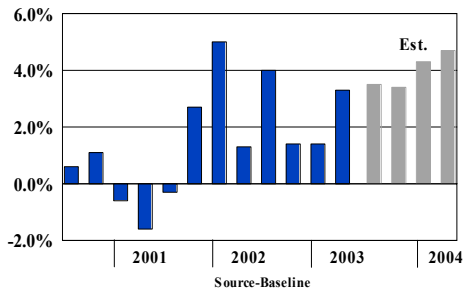


## Third Quarter 2003 Highlights

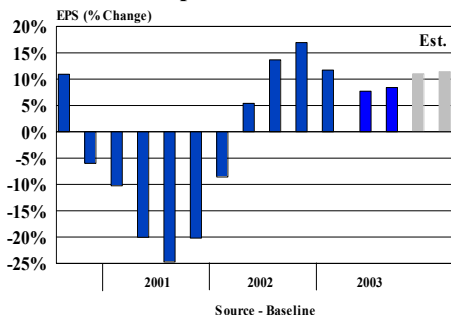
October 2003  
Issue 16

### Gross Domestic Product



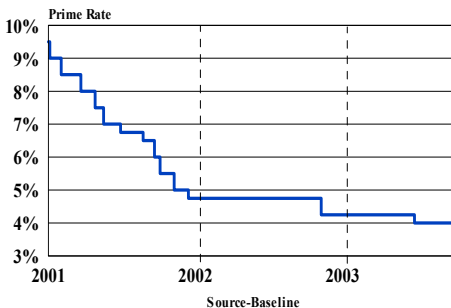
### Economists GDP Forecasts Are Rising

### Corporate Profits



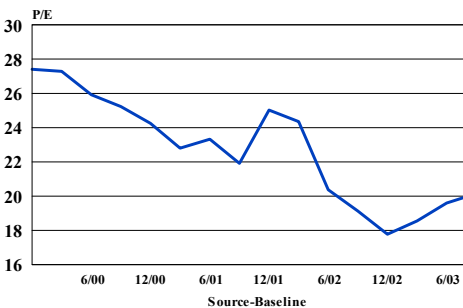
### And Corporate Profits Should Respond Accordingly

### Interest Rates

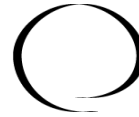


### Interest Rates Have Bottomed And Stayed Low

### S&P500 P/E Ratio



While Stock Market Valuation Remains Cheap  
Vs. Past Years



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## Is This A Normal Recovery?

By Charles D. Osborne  
and Brett Prior

While there can be little doubt that the US economy is much improved since the second quarter of 2001, for many people, this recovery doesn't feel quite right.

The sense that we are still not quite in "expansion" mode, raises the following question: Is this recovery actually different from other recoveries - or are our expectations for a more rapid turnaround simply unrealistic?

To answer this question, we need to first review the concept of the business cycle and the definition of "recovery". The business cycle is defined as "a predictable long-term pattern of alternating periods of economic growth (recovery) and decline (recession), characterized by changing employment, industrial productivity, and interest rates." Recession is defined as "a period of general economic decline; specifically, a decline in GDP for two or more consecutive quarters." Whereas, a recovery is defined as "a period in a business cycle following a recession, during which the GDP rises."

Accordingly, in order to have a recovery, we needed to have a recession - and that we did. Officially, the recession began in March of 2001, and ended in November of 2001. During those three quarters:

- U.S. Gross Domestic Product shrank in each quarter by an average of -0.8%
- Unemployment rose from 4.2% to 5.6%
- Industrial Production fell 3.8%
- Interest Rates on the 10 Year Treasury Bond fell from 4.9% to 4.7%

Using those same definitions, our current recovery would have begun in November 2001 and is still underway. So, how is the recovery going?

- U.S. GDP has grown in every one of the last seven quarters (average of 2.7%)
- Rather than decreasing, unemployment, has continued to increase from 5.6% to 6.1%
- Industrial production has risen a meager 1.3%
- Interest Rates on the 10 Year Treasury Bond continued to fall from 4.7% to 4.4%

At first blush, these numbers don't look too impressive. It is worth noting that we are only 21 months into this "expansion" phase, whereas the average post-war expansion phase has lasted 57 months. So the real question is: How does this recovery compare to other recoveries? To answer that, we have put together a few comparisons of the current recovery vs. the two previous recoveries (using the first 21-month period in all cases):

