Sound Investments Inc.

Kenneth A Gilpin CFP

Fourth Quarter 2002

SUMMARY:

It was a strong fourth quarter, but another rough year for the markets. It has been sixty years since the market has fallen three straight years, and 2002 was the worst single year since 1974. Still, we are pleased that most client portfolios have materially outperformed their benchmarks during the bear market as well as over all longer time periods.

There are valid positive and negative arguments on the near-term outlook and we think it is difficult to make successful investment decisions predicated on accurate short-term forecasts. Instead, we take a longer view that emphasizes areas we think we can assess with confidence; valuations are at the top of this list. Our valuation work suggests the market is modestly undervalued on a long-term basis.

Overall, despite near-term economic, war and terrorism uncertainties, we are moderately optimistic. There is a lot of liquidity, valuations provide some cushion, and corporate spending should improve. We continue to favor high-yield bonds. We also have a mild preference for international equities and for domestic small caps, but it is not strong enough to justify overweighting.

Investment Review and Outlook

While the fourth quarter was strong for stocks and high-yield bonds, it was small consolation in a tough year. (I have attached a performance chart for the last 3 years.) Every single Standard & Poor's sector was in the red and eight of ten sectors experienced a double-digit loss. We take some solace in the fact that our long-term record remains excellent, and that for the third straight year we have outperformed our benchmarks by a material margin.

Blame the Bubble

Bad bear markets tend to be blamed on a variety of factors, depending on who is doing the blaming. In our opinion there are a number of factors that contributed to the bear market, but without question the biggest was the stock market/tech bubble. Terrorism and war fears didn't help, but these only contributed at the margin to the magnitude and length of the bear market. Corporate governance also contributed, but was not the driver—it was more of an outgrowth of the environment of bubble-driven greed.

The bubble created three key problems. First, valuations got way out of line (as we warned repeatedly in 1999 and early 2000) and, while improved, they are still not in "screaming-buy" territory. Second, there was over-investment in the general economy as corporate management became overconfident in their growth expectations (this was particularly acute in the tech sector) and the resulting excess capacity has not yet been fully absorbed despite the fact that business capital spending is way down. Third, investors forgot about risk and were more heavily weighted to the technology sector, and stocks in general, than they had been in any prior bear market. The question we now face is whether it will take years for investors to regain their appetite for risk. In the past, investors have remained cautious for several years after the end of a major bear market.

The following is our valuation analysis and some additional comments about each asset class.

U.S. Equities: The volatility in the stock market in 2002 caused our view on valuations to shift around as the year progressed. The rebound since the July market bottom has not being large enough to eliminate the undervaluation. But it has cut the degree of undervaluation.

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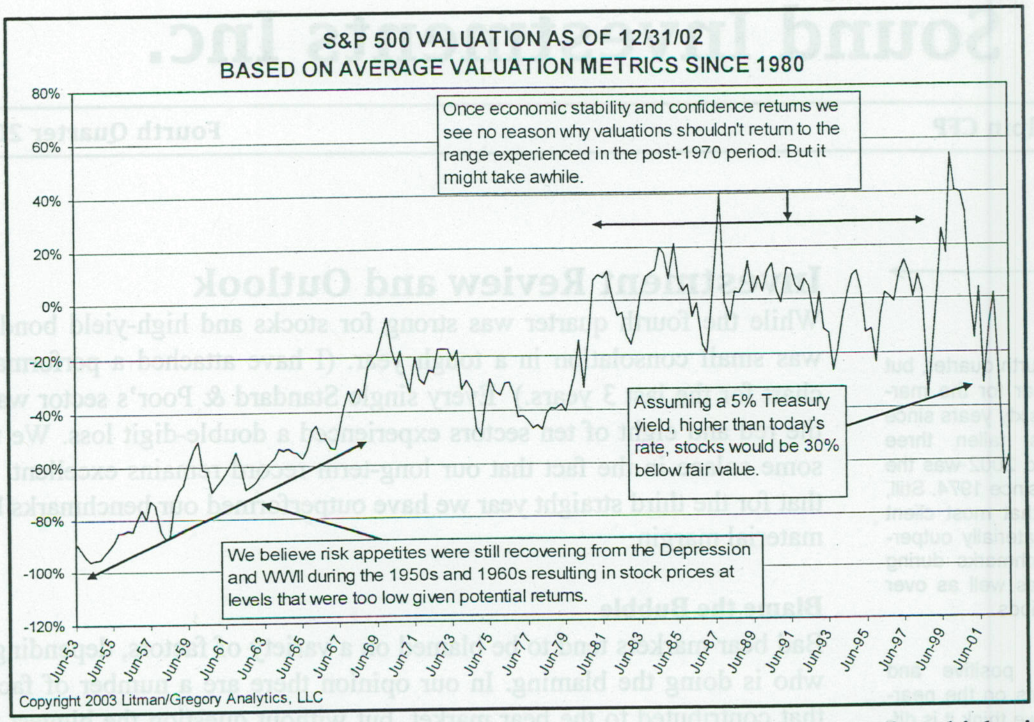

