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Active Management Is Risk Management

Insurance permeates virtually every part of our lives. We insure our health, homes, cars, most valuable possessions, our life and even our pets. But when it comes to our investments, which assure that we can continue to pay all those insurance premiums when we retire, the vast majority of financial advisors advocate buy and hold investing, leaving individuals completely vulnerable to the risk of down markets.

Admittedly, investing always carries some measure of risk and investors can lose money as well as make money, but doesn't it make sense to do something to try to control the risk of investing, just as we try to control the risk of loss in other areas of our lives?

Active investment management is designed first and foremost to minimize losses from market drops. It is hard to overstate how very important limiting losses is to the health of an investment portfolio. In 1994, ***Barron's*** ran an article looking at how deep the wounds of a bear market can go. Writer John Lisco discovered that 26 years later an individual with $10,000 invested in the Value Line Index on December 14, 1968 was still lagging an investor with $10,000 invested in U.S. Treasury bills on the same date. It will be very interesting to see how long the Nasdaq Composite Index takes to catch back up with a T-bill investor of January 2000.

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Is the Bear Market Over? Experts Differ

There are many reasons to be optimistic about today's stock market. The indices have been moving steadily up from their lows of last October, the economy appears to be improving; quarterly earnings are coming in on target or above projections and investors continue to shrug off bad news and focus on the positive. But in the midst of optimism, some voices in the investment profession are sounding the call for caution. One of these is Jeremy Grantham, a very highly respected money manager and analyst. His firm, Grantham, Mayo, Van Otterloo (GMO), manages $22 billion.

> ***"The markets can be irrational longer than you can be solvent."***
> *John Maynard Keynes*

Grantham's basic investment theory is that over time investment classes come back to the average. Working with colleague Ben Inker, Grantham looked at every bubble in stocks, bonds, commodities and currencies for which they were able to find reliable data. Bubbles were defined as 40-year events in which statistics went well beyond the norm by at least two standard deviations.[1]

Grantham and Inker found 28 such bubbles. Every one of the 28 went back to trend, with no exceptions, no new eras. According to their research, the long-term average price/earnings ratio for the S&P 500 is 14, and Grantham expects the P/E to

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Peter Bernstein's Shocking Words

Peter Bernstein is among the most respected figures on Wall Street. Founder and President of Peter L. Bernstein, Inc. - established in 1973 as economic consultants to institutional investors and corporations around the world; first editor of the *Journal of Portfolio Management*: economics professor on the Graduate Faculty of the New School for Social Research in New York; author of Against the Gods: The remarkable story of risk, he's known for advocating that investors stick to a strict asset allocation policy.

But Bernstein has a new claim to fame. At a conference for institutional money managers this year, Peter Bernstein expressed doubt that investors will be able to achieve respectable returns with a static portfolio.

"What if we can no longer be so confident that stocks are necessarily the best place to be in the long run," the *Wall Street Journal* quotes Bernstein saying. "What if moving around more frequently is now a necessity rather than a matter of choice? I am talking about market timing – dirty words."

"If we don't know what the future holds, why lock ourselves into a position for the indefinite future?"

Bernstein's comments may have been shocking words to Wall Street, but to investment advisors who have long advocated active investment management, they are common sense.

"Those Dirty Words: Market Timing. Prominent Strategist Bernstein Hints It's, Ahem, Time to 'Time'; Dismissing Conventional Wisdom," Tom Lauricella, *The Wall Street Journal*, August 27, 2003, page C1.

Want to Retire a Millionaire?

The earlier you start saving, the less you will need to save to be a millionaire at age 65. The catch of course, is that a million dollars isn't what it used to be. Fifty years from now it may take $10 million to equal the purchasing power of $1 million today. But it still makes sense to start early and save 'til it hurts if you want to retire comfortably. And, don't forget to use an investment strategy that manages risk so that if a bear market hits when you're ready to retire, you won't see your net worth disappear just when you need it the most. The following chart shows how much you will need to save to become a millionaire by age 65 based on an 8% return, compounded annually.

Age You Start	Annual Investment to Retire Millionaire at 65	Total Investment by Age 65
20	$ 1,025	$46,125
25	$ 1,720	$68,800
30	$ 2,920 (just $250/month)	$102,200
35	$ 5,000	$150,000
40	$ 8,770	$219,250
45	$ 15,600 ($1,200/month)	$312,000
50	$ 29,000	$435,000
55	$ 60,000($5,000/month!)	$600,000
60	$ 161,000	$805,000

This is a hypothetical example. There can be no assurance that any investment would achieve an average annual return of 8%. Investors could lose money as well as make money.

Active Management Is Risk Management

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To understand why minimizing losses is so important; you have to recognize the mathematics of gains and losses. It takes a 25% gain to make up a 20% loss and a 100% gain to make up a 50% loss.