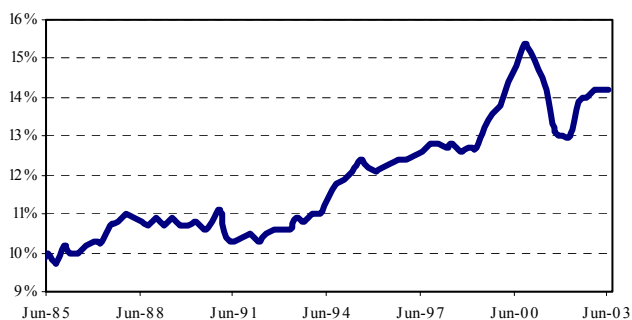
	<u>Avg. of previous 2 Recoveries</u>	<u>Current Recovery: '01-'03</u>
U.S. GDP growth	+4.9% avg.	+2.7% avg.
Unemployment	-1.4% pts	+0.5% pts
Industrial Production	+11.0%	+1.3%
Interest Rates	+0.4% pts	-0.3% pts

Two conclusions become clear:

1) In both cases, even with a recovery underway, the employment situation takes time to recover. In the case of the '90-'91 recession, it was a full 15 months after the recession ended before unemployment peaked (at 7.8%) and began to decline. This time around, unemployment continued to rise for 19 months before peaking at 6.4% in June 2003. It has since declined to 6.1% in August.

2) Whereas in the previous two recoveries, Industrial Production came back strongly, this time around the improvement has been anemic at best. Why? There are two reasons for this weakness. First, even though consumer spending has been strong over the last 2 years, much of the positive effect of that spending has leaked abroad – as consumers continue to buy imported goods. Unlike past recessions, where the US dollar was devalued and imports became relatively expensive for the American consumer, this time around the US dollar maintained its strength and imports remained attractively priced.

**Imports as a % of GDP, 1985-2003**

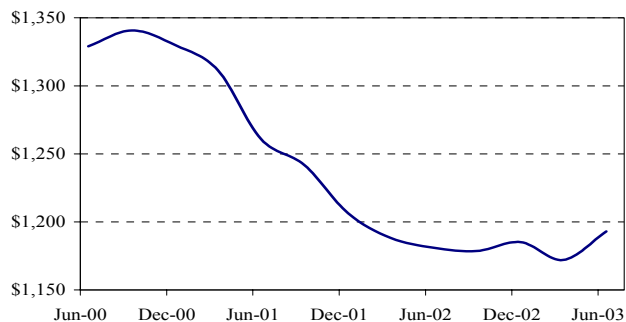


***“Consumers are spending more of their income on imported goods than in the past”***

Second, corporate executives have taken a “wait-and-see” approach to capital spending. Their companies were burned by overcapacity at the end of the last cycle, so they want to be certain that this recovery is “real” before committing to capital outlays and additional hiring. This wide-spread caution has resulted in the postponement of many large-ticket purchases, and these delays have caused capital spending to stagnate.

Is there hope that businesses will start spending and hiring again – thereby making this feel more like a textbook

**Real Capital Spending (\$B)**



***“Businesses are reluctant to resume capital spending”***

recovery? Sure, and there is plenty of data that indicates we are headed in that direction:

For the last 3 months, The Institute for Supply Management Index gave readings above 50, which means that the manufacturing economy is expanding (after having shown contraction for the previous 4 months).

Retail sales have improved every month for the last 10 months (on a year-over-year basis).

New Home Sales reached an all-time record level in June, and have maintained that strength through August

Existing Home Sales have been strong, and even accelerated in the last few months

To be fair, it should also be mentioned that there is no shortage of data to support the idea that our "recovery" is tottering and will continue to sputter.

Consumer Confidence, after rebounding strongly at the end of the Iraqi conflict, has once again begun to deteriorate.

The Trade Balance continues to balloon – with the deficit currently hanging around \$40B

Orders for Durable Goods have shown almost no improvement since the beginning of 2003

So, is this a “normal” recovery? Compared to historical data, this recovery is both slower and less robust. But it is a recovery, nonetheless.

While there are signs that point to future strengthening, and indicators that point to future economic weakness, on balance, the data would appear to be weighted toward economic expansion. Growth after recessions doesn’t always come as fast as we might like, and that is probably a good thing.

Hypothetically, if every indicator did point up, and we had a sharp v-shaped rebound – it wouldn’t take long before supply couldn’t keep pace with demand, and we would be in a real inflationary bind. Rest assured, that is not the scenario we face, and we should be thankful for that.

