Second Quarter 2003 Highlights

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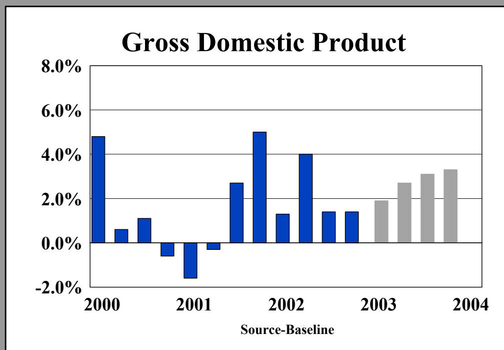
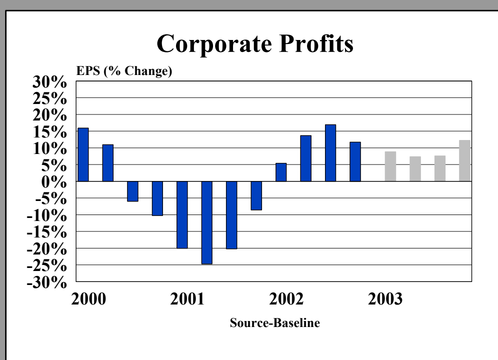
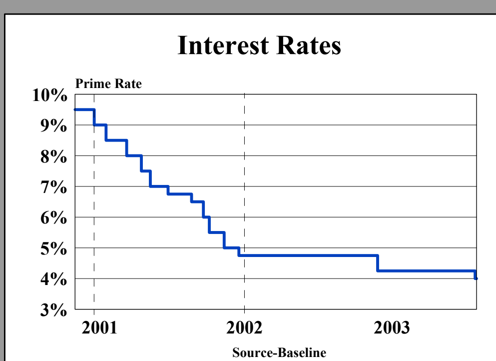
Issue 15



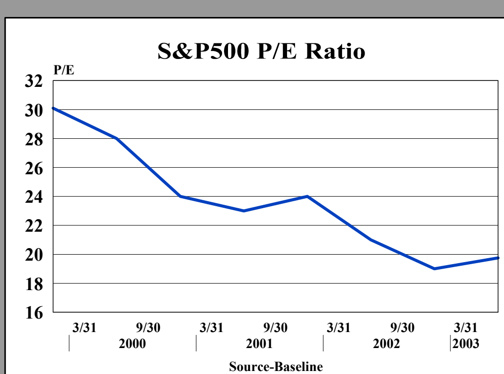
Economists Forecast Stronger Second Half Growth



And Corporate Profits Should Respond Accordingly



Fed Cut Interest Rates For Perhaps The Last Time



The Market Remains Attractive Due to Low Rates

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Business Cycle

By Charles D. Osborne

Economic indicators are pointing in every direction. We are coming off the strangest recession and recovery in the last century. Housing, a notoriously cyclical sector, stayed very strong during the slowdown. Joblessness never went much higher than 6%, yet personal income is still stagnant. Capital spending has yet to see any hints of improvement, but corporate profits have been on the rise for five quarters and interest rates are at 1958 levels. People are worried about deflation while the dollar has sunk to five year lows, and oil and other commodity prices are rising. <u>Just where are we in the economic cycle?</u>

The National Bureau of Economic Research, the official arbiter of recessions, has yet to say that the recession that started in March of 2001 has concluded. This would make it the longest recession, next to the depression, in the last one hundred years. A more likely scenario is that they will call the beginning of the recovery sometime in 2002, but their pronouncements take time to develop.

Since records have been kept from 1857, the business cycle in the U. S. has been pretty straight forward. An economy expands until demand starts to outstrip supply, shortages occur, wages rise, inflation sets in and causes price instability. Central banks raise interest rates. This slows down the demand for housing and other durables and kills inflation. The slower growth means factories lay off employees, businesses stop investing, and home sales drop. In order to resume growth, interest rates are reduced, businesses regroup as consumers start to spend, and the economy stabilizes then expands.

What was different this time?

In the first place, the expansion lasted longer than any on record, ten years. Despite this growth there were no real shortages of goods or services, thanks to increases in productivity and world trade. There was little inflationary pressure, and the central bank saw no need to substantially raise interest rates. Indeed, the only shortage seemed to be of internet stocks and office space in San Francisco. Then, the economy seemed to simply run out of steam. Over-investment in telecommunications, due to Y2K replacements and the internet frenzy stopped, and this affected the entire information technology industry. The fall of the tech stocks affected the entire stock market, thereby causing a negative wealth effect. The disaster of September 11th kept everyone at home worrying about personal security. The fragile recovery went through a second shock as the wars in Afghanistan and then Iraq distracted consumers and businesses alike. But, little by little, we started to see improvement.

