the Investment ADVISOR

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Desperately Seeking the Bottom

Is the bottom finally here? Read five financial publications and you will get five different readings on the market. Talk to five economists and you'll have five different answers. The media dithers about why the stock market, which typically leads a recovery, is failing to lead this one. A different analyst points to P/E ratios and says the market has yet to hit a bottom. Another respected analyst says that bonds may be signaling a bottom in stocks.

The truth of the matter is that no one knows for sure how low the bear will go, when it will end, or whether it has already ended. Nor do we know what the recovery will be like. But we don't need perfect knowledge to invest successfully over time. What we do need is a heightened sensitivity to trends in the market, rules for buying and selling positions that minimize risk, and most of all, the discipline to follow those rules without fail through thick and thin.

Including the darkest bear market in recent history, the Bear of 1929 when the S&P 500 lost 87% of its value, there have been 13 bear markets in the past century, as defined by the S&P 500 declining a minimum of 20%. The longest bear market lasted 41 months and took the impetus of World War II to recover. The shortest was in 1987, which lasted only four months. So far, this bear has lasted nearly 22 months, a bit longer than the average (18 months) but by no means a record. Nor is the percent of decline yet a record. Of course, if you look at the NASDAQ rather than the S&P 500, the current decline is in its

Statistics are like witnesses; you can always get them to testify for either side.

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401(k) Options to Protect Retirement Savings

Congress is in the process of attempting to pass bills designed to prevent more Enron-type meltdowns in 401(k) portfolios, but no law can take the place of common sense. If you are worried about your 401(k) retirement savings, there are a number of steps you can take now to help minimize potential losses.

(1) Limit the amount of your portfolio you have invested in your employer's stock or for that matter in any stock. If financial problems develop at your company, you could face both the loss of a job and the loss of value in your retirement portfolio.

(2) Diversify your portfolio. Diversification can take many forms, from diversifying across different asset classes to different management styles, such as growth and value investing. That allocation may be static or active. Our preference is an active allocation approach that seeks to position assets in response to market conditions. If you lack the time and confidence in your ability to decipher the market, investigate whether your 401(k) plan allows you to use a professional investment manager.

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Move Over for the Econophysicists

One of the most credentialed studies showing the potential value of active management was conducted by University of Michigan finance professor H. Nejat Seyhun for Townley Capital Management and published in 1995. Dr. Seyhun constructed a value-weighted index of the New York Stock Exchange, the American Stock Exchange and the Nasdaq stocks and then looked at the potential results of buying and selling at the right and wrong times.

While no one has come up with a perfect system, there is clearly room for improvement over a buy-and-hold strategy.

According to the Townley study, investing **$1** on a buy-and-hold basis in the value-weighted index would have returned **$637.30** from 1926 to 1993. A perfect timer would have ended the period with **$690,000,000.00.** While no one has come up with a perfect system, there is clearly room for improvement over a buy-and-hold strategy.

The latest group to pursue the dream of perfect investing is a new breed of market researchers dubbed econophysicists. Among the goals of the econophysicists are redefining risk and understanding price fluctuations from the ground up using principles and

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28th month, and the percentage decline has been almost 70%.

On the positive side, the U.S. economy appears to be making a slow but steady recovery. In June, Federal Reserve Chairman Alan Greenspan told a group of banking chief executives, "It's not going to be a dramatic upswing. But events look increasingly positive." Casting doubts on the recovery is the fact that historically, the stock market leads an economic recovery. Values typically turn up before economic growth. Of course, for values to turn up, investors have to see earnings growth or else have a good reason to expect earnings improvements. Right now there is some skepticism as to whether corporate earnings can recover to prior levels under stricter accounting rules and if the earnings some companies reported in the past were even real.

Even more discouraging can be the latest proclamations that investors might need to expect returns in the 4-7% range going forward, putting retirement plans on hold for many investors who were counting on the double digit returns of the 1990s to last forever.

What should you as an investor be doing? It is probably prudent to take a more conservative stance toward the market and your personal finances. You should be invested in strategies that provide downside protection — that don't leave you vulnerable to open-ended losses without an exit strategy. At the same time, these strategies need to be sensitive to the market's direction and move you back in when the trends turns up, even if that upward surge is limited.

Remember, even markets that end up being flat over extended periods of time can have interim periods of exceptional returns before the trend changes direction. When the market rebounds, not all sectors will move at the same pace. Picking the right sector and using active management have the potential to make a big difference.

On the personal finance side, look for ways to reduce spending and pay off debts. Sure, the economy needs robust consumer spending to speed a recovery, but leave that spending to others. If you can refinance and lower your payments or consolidate more payments in a tax-deductible loan, now's the time to do so. Greenspan can't afford to lower interest rates more without scaring off foreign investors and further weakening the dollar. And as Japan has proved, 0% interest rates don't necessarily spur an economic recovery.

