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Commentary
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Year End Returns

2000 and 2001 will be remembered as the worst two-year period for the stock market since the early 1970's. On the other hand, taxable bond prices increased sharply as the Federal Reserve Bank lowered interest rates eleven times last year. During 2001, the U.S. large company stock market, as measured by the S&P 500, declined 13.04% while the technology market index declined 21%. The blue chip index for non-U.S. companies declined 22.61%. This continued a long-term bearish trend for international stocks. In comparison, the Rikoon-Carret U.S. stock portfolio declined 14.19%, while our international stocks declined 21%.

The U.S. corporate and government bond markets experienced a very strong rally in 2001, due to investors leaving the stock market to look for safety in high-quality bonds. The Dow Jones 20 Bond Index returned 6.04%, on a price basis, while the Rikoon-Carret government and corporate bond portfolios increased 8.49%. Many individuals anticipated reduced benefits from owning municipal bonds, and so the tax free bond market actually declined 0.67% in the face of declining interest rates. Rikoon-Carret's municipal bond portfolios increased 5.65%. The reason our returns were so much higher is that we maintain a primarily conservative and short-term laddering approach to bond investments while the bond indexes lackluster results reflect a skepticism about future inflation. For the first time in a decade, we feel fairly certain that interest rates will rise during the next twelve month period, especially once economic activity picks up.

U. S. Markets

In case you haven't been reading the paper or listening to the news, the seventh largest company in the United States, once considered to be <u>the</u> <u>most</u> innovative energy trading firm, was brought to its knees and declared bankruptcy. Enron Corporation, based in Houston, grew from being a distributor of natural gas and utility company to become the world's largest trader of electricity and natural gas. The company also became a huge telecommunications firm, a paper and lumber trader, and one of the largest insurers in the United States. It had more than $100 billion in revenue last year. The collapse of Enron caused huge shocks to many of the nation's industrial sectors.

Enron Corporation employed over 21,000 people and three-quarters of its employees kept all of their retirement savings in Enron stock, which went from a high of $90 per share last year down to under one dollar this past week. At its peak, Enron had a paper value of $67 billion. It stands now well under one billion dollars!

The list of players who were drawn into the widespread, tangled web of Enron's activities reads like a Who's Who of American finance. Two banks, J.P. Morgan-Chase and Citibank, came to Enron's aid the last month of its demise and they pledged $1.5 billion. Chevron-Texaco stood behind Dynergy, the proposed white knight of Enron, to the tune of $3.5 billion. Several of the nation's largest mutual fund operators, including Alliance Capital and Janus, rode Enron's stock all the way down into the tank. Many individual investors & institutional investors, including our own firm, were drawn into the morass.

How could this happen? How could some of the smartest minds in the country be duped by Enron? The firm charged with responsibility for overseeing the truthfulness of Enron's financial statements has been caught in the web of lies. Arthur Anderson, one of the world's largest accounting and consulting firms, overlooked basic accounting errors. Why? Perhaps Anderson wanted to maintain its $52 million per year in fees from Enron. As a result, this conservative accounting firm may face prohibitions on taking new audit clients for a period of time. Some partners in the firm may be permanently barred from practicing public accounting. These seem like mere slaps on the wrist compared to the Enron employees' losses, but to a firm like Arthur Anderson, it could herald a downward spiral for this huge accounting firm.

During the last six-month period of Enron's demise, intense lobbying on the part of the company and its bankers brought pressure on the rating agencies at the worst possible moment. Standard and Poors, and Moody's, two well-known bond rating services, both failed to publicly acknowledge or anticipate Enron's problems.

The tragedy faced by Enron's own employees is among the worst that can be imagined. Those who put their faith and money in their own company by choosing Enron for their stock retirement plans were totally bilked because under Enron's internal rules, these individuals had no choice but to keep their money in Enron stock until they reached a certain age. This autumn, when the news got really bad, the employees were not allowed to change their choice of investments. There will be recriminations exchanged over the upcoming years, but it is already clear that almost every class of investor was duped.

