

Sound Investments / Client Letter

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Investment Review and Outlook

SUMMARY:

We think it is crucial that investment decisions be made in the framework of a process that is consistently applied and that is as far removed from emotion as possible.

We see the major risks as the chance that valuations will remain suppressed for a number of years due to risk aversion, and structural problems with the economy including high consumer and corporate debt levels, the current account deficit, and the potential impact of the war against Iraq and terrorism.

Given the many uncertainties, we are not raising our risk exposure as we normally might at this point in economic cycle. Our strategy includes maintaining diversification and exposure to asset classes such as REITs and High Yield that offer return potential close to that of the stock market at less risk. Rebalancing will also be more important in an environment of continued volatility.

The Investment Letter is mailed quarterly to our clients and friends. The intent of this publication is to share some of our more interesting views and research with our

It was a difficult first quarter, with virtually every equity asset class showing losses. Uncertainty over the prospect of war with Iraq was a drag on the markets through most of the first two months, followed by further unrest over the progress of the war as the quarter came to a close, with a brief but strong rebound in between during the first week of the invasion. Most indexes showed losses in the single digits. Junk bonds (featured in our last newsletter) were the star performers for the quarter, besting both stocks and investment-grade bonds with a 6.9% gain, compared to a 3.2% loss for the S&P 500 and a 1.4% gain for the Lehman Aggregate bond index. Our overweightings to both high yield bonds have continued to help our model portfolios stay ahead of their benchmarks so far this year. We have also outperformed by a wide margin through the difficult bear market and over the long term.

A Historical Opportunity?

I enjoy history and am wondering whether there could be an opportunity resulting from this war. In the late 1890's Britain had invested in railroads throughout the world and was having trouble collecting on the bonds. Around this same time they got into a skirmish with Persia (now Iran) and won a major victory in short order. Suddenly all those countries started paying up. This war should make it a safer place to invest and I am looking at the Oakwood Global Fund, which invest in mid-size companies throughout the world and could do well.

Psychology

It's no secret that investor psychology has a material impact on financial market volatility over the short run. Many stock pickers are fond of pointing out that the huge volatility in the prices of individual stocks over any given year doesn't reflect the actual change in value of the underlying business. Stock prices are volatile; business values are much less so. Stock price volatility reflects change in what investors are willing to pay for a share of those businesses, and while this is sometimes driven by fundamentals it is more often driven by emotion. When investors are driven by greed they tend to downplay risk. In periods of extreme greed many are incapable of

acknowledging any risk. A glass filled halfway is not just seen as half full, it is seen as full. Conversely when investors are driven by fear, risks are overblown and the positives are downplayed. The glass is not just half empty, it is seen as nearly empty.

The last five years have been among the most amazing in financial market history. Not only have we witnessed a greed-driven bubble environment on par with any in history, we've also watched its collapse. It is important to understand that the bubble was not simply a reflection of overvalued stocks. The greed that inflated stock prices permeated the economy in a variety of ways. Because rational thinking was not in evidence at the close of the 1990s, it is not surprising that there were other excesses that developed and are also now being addressed. Corporate governance abuses, debt levels and the excess capacity present in many segments of the global economy are in various stages of reversal.

As we've watched this period unfold, the evolution of investor psychology has been fascinating. Emotion is alive and well and fueled not just by the financial media, but also by the Internet and e-mail. Unsubstantiated stories, rumors and analyses from sources lacking in credibility spread like wildfire. One of the most surprising developments is the psychological swings of people who we consider to be very financially sophisticated. We're personally familiar with a number of investors who were not concerned about risk in early 2000 but instead were more concerned about keeping up with a roaring bull market. Now these same investors are concerned about risk and are interested in reducing equity exposure. Perhaps their desire to reduce equity exposure will prove to be wise, but the quality of their risk assessment must be questioned given the fact that at the start of the bear market (when risk was highest) they were bullish, and they have now become risk averse after the stock market has lost almost 50% of its value and the NASDAQ is down about 80%.