Bear markets are very healthy for economies in the long run and this one will be as well. We're already seeing real benefits in terms of flushing out deceptive accounting practices and bringing CEO salaries and perks back to earth. The dot.com debacle has helped bring a sense of perspective back to the markets.

There's a major shake up underway in Wall Street, and in the pension and defined benefits industry that could have very positive long-term impacts on investors. One of the more realistic bills before Congress is to allow employees to turn to investment advisors to help with their 401(k) investments.

The pendulum is swinging. The result of that movement will be opportunity. We need to keep our options open, stay flexible and allocate investments accordingly.

S&P 500 Bear Markets

1929 - 2001

Bear Market	Duration	% Decline	Time to Break Even
Sep 29 - Jun 32	33 mos	86.7	25.2 yrs
Jul 33 - Mar 35	20 mos	33.9	2.3 yrs
Mar 37 - Mar 38	12 mos	54.5	8.9 yrs
Nov 38 - Apr 42	41 mos	45.8	6.4 yrs
May 46 - Mar 48	22 mos	28.1	4.1 yrs
Aug 56 - Oct 57	14 mos	21.6	2.1 yrs
Dec 61 - Jun 62	6 mos	28.0	1.8 yrs
Feb 66 - Oct 66	8 mos	22.2	1.4 yrs
Nov 68 - May 70	18 mos	36.1	3.3 yrs
Jan 73 - Oct 74	21 mos	48.2	7.6 yrs
Nov 80 - Aug 82	21 mos	27.1	2.1 yrs
Aug 87 - Dec 87	4 mos	33.5	1.9 yrs
Jul 90 - Oct 90	3 mos	19.9	0.6 yrs
Sep 00 –	—	35.8	—

Source: Society of Asset Allocators and Fund Timers, Inc., 2001 Study.

Past performance is not a guarantee of future results. The performance information above is not illustrative of the past or future performance of any investment product.

401(k) Options to Protect Retirement Savings

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(3) Investigate your opportunity to move assets out of your 401(k) plan. Some plans allow you to begin rolling assets out of your plan even while you are working for the 401(k) plan sponsor. Moving assets into a Rollover Individual Retirement Account (IRA) allows you to avoid any investment restrictions the plan sponsor may have and assures that you can add a professional manager.

(4) If you have money in a former employer's plan, move it into a Rollover IRA. This removes any investment restrictions you might have under your former employer's plan and protects you from problems at your original 401(k) plan sponsor, such as changes that may prevent trading in your account for brief periods. With an IRA, your investment options are greatly expanded and you can add professional risk management.

(5) If you need money, avoid taking premature cash distributions from your 401(k) balance. Federal income taxes, state taxes and a possible 10 percent early withdrawal penalty can easily reduce a withdrawal by 50 percent. Many plans allow you to borrow against the balance of your 401(k) assets, leaving those assets to increase. This avoids the immediate impact of taxes and also gives you the incentive to rebuild your retirement assets.

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mathematics gleaned from the study of physics. Multiagent modeling, as this research is called, throws together psychological motives, rational strategies, and social dynamics in order to identify what elements control how stock prices evolve. With that said, it's worthwhile to remember that the creators of Long-Term Capital, which holds the distinction of most recently nearly bringing down the US banking system, were also recognized as mathematical geniuses.

All models of the financial markets need to be created with the recognition that history never repeats itself exactly. As Mark Twain said, "History doesn't repeat, it rhymes." Predicting the market will never be an exact science. Fortunately, there is great opportunity for achieving good long-term returns with an active management strategy without being perfect.

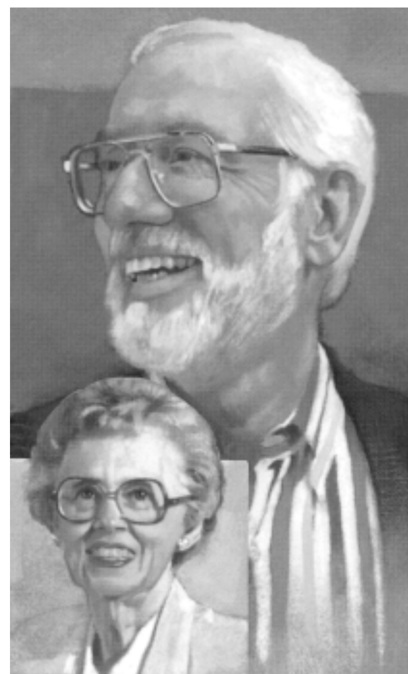
The Physics of the Trading Floor, Mark Buchanan, Nature, January 2002

Estate Taxes and Ownership

When it comes to passing on the assets you have accumulated to your heirs, you need to be aware that how you title assets and name beneficiaries on accounts take priority over anything stated in your will. Jointly held assets (joint tenancy with right of survivorship) pass directly from the decedent to the joint tenant, falling outside the reach of the will document. Even if the will states that the family home will be sold and proceeds divided equally among the family members, if one child was put on the title of the home as a joint tenant with right of survivorship, the will has no power to force the sale and division of proceeds.

