SUMMARY:

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The year 2003 was very rewarding for investors, with all equity asset classes delivering high returns.

The last five years have tested investors' discipline and confidence. Many suffered steep losses after the bubble, then became conservative and missed the strong gains in 2003. We are pleased that our discipline helped us outperform our benchmarks in this very turbulent five-year stretch, including both up and down years.

With rates remaining generally low, an improving economy, and investors more willing to take risks, many forecasters call for decent, perhaps double-digit, returns in 2004. We are never comfortable making short-term assessments ourselves, since it is too easy for near-term uncertainty to sway markets. But longer-term we are much more confident: based on current valuation levels, annual equity returns in the 8-9% range are realistic. Bonds are likely to return less than their yield, or sub-4% in coming years.

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 clients.

Year-End Investment Review and Outlook

For investors, the years from 1999 to 2003 amounted to a severe test and for many it was an excruciatingly painful experience. The truth is that in our investment lives, just as in the rest of our lives, we are always being tested. We are tested on the clarity of our Investment philosophy and process. We are tested on our intellectual honesty with respect to our belief in that process, for if we don't believe then we will not stay true to it when times are tough. And, we are continuously tested on our ability to stay disciplined and resist the many temptations that can pull us away from our philosophy and circle of competency. These temptations include pursuing hot investment trends simply because they are hot, investing based on gut feel, or cutting corners on our research while hoping those corners won't really matter.

The year 2003 may have been the final chapter to the bubble run-up and collapse that started in the late 1990s. Just as the most fervent bull-market revelers tend to experience the greatest suffering when the music stops, those that latch on to doomsday scenarios fail to recognize that bad times end too. In the worst case, former bubble investors morphed into gloom-and-doomers and missed the 2003 market rebound after participating in the worst bear market since the 1930s.

We have a very high degree of confidence in our investment process, which is based on rational analysis of underlying economic values, risk assessment, and discipline. These last five years have rewarded that confidence as we outperformed our benchmarks by a wide margin over this volatile period, and did so consistently with most portfolios beating their benchmarks in the down years and the up years, including 2003. We're grateful for this performance but we also are very aware that we have and will again at times make mistakes. We will not beat our benchmarks in every year. We also know that we can't rest on our laurels so we are as driven as ever to keep and, if possible, improve our edge. But we are very confident in our ability to continue to deliver good, long-term performance through the disciplined execution of our investment process.

It Was a Nice Year, But What About The Future?

In looking forward, a useful place to start is by assessing what has and hasn't changed from a year ago. Here are some key factors and how they compare to a year earlier:

- Cyclical, macroeconomic risks have substantially declined. The economy is in recovery and gaining strength. Deflation risk is much reduced.
- The economic recovery is global with most parts of the world showing signs of increasing economic activity.
- The uncertainty of an impending war is gone.
- Terrorism and geopolitical risks continue to be impossible to predict.
- The U.S. budget deficit is higher.
- Investors are willing to take risks again.
- Earnings experienced a powerful rebound from depressed levels. This rebound has supported capital spending and bodes well for the labor market. Going forward the potential for earnings growth is more limited. Consensus earnings growth forecasts for the U.S. stock market for 2004 are 12%.
- The dollar moved sharply lower against a number of currencies and is sharply lower against the euro.
- The current account deficit (mostly driven by the merchandise trade deficit) remains a significant long-term issue and is a major factor in putting downward pressure on the dollar.
- Household debt-service levels remain near historic highs compared to disposable income.
- Interest rates are higher but still very low on an absolute basis. Rates are very likely to move somewhat higher over the next few years.
- Equity markets are sharply higher compared to a year ago. But because stocks started the year undervalued and earnings have surged, they have not moved into overvalued territory. Based on our analysis, all equity-type asset classes are in a fair-value range.
- There are not any clearly undervalued asset classes. High-yield bonds and small-cap stocks all had big years in 2003, eliminating their undervaluation.

What the above has added up to is a devaluation of the Dollar and a Promising Turnaround of the Economy. I've tried to steer your investments into international funds, small cap stocks and gold which did well as the dollar declined in value. Also we have large holdings in high yield bonds which yield about 7% and the unit price went up as the economy improved. In the next two paragraphs I outline some of what we do to figure out the best investment positions.

We look at are there clearly undervalued asset classes that provide a margin of safety that is excessive relative to history. Valuation extremes are usually a function of temporary factors and therefore offer opportunity to longer-term investors. Part of our analysis includes assessing fundamentals so that we can understand the factors that are driving investors away from the asset class to make sure any clouds are likely to be just a passing storm. If we can gain confidence that this is the case, then we have a potentially exciting asset-class return opportunity, as well as a margin of safety to protect us against any big-picture risks coming to pass. <u>Unfortunately, at present there are no asset classes which offer exceptional value.</u> This was not the case a year ago when almost all equity-type assets were undervalued, with high-yield bonds, and small-cap stocks even more undervalued.

At present, cyclical economic risks seem to us to be below average. However, longer-term risks are more troubling (the current account deficit and debt levels), though a very bearish scenario is not the most likely long-term scenario.

At this time of year it's common for people in our business to make a return forecast for the year. But one-year return forecasts are speculative, since investor psychology and unpredictable short-term events can drive returns, rather than long-term fundamentals. We are much more comfortable assessing the potential for returns over longer time periods. Our expectations are heavily impacted by our valuation assessments. With most equity asset classes around fair value, returns over five years and longer are likely to fall in the 5-7% range. If interest rates rise somewhat as we expect in the face of a strengthening economy, bonds are likely to deliver less than their yield, which is to say they will probably deliver returns below 4%.

While these long-term returns are not particularly exciting, the next market turmoil will be the catalyst that will mark down the prices of one or more asset classes. If we can take advantage of an opportunity to load up on an asset class or two when they are available at "sale" prices, we will put ourselves in a position to improve returns. Until then we will have to be patient while staying close to our neutral asset-class targets. In the meantime we will continue to emphasize talented managers. Evaluating specific fund management teams remains a primary focus for our research team, and this continues to be an area where we can add a lot of value from a performance standpoint.

Final Comments on the Fund Scandal

For the most part we have avoided these problems in the funds we invest in. We attribute this to using no load funds and staying away from broker based funds (these have the highest expense ratios as well). Fund investing continues to give us the ability to easily hire and fire managers, choose from a large universe of managers and, within that universe, find a handful of exceptionally skilled investors, and to opportunistically access many asset classes. Going forward, ethical lapses are far less likely to be an issue given the fallout of the fund scandal of 2003. But shareholder-oriented business practices will still be a big issue and one that we will continue to focus strongly on. Our bottom line is that while we have always recognized the shortcomings of mutual funds, we continue to view the fund universe as one that gives us a handful of excellent choices and the flexibility to apply our fundamentally based approach to tactical asset allocation in a very effective way—one which, in our opinion, could not be as efficiently implemented using any other investment vehicles.

Best Regards,

Ken Gilpin CFP