## California Budget Deficit and Your Municipal Bonds

*By Robert C. Gillooly*

The State of California is once again in a budget crisis. Long gone is our state's once highly regarded AAA credit rating, in fact, California General Obligation debt is now rated only one level above junk bond status. How did the fifth largest economy in the world get itself into such a bind and when are we likely to dig ourselves out of this black hole? More importantly, you may ask, is how will this affect my municipal bond portfolio? There are over \$44 billion invested in California municipal bond mutual funds alone, so the impact of this situation is far reaching and of great importance.

Let's get the bad news out of the way first; the California Legislative Analysts Office projects a budget deficit of \$8 billion for each of the next two fiscal years. In other words, this problem will not be resolved anytime soon. Now that we got the ugly forecast out of the way, how did we get there? During the internet boom years the state of California was a huge beneficiary of revenue derived from taxes on stock options and capital gains. In fact, at its' peak in fiscal 2000/2001, stock options and capital gains represented 25% of all revenue received by the state. In dollar terms this amount topped \$17.6 billion, almost triple what it was three years prior. On an annual basis for 2004, the Legislative Analysts Office predicts that revenue from stock options and capital gains will amount only to roughly \$5.3 billion. With such a dramatic shift in our budget, sacrifices will certainly be made.

California General Obligation bonds are the issues most directly impacted by the aforementioned dilemma. Our state has a \$99 billion budget and the issuance of these G.O. bonds is important to its' solvency. Bonds usually trade at interest rate levels commensurate with their credit quality and consistent with the bond market as a whole. Right now California G.O. bonds are trading at yields about .5% greater than other states, which implies there is somewhat greater risk owning these bonds. California G.O. bonds, furthermore, trade at roughly the same rate on an after tax basis as Ford Motor Company. This begs the question, would an investor rather own California or Ford Motor debt? Our data suggests that the risk of holding G.O. bonds is overestimated, as common sense argues that the diverse economy of California is in far better shape than the incentive laden and cyclical auto industry. We are quite comfortable owning and holding G.O. debt.

A notable difference of this budget crisis, versus those of the past, lies within the improved flexibility the state and its' municipalities possess to bridge the gap. The California General Fund, for instance, expects to receive \$2 billion from a national tobacco settlement, \$2 billion from a bond issue for future pension obligations, \$3 billion in one year various revenue anticipation bonds and perhaps another \$1 billion

repatriated from municipalities. Hardly the perfect long-term solution, but perhaps enough to sustain things until the economic environment improves. The trickle down effect has also been minimized. The state has wisely loosened many of the cash reserve covenants that smaller 'in state' bond issuers had to abide by. For instance, school district requirements for cash reserves are temporarily half of the usual amount, allowing them to keep programs in place. Redevelopment agencies also now have the option of choosing from which project they will send money back to the state, so they do not put too much strain on any one project or bond issue.

At OPCM we believe the California municipal bond market is still a good investment. Issues such as water, electricity, and school districts all remain attractive due to their essential service nature and improved flexibility provided by the state. As a back up, virtually every bond we purchase carries private company insurance in case of default, giving them a AAA credit standing. So until California is able to rebound to more robust economic times, the diversity and flexibility built into our system should be more than adequate to maintain a strong municipal bond market.

## The Tax Cut: How Will it Work for You?

*By Shannon S. Gallo*

The Economic Growth and Tax Relief Reconciliation Act of 2001 provided for tax cuts that would be phased in gradually through 2010, however, this year President Bush signed a bill that accelerated those gradual tax cuts effective for 2003. The new provisions are subject to differing "sunset provisions" until 2010 but in the meantime, here is how you will benefit:

The biggest news for investors was the reduction of taxes on dividends and capital gains that went into effect May 6, 2003. Qualified dividends received by individual stockholders will now be taxed at 15%, rather than the individual's higher ordinary income rates. A few exceptions and special rules apply for dividends to qualify for the reduced rate:

1. A stockholder must own the stock more than 60 days during the 120 day period before the stock's ex-dividend date, if not, those dividends will not qualify for the reduced rate.
2. The reduced rate does not apply for mutual savings bank dividends or on employer securities held by a qualified ESOP, when dividends are distributed to employees.
3. Using investment interest expenses as a deduction cannot be done if the taxpayer uses the reduced rates for dividends.
4. Qualified dividends paid by real estate investment trusts or regulated investment companies are limited.