Valuation work is tricky because it depends on earnings, which are hard to measure, and interest rates, which change. We view our valuation model as a crude tool to help us make longer-term assessments as to the relative attractiveness of stocks. Our recent analysis suggests that large-cap stocks fall somewhere between mildly undervalued to very undervalued on a long-term basis. And the evidence continues to suggest that the broader market, including mid-cap and small-cap companies, is a better bargain.

High-Yield Bonds: High-yield bonds had an excellent fourth quarter, returning 6.7%. The rally drove yields down from over 13% to a still-healthy level of 11.7% as we write this. The default rate, though high, has improved steadily in recent months. Flows into high-yield mutual funds have been steady and healthy while high-yield fund managers have been cautious and recently held a sizable cash reserve of about 9% of assets. On the negative side, the improvement in default rates has been excruciatingly slow. If the default-rate improvement continues to be gradual as expected, it is unlikely that we will see an explosive snap-back in prices. Still, looking out over the next several years, high-yield bonds are still priced at recession-type levels. As the economy gradually improves so should pricing. Current price levels suggest that low double-digit returns are realistic. In 2002, high-yield bond returns were slightly negative and though this was disappointing it amounted to a huge performance advantage compared to stocks. If the economy and financial markets have a strong 2003, high-yield bonds should do quite well, though not as well as stocks. If things deteriorate, they are again likely to hold up much better than stocks. But stretching out our horizon over a few years, we believe high-yield bonds can be competitive with and even do better than stocks. Vanguard High Yield Corporate Fund (VWEHX) currently trades at $5.98 per unit and yields approx. 8.5%. It has very low expense ratio and holds higher quality bonds than the other high yield bond funds.

Gold Funds: When I got started in the investment business as a stockbroker in 1982 just after the oil and gas boom and I can remember talking to "gold bug" who wouldn't buy a 16% government bond for love nor money. Well they were very wrong for 20 years and bonds soared in value. However things change and by strictly looking at the charts or through technical analysis gold has definitely broke out of it's long term decline. I don't know the reason … maybe it's due to higher federal deficits ahead or a weaker American Dollar and investor are looking for a safe haven. As an investment class, Gold has almost being written off by the investment community and is notoriously risky. Two of the top performing funds, Gabell Gold (GOLDX) and American Century Global Gold (BGEIX) both were up over 60% last year. Prior to buying any of the accounts I will contact you and wouldn't recommend any more than 5-10% in a portfolio.

Foreign Stocks: Europe continues to look somewhat underpriced relative to its historical relationship with the U.S. In addition, the large U.S. current account deficit continues to suggest the odds favor a weakening U.S. dollar over the next few years relative to the euro. Finally, Europe has the potential to provide more new marginal stimulation from monetary policy than in the United States. Emerging markets, as a group, also look extremely undervalued with Asia offering more political stability now than Latin America. However, in total the weight of the valuation evidence is not high enough to confidently overweight our core foreign stock funds.

