ADDING VALUE

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SUMMARY:

It has almost happened. With the S&P down over 28% year-to-date through September, this may be the third consecutive negative calendar year for this index--an event that hasn't occurred in 60 years!

After the carnage of this quarter, some stocks have valuations that are extremely compelling. What a difference an additional 20% decline makes on future expected returns from last quarter to this quarter.

Bear markets are alarming. As in bull markets, emotions take over. Beware of the human emotions of today's market: risk aversion, extrapolation of the bear market into the future, and confirmation-bias (looking for and overweighting the significance of data that support our initial impressions, as in "See, I told you so!").

We add value to client portfolios by implementing sound, well-formulated investment policies that protect us from the very human emotions that we feel in times of stress.

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: So this is a Bear Market?

Bear markets are a normal part of the investment environment. Over long periods of time, markets experience repeated periods of expansion, consolidation, and contraction. During a bear market, the total return of the S&P 500 falls by 15% or more from a peak. The current bear leg is the longest in post WWII history and is just about tied with 1973-74 for the worst total return.

Why is the market down so much for so long? (Remember, if you have somehow forgotten, that this will be the third consecutive negative calendar year for the S &P 500.) Part of the answer resides in the period prior to the current bear leg. Since the market trough of August 1982, the next three bear legs were short-lived ranging from 2-3 months, but dramatic bull legs followed each. Taken together, the time from the summer of 1982 to the start of the millennium was the best stock market performance in US history, culminating in one of the greatest periods of speculation in modern history.

During this period, everyone increasingly had to own "new economy" stocks and then the latest Internet or technology stocks. At the height of the bubble, many of the companies had poorly conceived business plans, sparse sales, and no profits. But no price was too high to pay for these stocks. Rational thinking was ignored. As investors enjoyed huge gains they became less risk averse, pouring more money into the hot issues. Typical middle class people were walking away from good paying non-investment jobs to support themselves and their families by day trading in the stock market. People became overconfident in their abilities and thought that their skill made their portfolio go up in value. The

giddiness, greed and increased appetite for risk spread into the corporate management ranks resulting in the Enron, WorldCom, Adelphia, and Tyco debacles. One extremely insightful book on this topic is Charles Kindleberger's Manias, Panics, and Crashes: A History of Financial Crises. If you can find a copy, read or listen to it (we listened to the audio version), we are sure you will not be disappointed. (Actually as an update, this book was just re-published by John Wiley, but you can now find A Day in the Life of a Day Trader in the "bargain" section of a used bookstore!)

During these periods of "bubble thinking," people extrapolate the past into the future with respect to the market. "The more stocks go up, the more people think stocks can go up. But that can't go on forever," says Shlomo Benartzi, a business professor at UCLA.

Nevertheless, the concept is reinforced daily on CNN, CNBC, the newspapers, locker rooms, bridge clubs, investment club meetings, hospital operating rooms and even in popular books of the times (remember DOW 36,000). You should disregard comments and suggestions you hear daily about investment performance. It takes *exceptional* fortitude to avoid the inevitable wealth destruction brought about by investing according to the latest craze, and despite numerous examples in history, people continue to fall captive to the seduction of the power of the masses in good times and in bad times.

BEAR MARKET PERSPECTIVE (S & P 500 Index)

Peak-to-Peak Cycle			Bear Leg		Bull Leg		Peak-to-Peak	
Starting Peak	Through Date	Ending Peak	# Of Months	Total Return	# Of Months	Total Return	# Of Months	Total Return
May-46	May-47	Jun-48	12	-25.9%	13	31.9%	25	-2.3%
Jun-48	Jun-49	Aug-56	12	-15.2%	86	457.6%	98	372.8%
Aug-56	Oct-57	Dec-61	14	-17.9%	50	115.0%	64	76.5%
Dec-61	Jun-62	Feb-66	6	-26.8%	44	101.7%	50	47.6%
Feb-66	Oct-66	Nov-68	8	-20.4%	25	59.1%	33	26.6%
Nov-68	May-70	Jan-73	18	-32.8%	32	88.3%	50	26.5%
Jan-73	Oct-74	Sep-76	21	-44.9%	23	88.6%	44	3.9%
Sep-76	Mar-78	Nov-80	18	-13.8%	32	87.3%	50	61.5%
Nov-80	Aug-82	Aug-87	21	-20.7%	60	309.0%	81	224.3%
Aug-87	Dec-87	Jul-90	3	-33.0%	31	80.3%	34	20.8%
Jul-90	Oct-90	Jun-98	3	-19.4%	92	355.1%	95	266.8%
Jun-98	Aug-98	Aug-00	2	-15.4%	24	62.6%	26	37.6%
Aug-00	Sep-02	?	25	-44.7%	?	?	?	?
Averages	(Excludes Current Bear Leg)		12	-23.9%	43	153.0%	54	96.9%

Source: Wright Associates and Trinity Investment Management Corp.

