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Commentary
Winter 2003

2002 In Review

The stock market turned in its third consecutive year of losses in 2002, an occurrence not seen since the 1930's. The Dow Jones Industrial Average lost 17%, it biggest decline since 1977, and the Standard & Poors 500 fell 23.4%, its largest loss since 1974.

Over the last 2 ¾ years, the total value of stocks in the U.S. has gone from $17 trillion dollars to $10 trillion dollars. The Rikoon-Carret portfolios faired better than the broad market averages with an overall decline of 19.44% for calendar year 2002. Our international stocks declined 21.95% versus the Dow Jones Euro Stock Index decline of 25.99%. This 4% out-performance is substantial but still discouraging as many holders of stock are tired of negative returns!

The technology stock index fell 31.5% during 2002 and is now almost 75% off of its high of March 2000. Conversely, industrial stocks are down a 29% from their peak. What is the likelihood of another down year in stocks? There has only been one other time in the twentieth century, during the Great Depression, that stocks declined four years in a row. It happened only once in the previous 19th century as well, from 1836 to 1839. The nine-year period where stocks went up and up, until the late 1990's, had never happened in history at all, so it is not a sure thing that the market will recover in 2003.

The bond market continued to perform well in 2002 with the Rikoon-Carret corporate and taxable bond portfolios increasing 7% while the broad market indexes represented by Vanguard's Bond Market Index Fund increased 4.57%. Our municipal bonds gained 6.37% versus the Vanguard Intermediate Tax Fee Bond Market Index increase of 2.94%.

Subsequent sections of this commentary will describe where we see the best investment opportunities for 2003, as well as the positive and negative factors currently influencing market psychology.

Economic Outlook

We truly are blessed. As a community, nation, and world, so many wonderful gifts have been given to us. At this turning time of year, we feel it is important to appreciate just how many advancements mankind has made. The future is full of risks, and current events often seem overwhelming. A helpful way to start 2003 is to look around and appreciate what good things exist right now so that hope can be renewed.

Confidence in the future is a necessary ingredient for investing. We believe that most people in the world want peace, a promising future for everyone, and that people everywhere are willing to share the benefits of their livelihood to permit others to live and prosper as well. Through technology and the good fortune that has been bestowed upon us Americans by the natural resources of our land, we have good reason to be optimistic. Our hope is that our nation can be tolerant of another nation’s ways of life and remember that the freedom to choose is one principle on which our country was founded. This ideal should generate a wider sense of tolerance for people different from ourselves, and allow countries that have different political systems to coexist with us side by side. Our nation’s ability to maintain prosperity depends on our ability to remain open to new ideas.

We are all aware of how the winds of war blow chillingly through the news these days. The prospect of a war is sobering. Our job as investment advisors is to look forward and see what scenarios are most likely to happen and how they might affect our client portfolios. We believe that there will be a relatively conventional war in the Middle East, followed by a long period of adjustment in world markets.

The United States and its allies will accomplish their objectives in the Middle East, which should reassure world markets. The first result will be the stabilization of resources flowing into Western Europe and the United States economies. On the other hand, increased costs of security and the likely intermittent incidents of terrorism will make the cost of doing business higher, which indicates a falling level of productivity. More resources will be required to keeping the channels of supply open between the United States and our economic partners. War in the Middle East is likely to be greeted initially with optimism by the markets and may provide a short-term boost to the economy. The stock market is well overdue for a cyclical recovery. A military victory would enhance that recovery and there should be a surge in stock prices.

Conversely, in the long run, the increased cost of maintaining military dominance will lead to falling price/earnings ratios. This means that we may have fairly flat stock prices over the next several years. Given the uncertain effect of a war on consumer psychology, especially if either side uses weapons of mass destruction, it is possible that consumer spending could fall dramatically. If it does, there will be declining business activity, falling tax receipts, all at the same time government outlays for military spending and security rise.

The end result of a fall in confidence would be inflation and deficit spending, not unlike like the 1960s, where the U.S. tried to finance the Great Society social programs and the Vietnam War at the same time.

In this economic scenario, interest rates would stay low and investment grade bonds therefore would not have much price appreciation nor produce much income. The investments that would do best would be income producing real estate and high dividend stocks. We are readjusting our core portfolio to reflect the possibility of the above economic scenario.

Absent a war in the Middle East, the world economy should do quite well. We estimate 2.5% growth in the U.S., slower growth in Europe, and feeble growth for Japan. Japan is plagued with a banking crises approaching half a trillion dollars! It continues to lack the political will to address its structural issues.