Investment-Grade Bonds: With a yield of 4%, 10-year Treasuries appear overvalued relative to trailing inflation. Whether they are overvalued compared to future inflation is yet to be seen but with the likelihood of continued sizable fiscal and monetary stimulus we believe the odds are high that Treasury yields will be higher, on average, in coming years than they are now. Other sectors of the investment-grade bond market offer better value but not great absolute value. And with rates very low, it doesn't take much of a move up in interest rates to wipe out a whole year's worth of interest (about a 1% back-up in rates would do it). It is highly unlikely that investment-grade bonds will deliver attractive absolute returns over the next few years unless we fall into a deflationary environment and stay there.

Return Potential

As we look out over the next five years we believe financial markets are likely to deliver decent returns relative to inflation. However, there are two risks that we must mention:

1. Terrorism remains an unknown. We already know there are security costs which will have a marginally negative impact on productivity. What remains to be seen is the impact of terrorism on economic behavior. This will be determined by whether there are terrorist attacks that alter consumer and business behavior in a lasting way. This may or may not happen. The fear that it could happen is a secondary factor that could well result in a somewhat higher risk premium (lower prices than there would otherwise be) for equities and other equity-type assets.

2. Inflation and interest rates. We continue to view deflation as a risk. With excess capacity, a very competitive global economy, and lots of debt we are not ready to say that it couldn't happen. But we think the odds of sustained deflation are quite low—lower than a few months ago now that there has been further marginal improvement in the economy and since the Fed has made it clear it will be aggressive in using all its inflationary tools if needed. So the longer-term risk is that there will be some increase in inflation. While this bodes well for earnings growth it would not be good for P/E multiples. The risk is that a decline in multiples more than offsets the increase in earnings growth.

In spite of these concerns we are moderately optimistic. There remains lots of liquidity that at some point will begin to move out of cash. And in general valuations provide some cushion. The fact that companies have rediscovered spending discipline is very important and is likely to result in improving returns on capital in coming years. And, we also think it is likely that a higher level of earnings will gradually be paid out in dividends as investors show a preference for dividend-paying stocks (this preference is already happening). This will enhance equity returns. Generally, we believe returns from equity-type asset classes (stocks and high-yield bonds) will fall between the mid single-digits to the very low double-digits over the next five years. Returns from investment-grade bonds are likely to fall between 4% and 5% on average.

Yours Truly,

Kenneth A Gilpin CFP

Stock Market performance over last 3 years

Weightings	Sector	2002	2001	2000	Cumulative 3-years
14.4%	Technology	(35.7%)	(26.0%)	(41.0%)	(71.9%)
4.2%	Telecom	(33.7%)	(13.7%)	(39.7%)	(65.5%)
2.9%	Utilities	(32.8%)	(32.5%)	+51.7%	(31.2%)
11.0%	Industrials	(27.0%)	(7.0%)	+4.5%	(29.0%)
13.4%	Consumer Cyclical	(24.5%)	+2.0%	(20.7%)	(38.9%)
15.0%	Healthcare	(20.0%)	(12.9%)	+35.5%	(5.6%)
20.6%	Financials	(15.2%)	(10.5%)	+23.4%	(6.3%)
6.0%	Energy	(12.2%)	(12.3%)	+13.2%	(12.8%)
2.8%	Materials	(7.2%)	+1.0%	(17.7%)	(22.9%)
9.5%	Consumer Staples	(5.7%)	(8.3%)	+14.5%	(1.0%)
100.0%	**S&P 500 (Cap Wt.)**	**(23.4%)**	**(13.0%)**	**(10.0%)**	**(40.1%)**
	Dow Jones Industrials	(16.8%)	(7.1%)	(6.2%)	(27.5%)
	NASDAQ	(31.5%)	(21.1%)	(39.3%)	(67.2%)
	S&P Mid-Cap 400	(15.5%)	(1.6%)	+16.2%	(3.4%)
	S&P Small-Cap 600	(15.3%)	+5.7%	+11.0%	(0.6%)
	90-day T-Bills	+1.6%	+3.4%	+6.1%	+11.5%
	5-year Treas. Notes	+10.2%	+6.6%	+12.6%	+32.3%