

**Sound Investments Inc. / Kenneth A. Gilpin CFP**  
**Registered Investment Advisor**

**12821 West 78th St.  
Lenexa Ks 66216**

**Tel (913) 908 4366  
(800) 760 2172  
Res (913) 962 0059**

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Dear Client,

It has been more than 60 years since the U.S. stock market experienced three consecutive negative calendar years. With the S&P 500 down 13.1% on the year through June, it will take a 15.1% increase over the next six months to avoid that fate. We've managed to outperform our benchmarks by a substantial margin during the bear market but we can only feel so good about a relative victory in the face of a weak absolute-return environment. Like you, we're more than ready for something better but we feel stock returns will be in the single digits for several years to come due to the following reasons:

- Foreigners will invest less in the USA due to fears of a decline in the American dollar.
- While we believe that management at the vast majority of public companies are honest there was a number of companies such as Enron and Worldcom that were "ethically challenged." 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 P/E multiples.
- A related issue is the level of earnings. How much shenanigans has been going on? We believe that there will be more surprises but that it is unlikely that, at this point, earnings for the overall market are materially overstated given the huge earnings decline that has already occurred.
- Then there is the terrorism wildcard. It's hard to evaluate but the worst-case scenarios rarely happen and we've always tended to discount them. But at the very least the risk will lead to more defense and homeland security spending, however these are not productivity-enhancing activities.

**So Where Does This Leave Us?**

First, there are important positives that must not be forgotten. Stocks are generally much cheaper than they were over two years ago and we are very likely to see a decent cyclical earnings rebound over the next year. The



statistics say that the economy is clearly recovering and that's what could drive a cyclical 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 huge amount of cash on the sidelines earning very low returns.

Secondly, we believe we are invested with superior managers who will continue, on average, to provide higher long-term returns than their benchmarks. So while we focus our market assessments on the market averages, we expect our managers to outperform those averages. And while there are only a handful of great funds out there, we believe finding them is one of our strengths.

There are several things we can do to help increase the odds of investment success.

Make sure that you can live with the risk assumptions underlying the portfolio strategy we are using. The appropriate strategy should balance your risk tolerance, time horizon and overall investment objectives. I plan to call you and review the appropriateness of your strategy.

Maintain reasonable return expectations. The days of easy double-digit returns are over. Those days were an anomaly. Single-digit returns in a low-inflation environment can still compound out to surprisingly strong wealth creation over a period of years.

Remember that there is no free lunch in investing. Achieving decent long-term returns requires a willingness to take some short-term risk. When that occurs remember that it takes great discipline to stay the course.

In tough times like these, investors have succeeded when they have managed to hold their own, losing as little as possible while staying invested. Hang in there and you will be positioned to take advantage of the opportunities the inevitable turnaround will bring.

## **In Closing**

This is the toughest investment environment we've experienced. Nevertheless our fat-pitch plays, our confidence in our managers, and the potential to take advantage of volatility give us a high level of confidence that the next several years will be better than the last several years, with reasonably good absolute returns (though our performance has been quite good in light of the market environment). We remain focused, disciplined and diligent in our research and executing our investment process. And 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 and puts us in a strong position to add value.

Yours Truly,

Kenneth A Gilpin CFP