The origins of Enron's disaster began in the Reagonomic movement to deregulate the energy markets. As supply and demand for electricity and natural gas were left to the free market, companies willing to take risk, like Enron, filled a need to provide a market of buyers and sellers. Another major factor that allowed Enron to grow beyond its traditional roots as a gas pipeline business was the lack of regulatory scrutiny. Enron was willing to assume a variety of risks of a magnitude that no one else could match. It gave its customers the feeling that their power, energy, telecommunications, and basic materials costs would not be subject to wild swings of the market but would be protected by Enron, who was supposed to be more capable than the U.S. government in managing these risks.

In order to deliver on its promises, Enron created a complicated structure of partnerships that lent money to each other and secretly took cross-ownership positions. The result of these maneuvers was to present to the public a far rosier picture of its business condition than actually existed in order to support a higher stock price. The truth is that Enron executives fell prey to avarice and ego. They were able to adhere to the strict letter of new law, but avoided the law's purpose of protecting investors.

Enron's decline and descent into bankruptcy was heralded by a widespread loss of confidence in the integrity of its management team. Enron obscured its true financial picture and once that condition became public, Enron faced a fork in the road that many of us face in our personal lives. The choice was between being honest and coming clean about their mistakes and dealings, or trying to hide behind excuses and throwing up legal and accounting justifications. Unfortunately, from the very top ranks down to mid-level executives, Enron failed the integrity test. It gave out minimal financial information and when put under pressure, Enron's leaders became defensive and denied the blatant conflicts of interest. The company chose to hire lawyers and accountants instead of stepping forward in honesty and humility to regain the public's trust.

The lesson we take away from this is that when important members of a business's management depart suddenly, without adequate explanation of their performance shortfall or giving their real views, it is a cause for concern. Departing managers are often being silenced by agreements they make to save face called "gag" orders. The public then has no information about what is really going on behind closed boardroom doors. This built-in wall hides the inner workings of American businesses, resulting in a huge disadvantage for shareholders. Full and immediate disclosure of financial problems, slipping market share, falling earnings or other similar issues ought to be encouraged as opposed to being discouraged.

Outlook For The New Year

As we now have landed in a new year, most people are not now overly worried about their personal safety but there is a general sense of unease about the economic future of the country. In order to retire, for example, we may well have to work harder to achieve less than we previously came to expect. This is not to say that stocks and bonds will not be productive in the upcoming years, but a return to fundamental values, including integrity, clarity and simplicity, will go a long way towards making sure that portfolios do not fall victim of the next Enron. When we can take this type of approach to investing, through effective diversification, other companies and opportunities will surely arise that are attractive to the prudent investor. At Rikoon-Carret, we are finding the best opportunities in the small and mid-capitalization companies. Many of these companies are less well known and off the beaten path, but represent real companies with real earnings and strong growth potential through focused strategy.

Although our sense of comfort and 'predictableness' has diminished, the good news is that we have opened the door to new ways of looking at our economy. A friend of mine on Wall Street, who was waxing philosophic to me recently, reflected on how things are going in the financial world. He said, "I think God gives us just about as much as we can handle". If we can look at the markets' travails in such a light, I think we will be able to ride through the present difficult times with more equanimity and the eventual return of confidence may occur sooner.

Most analysts are predicting that economic activity bottomed out in the fourth quarter of 2001. Up until recently, most Wall Street wire houses failed to acknowledge this sobering fact. Since the attack on the World Trade Center this past fall, things have gone from bad to worse. What was purported to be a short and mild recession has been replaced by a more pronounced downturn in economic activity. The fact that consumers have reduced their spending is clear and evident to anyone in high-end retailing. So why has the market done so well these last few weeks? The key lies in investor hopes for the future! The market is anticipating the day when the upturn in consumer demand will materialize.