When the market finally reverses, and it always does, the same psychological elements play on investors but in the opposite direction. Just as investors become less risk averse in bull markets, they become more risk averse in bear markets. Today, individuals are taking money out of stocks and investing in more stable investments such as bonds, money market funds, and bank CD's. As the stock valuations were at 50-year highs during the bull market, now fixed income yields are at 50-year lows during the bear market. As individuals extrapolated the bull market into the future, now they are extrapolating bear markets into the future, believing that it could be a long time before stocks will ever go up. Fear replaces greed as the dominant emotion influencing decisions. Confidence is shattered.

So, what should we do?

First, if you have a good long-term investment program, stick with it. If you don't, get one. Bear markets test the emotions. In some cases, the test could be the final exam. A long-term, thoughtful investment policy should be an anchor, grounding the investor when financial markets become turbulent. The most difficult part of investing is not intellectual but emotional. One must sustain a long-term focus when things look bleak. It is really fear combined with other psychological elements that cause us to abandon investment policy in a bear market. We can remember after the 1987 market crash a major corporation discarding its investment policy and moving all of the pension plan assets away from stocks and into all fixed income securities only to miss out on the great returns from stocks in the 1990's. The cost to both the corporation and the pensioners when this occurs is huge. Try to avoid ad-hoc investment decisions especially in bear markets. Remember that the long-term odds favor the bulls and not the bears. Success in investing is simply making decisions that place the odds in your favor.

Second, don't try to time the market--*ever*. We often hear the words, "If you knew the market was speculative and overvalued in the 90's, why didn't you get out avoiding the subsequent bear market?" Unfortunately, one could have come to the conclusion that the market was high and speculative in 1995, 1996, 1997, 1998, 1999, and 2000. The problem is just because one makes the conclusion doesn't mean the market is headed for an immediate reversal. Markets can stay overvalued or undervalued for extended periods of time. We could conclude today that the market is bargain priced. That doesn't mean that the bear market is over. The overwhelming conclusion of the empirical and academic studies on market timing is that the odds are not in your favor. Market timing decisions must be correct 70% of the time just to stay even with the non-timer. Bull markets generally start with a bang. On average, in the first 20 trading days of each new bull market since World War II, the S&P 500 jumped 9.5%. So being out of the market in big moves can be very costly. Remember that the odds are in your favor to stay with a solid investment program through thick and thin.

Third, bear markets provide opportunity for the long-term investor to buy stocks at low prices. The stock

market is the only market where when prices are lowered buyers stop buying. Likewise, when prices go up, people start buying. It is normally the complete opposite in the markets for food, clothing, autos, etc. As Jason Zweig puts it, "If we shopped for stocks the way we shop for socks, we'd be better off." Thoughtfully adding to a solid investment program during a bear market can add value to your portfolio in the long run. This is because the succeeding bull market generally wipes out bear market losses. However, patience is required. Some might say, "I'm in retirement and taking money out of the portfolio and can't take advantage of the bear market buying opportunities." While that's true, an investment policy that includes diversification through non-correlated asset classes can help cushion the impact of withdrawals in a bear market. For example, real estate securities and value style investment managers have held up relatively well in this bear market. Secondly, rebalancing the portfolio after extreme market reactions serves the same purpose as using new cash to "buy low."

Fourth, don't get too concerned about over- or under-performing the popular averages. If you achieve consistently good absolute returns over the long run, you should be able to meet your investment objectives.

In closing

We were investors during 1973-74, but we were also younger. Our life savings was small compared to what we have accumulated over the past 30 years. Bear markets are humbling experiences even for experienced investors. While we have avoided the major carnage of the technology bubble, there has been no avoidance of the declines in the third quarter. Of all the equity assets in every client portfolio, there was only one with a positive return. That single positive equity investment was in Berkshire Hathaway stock. In the parlance of our children, "That's awesome!"

Unfortunately, investors are people and, like all people, make decisions based on emotions. Ironically, as human beings, investors like best those upward market movements that are most adverse to their long-term interests and dislike most those downward market movements that are in their long-term interests. Who among us does not feel a warm glow of affection for stocks and markets that have gone up, even though the future rates of return at these price levels will surely be lower? Using that same logic, we should be ecstatic about today's bear market, because now our expected future returns are considerably higher than they were last quarter. Only by understanding this paradox and developing and adhering to wise and appropriate policies that can over time achieve realistic and relevant investment objectives can investors achieve superior returns.

Your comments are most welcome.

Our Best Regards,

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