For capital gains, from sales and exchanges held for more than one year, the 20% rate has been reduced to 15%; however, the deduction for capital losses is still limited to \$3,000. For those individuals in the lowest tax bracket, the 10% rate has been reduced to 5%. The reduction in capital gain rates

may present some gifting opportunities for individuals who wish to gift low cost stock to their children and/or grandchildren, who may be in the lowest tax bracket.

Personal income tax rates have also been cut, so individuals should have more money to take home in their paychecks. The impact may seem insignificant but for a couple making \$70,000, they will save an additional \$1,486 dollars. Individuals, who in the past have been subject to the Alternative Minimum Tax (AMT), may receive a break as the AMT exemption amount has been increased. Married couples filing joint returns will no longer be penalized, as the basic standard deduction has been doubled. Finally, the child tax credit has increased from \$600 to \$1,000 per qualifying dependant child under age 17, and most individuals with young children will see an immediate benefit in the form of a payment from the government.

Overall, this creates some new savings opportunities for everyone. Investors can take advantage of selling appreciated assets held for more than a year. Some investors may choose to add dividend paying stocks to their portfolios, retirees who receive dividends may be able lower their quarterly estimated tax payments for 2003 and nearly all individuals will see an immediate benefit from the reduction in taxes withheld from their pay. With the uncertainty associated with the Act, most of the changes may be short lived, but with proper planning investors and individuals should be able to take full advantage of the new provisions until then.

## Investment Managers, Stock Brokers, Financial Advisors, and Wealth Managers – What’s the difference?

*By Kirk Michie*

Over the course of the last decade, the distinctions have become very fuzzy between professionals in the financial services industry. From one side, traditional banks, brokers, and trust companies have moved toward offering more products and services using the catch-all phrase, Wealth Management. This makes it very difficult for most investors to understand the difference between Bank of America (Bank), Smith Barney (Broker), and Northern Trust (Trust Company). Further complicating the issue, each one of these firms (and each of their best competitors) overlap with the other – banks offer brokerage services, brokers have trust departments, and trust companies offer investment consulting services. The driving force is control of more and more of each client’s assets. Because of these additional services, a client who comes to Merrill Lynch for basic brokerage services might ultimately find that their mortgage loan is also of great interest to their broker. Many of these additional services are truly beneficial to clients when the relationship manager at the bank, broker,

or trust company, truly understands their client’s total picture. Often, however, clients become dissatisfied with the lack of clarity and accountability with all of these overlapping areas, and find themselves faced with the same dilemma again when trying to find a new “Wealth Manager”.

Since 1937, it has been the experience of the investment professionals at **Osborne Partners Capital Management** that focusing on our core strengths is the best use of our time, which ultimately is the most beneficial activity for our clients. We work with trust companies when there is a need for professional fiduciary services, and brokerage firms to handle custody and trading within our clients’ accounts. Our clients often call on us for recommendations for banking services related to both their business and personal needs, and we find that 65 years of experience in our marketplace leaves us well informed to assist them. Additionally, the firm regularly provides other professional recommendations to clients for tax, estate planning, insurance, and sometimes even alternative investment expertise. Helping our clients protect and grow their assets in the most prudent and thoughtful manner means assessing their goals and objectives, structuring their investment and financial plans to optimize income and estate tax laws, and a host of other considerations. On behalf of current and prospective clients, we routinely provide or assist in the following activities:

- *Investment Management*
- *Financial Planning*
- *Asset Allocation*
- *Restricted Stock Analysis*
- *Mutual Fund Investing*
- *Estate Planning*
- *Income Tax Planning*
- *Investment Consulting*
- *Alternative Investments*

For the bulk of our clients, we are the primary point of contact on finance and investment issues, and have developed our skills and expertise accordingly. Charles Osborne, Robert Gillooly, and Justin McNichols have over five decades of investment management expertise with both private and institutional clients. Kirk Michie has 20 years of experience with investment planning, income and estate tax issues, and investment consulting. Finally, we are proud to announce that in her tenth year with Osborne Partners;



**Shannon Gallo**, our *Director of Client Service*, has been awarded the distinction of **CERTIFIED FINANCIAL PLANNER**

When it comes to drawing the distinctions discussed earlier, the necessary clarity will not come from someone who’s trying to sell you other products and services, or does not fully understand your specific circumstances. To that end, please feel free to call any of the professionals at Osborne Partners Capital Management with your questions or concerns. Often, we can provide the most effective solution, and when the issue is beyond our area of expertise, we can objectively assist you with a more informed decision about your options.