In response to the threat of war in Iraq and/or Korea, the U.S. dollar has fallen to its lowest level versus the Euro in 3 years while oil prices have gone above $30 a barrel. This is considered to be the price at which the economy is hurt and so we now see OPC offering to increase production.

Unemployment in the United States is 6%, 7.7% in Europe, and approaching 5.5% in Japan. American businesses and consumers continue to import huge amounts of goods and services from overseas and this has kept the world from falling into a deeper recession. It is likely that the U.S. will continue to lead the world in business in 2003, but not with enough momentum to pull Asia or Europe out of their basically stagnant economic circumstances.

The European Central Bank has started to cut interest rates, though not to as great an extent as the U.S. This is because there are still countries in Europe with inflation and the variance in growth rates between different countries in the European Union doesn’t allow Europe to react as quickly as the United States does to change.

Business capital spending is expected to rise 4.5% during the first six months of 2003 and by more than 7% in the second half of the year. This bodes well for technology and telecommunication companies that have been shunned by investors for three years. Governments everywhere are trying to stimulate their economies in whatever way they can, but their options are limited. The real issue at hand is confidence, and confidence depends on good news and better prospects for the future.

Due to the preparations for war, economic action had low priority during 2002. A U.S.-U.K. incursion into Iraq without U.N. auspices would be a financial disaster for our markets because the cost of an incursion, no matter what the outcome, would be astronomical and would be borne primarily by U.S. taxpayers. This would negatively impact U.S. equity and bondholders.

The long-term ramifications of a U.S.-U.K. victory may be Pyrrhic. The additional costs to our economy, to the national psyche, and to our important alliances around the world would be high. If a quick, clear and easy victory were possible, with an effective exit strategy implemented, the market might believe we were back to the way things were before September 11th. The future will bring unexpected twists that we will strive to be ready for as a firm.

Investment Avenues for 2003

Recently, I was reminded of the analogy of a pendulum for the market. Investors tend to respond to current news reports neglecting their original goals and that’s why there are always certain sectors of the market swinging from euphoria to panic, then back to euphoria again. At any given time, one sector is over and another is undervalued. The Pendulum Theory applies to individual stocks, industries, bonds, commodities, even real estate.

Within the Pendulum Theory is the unintended potential for additional risk. Investors are generally blind to when the pendulum is at extremes, because they desire, above all, to avoid risk. Most investors take action after nearly all the opportunity is gone. They wait until they feel comfortable, relying on Past Performance. This is especially the problem now that we have all had shocking experiences in the current bear market. Once an investment displays significantly good past performance, its price pendulum has past reasonable on its way to peak at euphoria. This is also called "momentum investing." Many investors were beguiled by this psychological phenomenon during the late 1990's. Stocks were purchased simply because their price had gone up and everyone was making money. This is not the way to make rational investment decisions.

Whereas fear is so prevalent today, many people can think only about avoiding risk. There are billions of dollars sitting in money market accounts making no more than 1% due to this dread of further harm. This fear is understandable, as we have had the worst bear market since the Great Depression with three consecutive years of negative stock performance. Some investors may never buy stocks again. But remember, every investment carries some kind of risk, even Federally insured CD's which have inflation risk. The key to understanding and managing risk is to know how to avoid the extremes in the investment climate.

There are three areas of opportunity created by today's emotional anathema to "risk": 1) deeply discounted stocks; 2) high yield bonds; and 3) stocks with growth potential that also pay good dividends.

Deep Discounted Stocks

Our stock philosophy has always been growth at a reasonable price (GARP). This means we are looking for stocks with growth potential that are priced well below what we consider to be their fair market price or intrinsic value. To make this work, we must have a strict sell discipline—that is, when a stock rises and hits its fair value price, we sell a portion of it. The basic concept is to buy stocks that are significantly cheaper than their peers, but who, at the same time, has exhibit a consistent, five-year positive pattern in earnings and sales.

For the first time, for anyone who contacts our office to express interest, we are making available as a special supplement to this commentary, short descriptions of the 20 stocks that comprise our current "core" portfolio that will be updated quarterly from now on.

High Yield Bonds

Opportunities exist today in the bond market that most investors will miss. It is understandable that people want to run for cover into annuities and the safest bonds available even though interest rates are hitting 40 year lows. These are the same investors, the Pendulum buyers, who followed similar emotional buying patterns buying technology stocks in 1999 as stocks were hitting all time high prices. Pendulum investors tend to move in packs and this pushes prices to the extreme. The bond market today is no different, as good quality bond prices are sky high much the way stocks were in the bull market. All people see when they look at a triple-A rated bond is a safe haven—and after the beating many investors have suffered in stocks, perceived safety is their sole and supreme concern.