In the last few quarters we have seen many positive indications of recovery and expansion. Consumer sentiment is on the rise, after hitting ten year lows in March. Housing never slowed down, industrial production is rising albeit fitfully, and the stock market staged a nice recovery. Employment and capital spending always lag in recoveries but it seems they have at least bottomed out. The low interest rates and tax cuts will work very positively on the economy and savings rates, and corporate earnings are still improving. We are clearly in some kind of recovery through the second quarter.

The boom-or-bust business cycle as we have known it in the past is probably dead. World trade, massive increases in productivity and real-time communications killed it, and our shift from an industrial-based to an information-based society insures us of that. This does not mean economies will not modulate, but that the extremes will be much more muted or confined to sectors. The general tops and the bottoms have been cut off. Just as we did not see a peak in this last cycle marked by shortages, we probably will not see a trough marked by widespread surpluses. After periods of rapid wealth creation, due to innovation like the internet and wireless technology, there will be periods of consolidation.

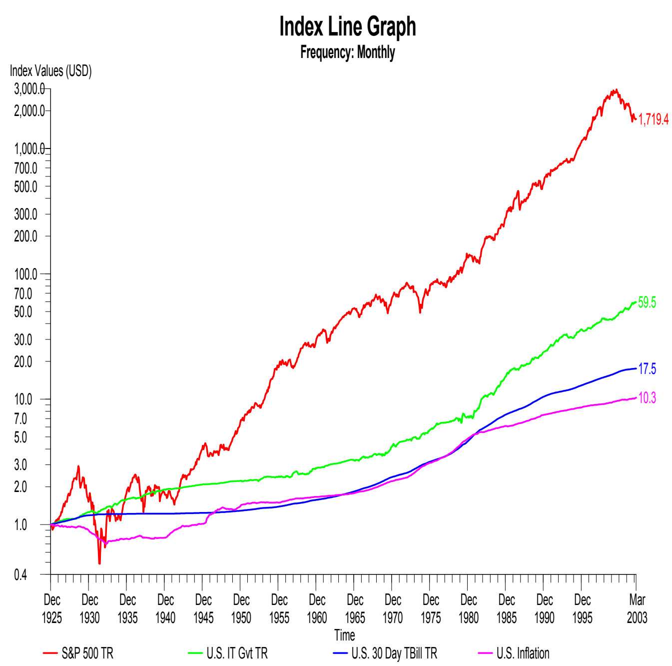
So we are in the recovery or consolidation stage of the cycle, even if it does not feel like it. Recoveries by definition are spotty and irregular. The conflicting data represents some of the new aspects of our high speed world, but underlying fundamentals are intact. <u>The population of human desires will never decrease.</u> These desires drive our economic growth, and it will be world trade, the rapid exchange of information and expanding population that provide the means to achieve these desires.

Real Investment Planning is Both an Art and Science

By Kirk Michie

The most common proxy for "The Market", the S&P 500 has just finished its best performing quarter since Q4 '98. Impressively, 469 of the 500 companies in the index finished the period in positive territory – clearly, the tide came in, and virtually all of the ships rose.

While the U.S. equity markets are still down from their highs in 2000, investor interest is on the upswing, and many market participants are re-examining their portfolio strategy accordingly. This is the kind of trend that causes investors to move more money toward the equity markets, and away from fixed income and liquidity alternatives, which seems both intuitive and correct. Let's examine some historical data:



If investors, professional or novice, were able to accurately time being in the market during its upswings, and out during the downturns, the potential returns would be extraordinary – history tells us that neither group can do this with any measure of success. Most professional investors instead rely on maintaining a strategic asset allocation (mix of stocks, bonds, cash, etc.) for the long run. The problem, however, involves a number of analytical factors, and then a few decidedly non-systematic variables like emotion and experience. If we only dealt with the math of asset allocation, it would be as straightforward as the following example for an Investor with $1 Million and 20 years until retirement, using historical data for returns and inflation:

Year 1 Expenses @ $75,000/year (after tax, covered by current income until Retirement)
Year 20 Expenses = $136,557 (assuming 3%/year inflation)

Initial Value of $1 Million invested 60% stocks/40% bonds would produce approximately 8% (10% from stocks & 6% from bonds)/year before taxes & 5%/year after taxes:

Portfolio Values

Year 20 (pre-tax)	Year 20 (after-tax)
$ 4,926,803	$ 2,712, 640

If this investor begins to spend 100% of the Total Return of his portfolio beginning in Year 20 (@ Retirement), the after tax amount should be approximately $135,632, nearly equal to the Year 20 Expenses of $136,557. With that basic mathematical logic, this investor can then preserve his/her capital, and meet their living expenses comfortably.