Since September 11th, the Federal Reserve has taken the most aggressive monetary and fiscal action since the early 1980's in order to try to contain damage from our collective trauma. Most of us hope that this will underwrite a powerful and rapid upturn. In my opinion, that upturn will be more subdued than many experts expect. A recent government report showed the sharpest monthly decline in retail sales since 1992. It is quite likely that if current trends continue, we will be looking at the largest drop in consumer activity since the spring of 1980 when there was a free-fall in consumer demand. The situation today is quite different than 20 years ago. At that time, inflation fears drove investors to spend tomorrow's paycheck today in order to try to protect their dollar's purchasing power from eroding and to avoid high taxes. Today, inflation is subdued in raw materials but the cost of education, health care, and personal services continues to rise.

The U.S. economy faces an arduous road to recovery. If declines in consumer spending continue, we will see increasing corporate layoffs due to poor corporate performance. If, along with increasing unemployment, we add the higher cost of doing business due to security costs, we may see a lowering of valuations for the stock market as a whole. This would lend credence to the belief that the speculative bubble of the stock market in the late 1990's is truly over.

Because consumer expenditures count for approximately two-thirds of the nation's economic activity, it plays a decisive role in driving the rest of the economy. Once consumers stop spending, businesses start to reduce inventory. This sets in motion reductions in industrial production that further reduce levels of employment. That, in turn, stymies wage increases, which affects the mood of consumers, and the downward momentum gains force! As U.S. industrial activity declines, demand for imports goes down and this spells serious trouble for America's trading partners. If a sustained, consumer-led decline in the U.S. economy occurs in the upcoming few months, the aftershocks overseas will deepen the cyclical downturn here at home, creating a self-perpetuating global slowdown that only a significant shock will reverse.

So, what is the good news? For starters, the disaster in technology stocks should be pretty much over. Market leaders in areas of specific activity, such as Cisco and Nokia, have already started climbing out of the hole dug during the bear market of the last eighteen months.

In broad terms, the deeper the recession we experience, the sharper the rebound later. As inventories are liquidated and people eventually satisfy their need for new equipment, the Fed's aggressive fiscal and monetary stimuli will take hold. The strength of the ensuing rebound of the market will take many by surprise.

When this might happen is an open question. Before the tragedies of September, I felt the recovery would come early in the year 2002, but now it is looking like it will be later in 2002, if not well into 2003. Much of this depends on how people like you and me act and believe. Fortunately, we are a nation of individuals. We have the ability to make up our own minds about hunkering down to hoard food, water, guns and gold, or whether we will take an active role within our local economic communities. The decisions that generate our society's level of confidence are made one by one, in personal moments wherein we ourselves decide if our guiding philosophy will be fear or faith.

Personal Notes

During the fourth quarter of 2001, Americans by and large showed the basic understanding that it is important to maintain a healthy, positive outlook on our lives both inside and outside of work. The first Sunday in November was the New York City Marathon, in which I competed and, much to my surprise, I did fairly well. Out of a field of 25,000 runners, I ended up finishing around 2,000th, in the top ten percent of all runners with an unofficial time of 3.5 hours. Training at 8,000 feet on rutted dirt roads helped me negotiate the potholes and New York City's bridges! It was an amazing experience and the enthusiasm and support of the volunteers and spectators along the way made a big difference. It was a great event for everyone involved. At the end of December, my family and I celebrated our daughter's coming of age in the Jewish tradition of her becoming a Bat Mitzvah. In February I will once again endeavor to climb Mt. Taylor in the annual quadrathlon, which involves bicycling, running, cross-country skiing, and snowshoeing.

The other portfolio managers here took various trips, with Chris visiting the panhandle of Florida for a well-deserved week of rest on the beaches of its western coast. Juliana took a number of trips this fall, visiting North Carolina for a wedding, Southern California for Christmas, and in general having fun with her mother while waiting for a newborn niece/nephew to arrive. We are waiting for some real snow in Santa Fe. The ski- based, winter economy and our dry forests badly need moisture. Santa Feans, like many people around the country, have been pulling together and exhibiting great community spirit. We hope that all of you enjoyed a healthy holiday season.