Following stock market reports in the media makes it sound as if the Nasdaq Composite Index[2] is quickly regaining ground and will have investors back to break even in no time. After all, the index has gained nearly 65% since its low in October of 2002. The catch is that the index needs to gain 337% from its low to return to break even. Even with the recent market gains, the Nasdaq still needs another 165% gain from its current levels to retrace its high. How long that will take is anyone's guess.

Investment advisors who subscribe to buy and hold investing will argue that bear markets happen very infrequently and that the long-term direction of the market is up, so there is no need to take the risk of missing part of the gain through an active management approach. But don't we insure our houses even when the likelihood of a fire destroying the structure is far less than the certainty that a bear market will occur?

The buy and hold advisor also likes to conveniently overlook the advantages of preserving capital and having more to invest when the market begins to recover. Suppose by using active management you had missed some of those good days leading up to the market's downturn in 2000 but you preserved the majority of your capital. Now instead of simply trying to recapture your portfolio's prior value, a 65% increase in the Nasdaq Composite is contributing to real growth in your portfolio. That's the rationale for active management. And it's a good rationale.

Sure, there are no guarantees in investing. Nor are there any guarantees that you will live a long and healthy life, that your house won't burn down and your teenager won't wreck the car. But we put systems in place to manage risk and to limit its financial impact on our lives. Active management is one of those systems.

2 The Nasdaq Composite is an index use to measure the value of stocks traded on the Nasdaq National Market... Individuals cannot invest directly in an index.

Is the Bear Market Over?

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return to 17½ in the next 10 years (allowing a slight upward trend to account for the stability of the markets).

Most P/E ratios for the S&P 500 stocks now range from 30 to 35. They actually worsened during the bear market as earnings declined. If Grantham's theory again proves correct, but the return to average is gradual, there will be only a modest negative return to shareholders. This is because equity prices will essentially stay where they are as earnings increase (S&P earnings have grown at an average of 5.7% including inflation over the last 40 years). If the decline in earnings per share is more dramatic, there may be more bear market news ahead.

The fact that markets return to their average is a point also made by Professor Robert Shiller in his book, Irrational Exuberance. He points out that no stock market at the P/E levels of the late 1990s has ever returned anything to buy and hold index investors after ten years.

Grantham also pointed out in a 2001 interview in *Barron's* that great bear markets take their time. 1929 started a 17-year bear market, as did 1965.

So what does this all mean to an investor today? Bear markets do their greatest damage to buy and hold portfolios. For investors who are willing to be nimble, there are always opportunities for profit during bear market. Markets often stage short term recoveries. Seasonality patterns occur. Sectors stage strong recoveries.

Successful investing often means taking an opportunistic approach to the market and being willing to buy when opportunities appear to present themselves and sell when trends change. This is the objective of active risk management. While there can never be a guarantee that an investment strategy will make money and the potential for loss always exists, an active risk management strategy could be especially valuable if Grantham's views prove to be valid.

Past performance is not indicative of future returns. While history often follows similar patterns, it never repeats exactly.

1 Standard deviation is a measure of variance within a list of values. Roughly 95% of the values will fall within plus or minus two standard deviations of the average value.

Why September and October Are Sometimes Tough on the Financial Markets

While October generally gets the most media coverage as a bad month for investors, thanks to major market downturns in October of 1929, 1987 and 1997, September has historically been the hardest month on investors, falling in 30 out of 51 Septembers since 1952. Yet, as we go to press, it appears that 2003 will buck the averages.

According to Art Cashin, Managing Director at UBS Financial Services and head of floor trading at the New York Stock Exchange, the pattern of September-October lows can be traced back to the crop cycles of the early U.S.

Wall Street folklore, explains Cashin, maintains that the two most likely periods of the year to see a low are April/May or September/October. Historically, these months were periods when major changes took place in the flow of deposits between rural and urban areas.

As factories became clustered in cities, so did their banking accounts. Every fall, when factories purchased crops for processing, cash flowed from the city banks to the country banks. In the spring the pattern reversed as farmers bought seeds and equipment from city-based businesses. The result was less money in the city or rural area temporarily. But that was often enough to put some shaky enterprises out of business... and start a panic.

The Panic of 1907, perhaps the worst bank panic in American history had some part of its root in the crop cycle and is the primary reason the Federal Reserve Bank was established. Why the same pattern has continued in recent years could be from factoring in historical expectations, seasonality trading or perhaps just chance.

Do You Know Your Federal Capital Gains Tax Rate?

As a result of the new *Jobs Growth Tax Relief Reconciliation Act of 2003*, federal capital gains tax rates on investments have changed, potentially impacting your investment decisions.

Gains recognized on or after May 6, 2003 through December 31, 2007, on securities held more than one year, now have a maximum federal tax rate of 15%, down from 20%. Taxpayers in the 10 and 15% income tax brackets will pay only 5% on long-term capital gains as of May 6, 2003, down from 10%. In 2008, taxpayers in the 10 and 15% brackets have a 0% tax on long-term capital gains. Then in 2009, federal capital gains taxes are scheduled to return to rates in place prior to May 6, 2003.