In light of the events of the last few years this is a good time for all investors to be intellectually honest by thinking back to their view of risk and return in early 2000. If views were detached from reality back then, what does that suggest about the wisdom of trusting an emotional point of view today? This is exactly why we believe it is so important for investment decisions to be made in the framework of a process that is consistently applied and is as far removed from emotion as possible.

Staying Rational

Our investment process is intended to lead to decisions based on rational and realistic analysis. It doesn't ensure that all our decisions will add value but we believe, and our experience supports, that our process provides a framework for being right more than we are wrong, thereby adding value over the long run. The foundation of our process is valuation analysis. As part of our job "to stay rational" we must be aware of as many of the potential risks as possible and assess their probability and magnitude and take them into account in our portfolio construction. Our objective is to manage, not avoid, risk because avoiding risk also removes return potential.

Clearly there are risks that could present problems over the years. The geopolitical situation is an uncertainty that has weighed on the markets for many months, and we can't be sure how it is going to play out. There is the chance that our analysis of *valuations* does not take into account the environment we will face in the coming years. It's also difficult to confidently assess and predict the *structural problems with the economy* coming off of the long period of declining inflation, the near 20-year secular bull market, and the final greed-driven run that contributed to high debt levels, large growth in manufacturing capacity and robust consumer spending.

We now face growing federal and state deficits. Also there is the unsettling force of climbing

unemployment and it's delayed affect in consumer spending.

Analysis

We remain seriously concerned about the points cited above. However the conventional wisdom you heard on talk shows such as Wall Street Week etc. use the following facts to justify higher stock prices:

1. Competing returns from non-equity assets
2. Sizable amounts of cash on the sidelines
3. Significantly reduced allocations to stocks
4. Stimulate monetary policy that has been helping (primarily through mortgage refinancing and the housing market)
5. Also, the fact that consumer confidence is low, profit margins are near a 50-year low and five-year real earnings growth is also near a 50-year low suggest that upside surprises could be strong. Finally, the magnitude and length of the stock market decline, from a historical standpoint, suggests that it is unwise to bet against stocks looking out over the next few years.

I am not this optimistic. I have a client who owns a siding and window company who reports a big drop in orders as people were watching the war. I think the economic results will be lower. Also we think if the market can move up it will be constrained by the already high valuations.

Portfolio Strategies in an Uncertain World

We continue to like high-yield bonds and global equity funds. Each likely to deliver high single-digit to low double-digit returns over the next five years. Because of very low interest rates, investment-grade bond returns are likely to fall in a range of 5% or (probably) less over the next three to five years unless we have sustained deflation, in which case returns will be slightly higher.

Given the geopolitical environment, post-bubble risk aversion and vulnerable economy

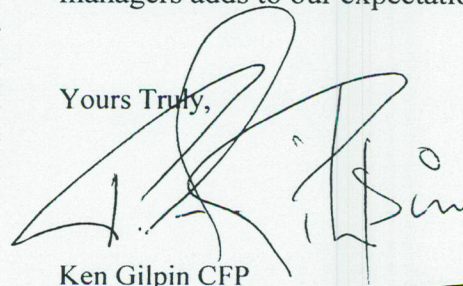
we believe market volatility (upside and downside) is likely to continue for an extended time period. And while we believe a decent return environment for stocks is the most likely case over the next few years, we are concerned that the end of the 20-year bull market may be the trigger for downward adjustments in debt levels and consumer spending at a time when the global economy is vulnerable due to related structural issues and geopolitical shocks.

Diversification is especially important in this environment. Our exposure to high-yield bonds allows us to hold assets with equity-like return expectations but with somewhat lower risk (though these assets are not immune to the same risks).

As always, the most important decision for each investor is the model you choose to follow. Careful consideration of return needs and risk tolerance should drive this decision.

Despite the risks we see we are quite confident that the odds for at least decent returns relative to inflation are high over the next few years. Our confidence in the ability of our investment managers adds to our expectations.

Yours Truly,



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