The same applies to retirement or insurance accounts where a specific individual is designated as the beneficiary. The individual(s) listed as the beneficiary has no obligation to comply with any directives of the will. The assets pass directly to that individual upon the account holder's death.

This information is not intended as legal advice, but an alert to the complexities of estate, inheritance, fiduciary and tax issues. To control what will happen to your assets after your death, you need to talk with professionals familiar with the issues.



How you title assets and name beneficiaries on accounts take priority over anything stated in your will.

Fixed Income Investing Comes with Its Own Risks

There's an inclination when the stock market heads south to turn to bonds and other fixed income investments. After all, historically bonds and equities have moved to different drummers. When stocks are down, bonds have done well. But that is not always the case. *Successful fixed-income investing, much like equity investing, requires an active approach.*

Over the last 20 years, junk bonds have been repackaged as "high-yield" bonds, and with that repackaging has come the tendency of investors to forget that the value of a bond depends on the company's ability to repay the bond and interest. With a strong bull market, risk was less of a concern. A company could always refinance or sell stock if needed to service its debt. The spread on high-yield bonds has become increasingly attractive over the last four years, not because the companies are better positioned financially, but because the risk is greater than ever.

Successful fixed-income investing, much like equity investing, requires an active approach.

That doesn't mean high-yield bonds are not a viable investment alternative, but buy-and-hold can be a risky approach in fixed-income investing as well as equity investing if you are not careful in selecting bonds backed by solid companies and are not prepared to hold bonds to maturity.

Bond values correspond with the earnings ability of the issuing company. With operating earnings under pressure and access to the capital markets limited at best, some high-yield bonds are slipping into default. To avoid the credit risk associated with high-yield bonds, an investor might consider U.S. Treasury bonds, but these offer less return and have interest rate risk unless held to maturity. Since interest rates are more likely in our view to increase rather than drop further from current levels, this will depress the value of long-term bonds.

Bonds have their place in your portfolio. But they aren't risk free. Active management adds value to a bond portfolio as well as to equity investing.

Tax Deferred Can Mean More Growth

One of the first rules of investing is to take advantage of tax-deferred opportunities as much as possible. By postponing the payment of taxes on investment gains until you actually withdraw those gains, your money works harder for you. Amounts that would otherwise be lost to taxes are earning returns.

If you will be withdrawing earnings at retirement, when theoretically your tax rate will be lower, tax-deferred is an even better option.

How much difference can tax deferral make in the long run? The table below shows the after-tax results of $100,000 invested in a taxable and tax-deferred investment earning 10% annually for 20 years. We've assumed a federal tax rate of 28% and state income taxes of 5%.

If the taxable investment is in a tax-efficient fund, which offers more long-term capital gains, annual taxes could be lower due to a lower capital gains tax rate. But few mutual funds are truly tax-efficient. Many generate considerable short-term gains, resulting in gains taxed at an individual's personal tax rate. An investor's tax rate could also exceed the rate used in this example, adding more value to tax deferral.

Initial Investment	10% Return Compounded Annually	Ending Value of Taxable Investment	Ending Value Tax-Deferred Investment	Tax-Deferred Advantage
	Before taxes	*After 20 years of 33% annual taxes*	*After 33% taxes at the end of 20 years*	
$100,000	$672,750	$359,041	$444,015	**$84,974**

Another way to increase the after-tax value of your investments is a Roth IRA. With a Roth IRA, taxes are paid up front on contributions, but there are no federal income taxes on the final withdrawals, provided the accountholder is 59½ years of age and meets the Roth withdrawal rules. Contributions to a Roth IRA are limited to $3,000 annually through 2004 but rise over time as shown in the chart below. Investors may also rollover existing retirement accounts into a Roth IRA by paying taxes on accumulated earnings at the time of the rollover. Talk to your tax consultant to see if this makes sense for you.

Year	IRA contribution limit
2002-2004	$3,000
2005-2007	$4,000
2008 and after*	$5,000

* Beginning in 2009, the contribution limit will adjust annually for inflation in $500 increments.

If you are 50 or older you can make additional "catch-up" contributions of $500 more than the normal limits in 2002 through 2005. Starting in 2006, the "catch-up" amount will increase to $1,000. In order to qualify for the "catch-up" contribution, you must turn 50 by the end of the year in which you are making the contribution.

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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ADDRESS ____

CITY ______________________ STATE _____________ ZIP __________________

PHONE ______________________ BEST TIME TO CALL ______________________