Interest rates on US treasury bonds are currently at 1.7% for 6 month T-bills, 3.13% for 5 year T-notes, and the long-term 20-year US Treasury bond is only paying 4.94%. These are the lowest rates since the 1960's.

Real estate, as an alternative investment vehicle, has some appealing aspects. Like all investments, it has both positive and negative aspects and it is crucial to remember that real estate is just another type of investment. It has its own cycles. Our estimate is that prices of the homes in most metropolitan areas are fairly near their peak. There exists today a dangerous assumption reminiscent of the 1990's attitude towards stocks, by many investors, that real estate is "a sure thing". As in all investment areas, the key to a good investment is buying at the right price. Here is a way to estimate if a piece of real estate is of "value".

One way we try figure out the underlying value of a piece of real estate is to use the capitalization rate, often referred to as the "cap rate". If we know what the net income will be, that is, the income that clients can put into their pocket after paying real estate taxes, building insurance, repairs and maintenance, and any management fees. If we expect a thousand dollars a month, we multiply by 12 to get $12,000 per year, then divide the $12,000 by 8%, the expected before tax rate of return to arrive at a value for

the property of $150,000. If the expected net after net income is $2,000 per month, it would indicate that the property is worth around $300,000.

Many people assume that the appreciation of real estate is a "sure" thing. Here are a few aspects of real estate that are possible to know. First, it takes time to manage property, often-considerable amounts of time. Dealing with city and county ordinances around here is a considerable hassle. Rental properties also involve being a landlord. While there are useful aids to establishing straightforward relationships with renters, there are always challenges dealing with the various kinds of people one encounters as tenants. We often can contract out these services to management companies, who are skilled in checking references, collecting rent, inspecting properties for damage and dealing with other ongoing issues. Management companies can be fairly expensive, but they work hard for their fees and serve to relieve much of the hassle factor involved in direct ownership of real estate.

Real estate investing involves an ongoing cost of repairs and maintenance, though it is possible to write a lease that passes along these costs to renters. This is called a "net lease." There are "triple net" leases where the tenant pays for taxes and insurance as well as repairs and maintenance.

In my experience, anything that can go wrong with buildings will! Any job that needs to be done will likely need to be redone at least once. So we figure in the time and money needed to supervise the activities involved in keeping a property in good order.

One decision to be made regarding real estate is whether or not to have a mortgage. In times of rising real estate prices, borrowing money to buy property is generally a good investment move. This is true when the rate of appreciation one receives is higher than the rate of interest one pays. Often, investors end up paying high rates of interest on their mortgage while struggling with low or negative cash flow investments. We really don't know for sure if borrowing makes sense until the property is sold. A good guideline is not to invest in property that can't pay its own mortgage.

There is a myth that having a mortgage is good because the government is paying for part of interest costs through the tax deduction for mortgage interest. However, if the rate of total earnings, after tax, on the real estate is lower than the money paid out on the mortgage, it doesn't make sense to borrow money. Taking a deduction on our income tax return makes us feel good; paying interest in general feels pretty bad. Today, we are advising many clients to pay down their mortgages.

We are always aware of the lack of liquidity in real estate. This means it is difficult to change your mind and investment strategy if things don't work out. As a rule of thumb, I advise people to buy real estate only if they plan to keep it for five years. The cost of buying and selling real estate, as well as fixing it up, are expenses that involve a considerable outlay of cash. Real estate can sometimes be liquidated quickly, but it often takes years. Patience is not just a virtue when it comes to investing in real estate; it is a necessity. Looking for good tenants, searching for appropriate brokers, or fixing things up in order to get maximum value all take time and effort.

With these caveats, real estate can be an excellent addition to an overall portfolio. It should not comprise too big a portion of one's overall assets. Our thoughts are that one third real estate, one third stocks, and one third bonds is a good diversification guideline. This is one way to deal with the uncertainty about the future. No matter what happens,

one of these three types of assets should provide steady income and financial security to a family.

Personal Notes

We are please to announce the addition to our staff of Jeff Sand, who is serving as a Portfolio Manager. Jeff comes to us from Charles Schwab where he was responsible for client security selection and relationship management. Denise Johnson joins our firm as a receptionist/file clerk. We affectionately call Denise our "Document Diva."

Juliana's big event was a 2-week float trip through the Grand Canyon in late September, celebrating her husband's 50th birthday. Stephen and Patricia both decided Spain was the place they had to see this year, so we have been treated to two separate reports about how wonderful it is these days in Europe. Beth is open to offering a private seminar for our clients on James Joyce's *Ulysses*, so if you would like to read this opus with a group, please let her know.

This year has turned out to be a sabbatical for me in terms of athletic competitions. It is great to be traveling less and painting very early most mornings on my chapel project. Please let me know if you would like a studio tour, as after three years, the first two of four walls are ready for public viewing.

We will hold our next afternoon "tea" here, at the office, 510 Don Gaspar, on Thursday, November 14th at 3:00 p.m. Refreshments will be served and as always, you are welcome to bring a friend. We look forward to seeing you.

Our hopes for a tranquil autumn season go out to all our readers.