

ADDING VALUE

Inaugural Edition

Second Quarter 2002

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SUMMARY:

With the S&P 500 down 13.1% through June, it will take more than a 15% gain in the second half to avoid a third straight down year. The market has not had three consecutive negative down years in more than 60 years.

Despite the lengthy decline in stock prices, valuations are still not compelling. While we could see a decent cyclical rebound, longer term it seems unlikely that we would see more than single-digit returns.

Corporate accounting, terrorism threats, and declining foreign capital flows pose further problems for the market.

There are also positive trends. Valuations are at much better levels today than two years ago and we think there are selective stock opportunities.

Volatility and bear markets are actually friendlier to long-term investors than bull markets.

Adding value is more than achieving high returns. This will be the topic of future newsletters.

Adding Value 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.

Investment Review and Outlook: A Tough Environment Continues

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% for the year through June, it will take a 15.1% increase over the next six months to avoid that fate in 2002. *We've managed to outperform our benchmarks by a substantial margin during the bear market. However, absolute losses were hard to avoid during this quarter. We can only feel so good this year about a relative victory in the face of a weak absolute-return environment. As the saying goes: you can't eat relative performance!* Like you, we're more than ready for something better. So how does this decline stack up as a buying opportunity?

Well, as far as market overreactions go we can say that, as we write this, the U.S. stock market has sold off to a level that is beginning to look *somewhat* attractive. Our own assessment and that of most stock pickers we talk with is that it is still a time of caution. It is also a time to reduce long-term return expectations.

During many client meetings, we have articulated the main components of investment return: dividends, earnings growth, and P/E expansion or contraction. Dividends are at a record low, so there is only 1-2% return available from this component. Despite the hoopla, earnings are fairly constant over the years at 5-6%. The most volatile component of return is the expansion and/or contraction of the P/E ratio, which is directly related to interest rates and the willingness of investors to pay high multiples for stocks. The huge P/E-multiple expansion during the last two decades was mathematically tied to the big drop in interest rates, which was a massive tail wind for the stock market. But now, with rates low there may be no tail wind at all. We can hope for a period of rate stability (no wind) and that is quite possible. But it is also quite possible that there will be a slight headwind of rising rates that could cause multiples to contract and become a negative for stock prices.

Valuations and the lack of an interest rate tail wind is the basis for our general view that stock returns will be in the single-digit range for years to come (on average). We've been saying this for a number of years (since the annual presentation in 1999 at the Pittsburgh History Center for those of you who were clients) and now this view is widely articulated. Besides the valuation-interest rate argument, it seems to us that there is a longer-than-average list of problems that are difficult to brush aside, including:

- Foreigners invested \$386 billion into U.S. stocks in the three years ended 2001. This year the pace of flows has dropped by about 50%! With the U.S. image somewhat tarnished relative to other markets and foreign investors already heavily invested in the U.S., there is the risk that foreign flows will continue to be scaled back. We don't know if this will happen but in our opinion it is a high enough probability to be worthy of mention. To put the importance of foreign flows into perspective, foreign investment in U.S. equities wasn't far off of the \$490 billion of flows into U.S. equity mutual funds over the same three-year period.
- The onslaught of troubling headlines on corporate management misdeeds will result in significant positive behavioral changes. Regulation, prosecutions, accountability, embarrassments and more attentive investors (they weren't during the bubble) will drive change in behavior and make the corporate governance issue temporary. There may be more surprises, but we believe that management at the vast majority of public companies is honest (if not, we hope our experience in recognizing the signs as with the AGH chicanery holds us in good stead). Still, there is no question that we were in an environment where far too many management teams 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? When we assess valuations, we must use an earnings number. Is the number valid or is it in the process of being restated downward? 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. Many potential terrorist acts would probably not have a far-reaching economic impact. However, if the worst-case scenarios involving weapons of mass destruction come to pass, a severe economic impact could be felt. This is not priced into the market (nor should it be—it is far too uncertain). 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. 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. 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.) Lastly, there is a huge amount of cash on the sidelines earning very low returns.

But given all the risks, many investors are probably wondering if stocks will become a screaming buy (fall more). And that begs the next question: should we gamble that they do?

It's tempting, but our answer is no. First, we are already under weighted relative to S&P stocks, with part of our stock allocation allocated to REITs and high-yield bonds. Second, if stock returns are disappointing (low single digits) they are still likely to be competitive with the defensive alternatives of cash and bonds. And third, at two-and-a-quarter years (assigning the market peak to 3/31/2000), it is worth noting that this period of market weakness is already very long. The compounded five-year return for the period ending 6/30/2002 on stocks (S&P 500) is now only 3.6%, a period that included the "Great Bubble!"

Second, it is always important to remember that declining stock markets can be friendly.

Volatility creates opportunities for disciplined long-term investors. Several years ago Warren Buffett asked the following question in his annual report: Should a long-term investor be more appreciative of an up market or a down market? The answer, which may not be evident, is that a down market is more favorable for long-term investors because of the opportunity to buy solid companies at attractive prices.

Third, 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. It's worth mentioning that the brief love affair with individual stocks at the expense of mutual funds at the latter end of the bull market seems to be reversing. The diversification offered by funds and the realization that *good* professional management can make a difference has again underscored the common-sense appeal of funds. And while there are only a handful of great funds out there, we believe finding them is one of our strengths.

Fourth, while we are not particularly excited about the long-term return potential for stocks, we continue to view several other asset classes as quite attractive. We have below-average S&P stock market weightings

because of our exposure to high-yield bonds and REITs, both of which, we continue to believe, offer quite attractive long-term return potential. We also have significant weightings in foreign stocks, which, we believe, offer a somewhat better risk/reward relationship than U.S. stocks. Given our expectations for returns from these asset classes (which collectively make up 30% to 35% of most client accounts), our return expectations for your portfolios fall into the decent-to-good range looking out several years (though we are not expecting 1990s-like double-digit returns.)

In Closing

This is a tough investment environment. Nevertheless our asset allocation strategies, our selection of managers, and the potential to take advantage of volatility give us a high level of confidence that the next several years will provide reasonably good absolute returns. 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 longer-term outlook.

As for you, there are several things you can do to help increase the odds of investment success.

1. *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. Knowing these portfolios and each individual client as we do, we are confident that the portfolios are allocated correctly. However, if you would like to review the appropriateness of your strategy, please let us know.
2. *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.

3. *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.

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. Our ability to look at a broad spectrum of asset classes, search for the most skilled managers to implement our asset class plays, and to do so absent any conflicts of interest, puts us in a strong position to "add value".

It is our intent in subsequent editions of this quarterly newsletter to review classic investment concepts (they never went out-of-style) and to continue to educate you regarding long-term strategies. Most problems that we see in investing are not in the financial markets but in our perceptions and emotions. The burden is on us to do a good job of counseling you to understand the true nature of the financial markets and to know and possibly improve through education your risk tolerance. Adding value encompasses both quantitative and qualitative factors that are not always readily apparent. The amount of investment information (and misinformation) that is available today is overwhelming. Our goal is to develop in our clients a level of long-term trust in our services and us so that when the market is not working well, clients can rely on us to help them through. We believe that this can be done by true professionalism and scrupulous honesty. In this way, we help you to avoid permanent losses. We, in turn, build a business that is fundamentally different from most other financial service institutions.

Your comments are most welcome. Please feel free to ask for investment explanations or to suggest future newsletter topics. Please use us as an interpretive resource for the plethora of information that is constantly being distributed through multiple media venues.

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