We understand this phenomenon and are using extremely short-term bonds to address these needs. Please recall, however, that for the last few years interest rates have steadily gone down and investment grade bond prices have done very well, but their day in the sun is almost over. We believe that the economy is turning around and that the U.S. will see positive GDP (gross domestic product) numbers in 2003. If this is so, then interest rates should go up. If they do, investment grade bond prices will fall. In fact, if interest rates rise 2%, a 20 year investment grade bond could fall as much as 19%! This would include government, municipal, and corporate bonds, all considered to be highest quality.

Here is a chart showing the potential decrease in bond prices as rates rise:

	Years to Maturity				
Interest Rate	**Price declines for bonds maturing in:**				
Increase	**1 Year**	**3 Years**	**7 Years**	**10 Years**	**20 Years**
0.50%	-0.50%	-1.30%	-2.70%	-3.60%	-5.30%
1.00%	-0.90%	-2.60%	-5.40%	-6.90%	-10.30%
1.50%	-1.40%	-3.90%	-7.90%	-10.20%	-14.80%
2.00%	-1.90%	-5.20%	-10.40%	-13.30%	-19.10%
2.50%	-2.30%	-6.40%	-12.80%	-16.30%	-23.00%

We are not overly concerned if the potential decreases because we buy bonds for their steady income stream and hold them until maturity.

There is one type of bond that will escape this negative effect—high yield bonds. These are non-investment grade bonds, which means they are rated below BBB. Companies such as Moody's or S&P issue credit rating, and these lower rated bonds tend to react to the economy and not to interest rate changes. At Rikoon-Carret Investment Advisors, we think high yield municipal bonds are of particular interest at this time.

In the early 90's, as the economy gained ground after the 1990 recession, high yield bonds performed extremely well while investment grade bonds fell in price. It's our belief that a similar phenomenon will take place again soon.

Stocks with growth potential that also pay reasonable dividends

Until recently, most investors focused their attention on growth stocks and avoided stocks that paid dividends. This was justified by the belief that earnings should be reinvested back into the company for growth, not paid out as dividends.

We do not look for stocks that pay the highest dividends as they often act like bonds, i.e., they fall in price when interest rates go up. It is important to focus on stocks that have some upside potential as well as pay a reasonable dividend.

Our strategy for selecting these kinds of stocks is similar to the strategy used above for deep discounted stocks. The main difference is that we are being paid dividends while we wait for the stock to appreciate in value.

These three strategies working together produce a lower risk portfolio in the current investment climate with upside potential. Our strategy of continuing to buy undervalued securities reduces risk somewhat, while our use of screens that select some stocks based on production of a steady stream of income also helps buffer our portfolios against risk. If the economy does marginally better in 2003, whether the stock market goes sideways or not, this combined strategy should continue to do slightly better than the overall market.

Personal Notes

Santa Fe has been blessed with some good moisture so far this winter. While our staff has remained close to home, given the high demands of the market and year end activity, Juliana took time to go to Big Bend National Park to do some serious birding.

Ever since the end of autumn, I've been using my bicycle for 90% of my commuting needs and have been participating in various citizens' groups around Santa Fe to help promote the local business environment and peaceful resolutions to problems that face our community.

Jeff Sand, who joined our firm in September, has graced us with several musical performances. Our next regularly schedules "tea" will be held on Thursday, February 13th at 3:00 p.m., after which Jeff will give a short performance. Stephen Madeyski is making good progress on the Certified Financial Planning program, having passed 3 of 6 parts. We look forward to Stephen's certification so that our clients can benefit from his expertise in this area. Patricia Cody, formerly know as Patti Yuhas, visited her son in London this fall with a side trip to Barcelona — she feels it was much needed and well enjoyed vacation. Beth Humphreys, now full-time, is trying to psyche herself up for her planned 22-hour flight to Korea this spring to visit a friend who is teaching there.

This past December, rather than mail out Holiday greeting cards, we decided to donate funds that would have been spent on cards and postage to several local charities. These include the Empty Stocking Fund, Challenge New Mexico, and Heifer International. We hope you support us in our commitment to sharing with those less well off.

As winter progresses, we hope to get enough snow to make up for several years of drought. It would also help my participation in the Mt. Taylor annual quadrathon, scheduled for February 15th in Grants, New Mexico. Please join us for our client get together on February 13th as we gather here in our office to discuss the markets, the economy, and world events.