Short-term gains on assets held for a year or less continue to be taxed as ordinary income.

Prior to the Act, dividends paid by corporations were taxed at the same rate as ordinary income. Now dividends will be taxed at 15% for most taxpayers, effective January 1, 2003 through December 31, 2008. Taxpayers in the 10 to 15% tax brackets, however, will pay federal taxes on dividends at 5% through December 31, 2007 and then 0% in 2008. To qualify for the lower taxed on dividends, common stocks must be held for 60 days (90 days for preferred stocks).

Distributions from real estate investment trusts, may not be considered dividends for this purpose and will be taxed at the higher ordinary income tax rates. Dividends paid by a mutual fund may qualify for long-term capital gains and dividend tax rates if they meet the standards set by the legislation. Year-end mutual fund reports should show this breakdown.

Beyond Securities, Rates Multiply

If you sell a personal home you have lived in for two of the five years preceding the sale date, there is an allowable exclusion from taxable gains of $250,000 per individual and $500,000 for a couple. Gains above the exclusion levels will now be taxed at 15%. If you have not lived in the home a full year, the gain may be taxed at your personal income tax rate.

The exception is those taxpayers in the 10 to 15% income tax brackets. They will pay a maximum 5% long-term gains rate on property held for more than a year, except in 2008, when the rate drops to 0%. Lower income sellers may find, however, their capital gains push them into the higher 15% tax bracket on at least a part of the gain. Here again, gains on property held for less than a year may be taxed at the individual's personal income tax rate.

There is still a 25% rate on gains from selling real estate that has been depreciated, allowing the IRS to recapture some of the tax breaks the property owner has received via depreciation.

Collectibles held as personal investments are subject to a 28% tax. Gains for small business stock are also subject to the 28% rate, however, qualified stock held for more than five years may qualify for a one-half exclusion of the gain from income.

This information applies only to federal tax rates. Each state has its own capital gains tax structure. To optimize after-tax values, it makes sense to work with a tax consultant prior to selling or gifting investments or properties that have experienced substantial appreciation. Keep in mind, the provisions of the 2003 tax relief act expire at the end of 2008.

The above information is intended as a general discussion of tax rates on capital gains and does not purport to cover all the complexities of the current tax code. Please consult with your financial advisor on the tax impact of selling or gifting investments and property.

Eliot Spitzer and the Canary Capital Brouhaha

In early September, New York Attorney General Eliot Spitzer announced a $40 million settlement with a New Jersey hedge fund, Canary Capital, over allegations that it engaged in illegal trading in mutual fund shares sold by a number of Wall Street firms and banks. The settlement coincides with the filing of a civil complaint in a New York state court that outlines an elaborate scheme between a hedge fund and group of big mutual funds to game the system at the expense of ordinary mutual fund investors.

Repercussions of that announcement continue to shake the mutual fund industry. Because Mr. Spitzer ***incorrectly*** termed the actions of the hedge fund "market timing," mutual funds are reviewing timing policies and strengthening enforcement of existing policies.

Among the positives emerging from the rubble are improved monitoring to detect illegal after-hours trading, consistent application of policies among all shareholders, greater disclosure from fund companies, more consistent marketing approaches, and an assessment from the fund companies themselves of the actual cost of frequent trading.

One concern is that, in an effort to limit excessive trading, which some label by the term "market timing," fund companies could adversely impact the ability of individual investors to limit losses in their portfolios and take advantage of market opportunities through penalties on transactions that take place within a 90-day or shorter period. In some instances, quarterly rebalancing of portfolios could even be deemed "market timing."

The "exchange" privilege which facilitates active management of mutual funds actually arose out of the bear markets of 1973-74 as a way to lure the small investor back into a very volatile market place, similar to today's. Revoking this privilege will restrict the liquidity of investors in the funds and could have a much larger impact on the average investor than any hypothetical cost of timing.

As you receive notices from your fund companies, read the policies carefully and consider how these policies might have impacted your account in the past. And then let your fund companies know when you have concerns. Overall, assets are down dramatically at the fund companies and they are much more sensitive to the concerns of their existing shareholders than they were when assets were on the rise. Your comments do matter. If you have concerns about how changes in fund company policies will affect your accounts, don't hesitate to call.

I would like more information about:

- ❒ Retirement planning
- ❒ Investing lump sum distributions from retirement plans
- ❒ Risk management of mutual funds
- ❒ Investment options offered by your firm
- ❒ Past performance for your investment programs
- ❒ Tactics used by your firm to avoid market declines
- ❒ Information on your firm's history
- ❒ The following topics discussed in the newsletter ______________________

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PHONE ______________________ BEST TIME TO CALL ______________________