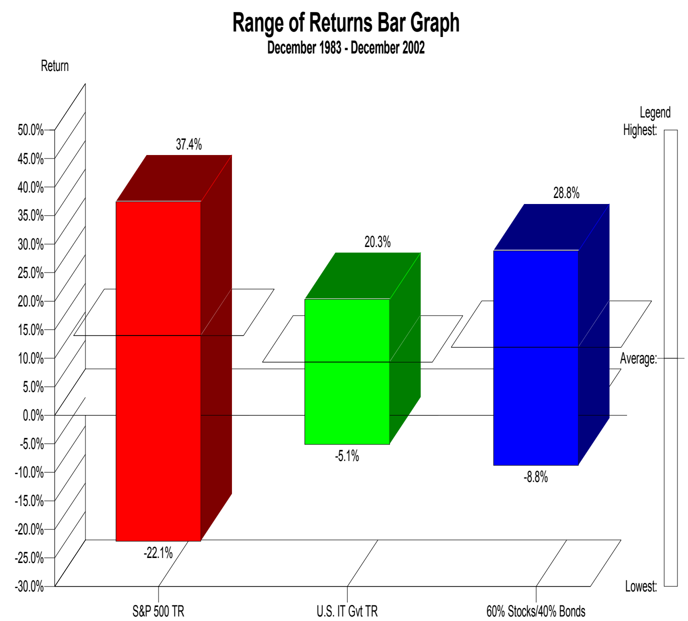
The tricky part, however, is factoring in the investor's biases, the market's vagaries, and other external data. A number of very good questions emerge, the least of which is; Will the market produce historical levels of return going forward?

Let's set that aside for a moment, and focus on often overlooked, but very critical variable in this equation; *How will this investor **feel** in getting to this return, and living with this portfolio?*

Here are the returns for stocks, bonds, and a balanced portfolio for the *past* 20 years, as well as the value of $1 Million invested, at the beginning of the period, in each Asset Class/Mix (pre-tax):

Annual Returns (12/82 – 12/02)

Asset Class	Avg	Best	Worst	Value
Stocks S&P 500	13.98%	37.4%	-22.1%	$8.9 Million
Bonds Int. Govt	9.33%	20.3%	- 5.1%	$5.4 Million
60% Stocks 40% Bonds	11.23%	28.8%	- 8.8%	$7.7 Million



The most counter-intuitive notion in Investment Planning is borne from the above table – the relationship between return and risk is not perfectly linear. Said another way, the trade off is not even. A portfolio of 60% S&P 500 (stocks) and 40% Intermediate Government produced a bit more than 80% of the return of an all equity portfolio (11.23% v. 13.98%), yet only incurred about 65% of the risk (variability). While the fixed income investor had the easiest ride, the sacrifice for the comfort was a cost of more than $2 Million – a hefty price to pay, to be sure.

One of the key tenets of our philosophy over the past 65 years at Osborne Partners has been strategic asset allocation. Whether the market seems poised for rally or correction, over time it will cycle, and we'll be compensated for accepting some risk, and anticipating some reward. Our advice to clients is always; First, apply the math necessary to figure out the allocation you *need*, then assess your experiences, and next apply the art of determining what your comfortable with going through to meet your objectives.

Source: Standard & Poors, Ibbotson Associates

A 25% Rally, Now What?

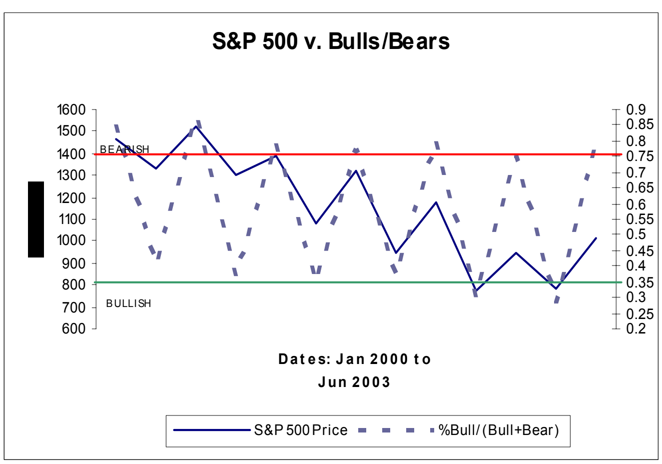
By Justin W. McNichols

Interest rates low, inflation low, earnings bottoming, everyone bearish = S&P500 index $790.

Interest rates low, inflation low, earnings bottoming, everyone bullish = S&P500 index $1015.

As witnessed countless times in history, the market deceived the herd again. Many of the factual signals were there – low interest rates, the Fed pumping money into the system, companies matching reduced earnings expectations, historic low P/Es on trough earnings, massive pessimism, and high volatility.

Unfortunately, after a 25% rally, all the bears have become bulls (see chart).



* Bulls now outnumbers Bears by a margin of 60% to 16%.

This is not a directional market call, but simply a lesson on sentiment. The story the chart portends is one similar to most market bottoms – we are due for a period of digestion from the recent move to SPX 1015, and much of the easy money has been made.

Bear markets bottom for a multitude of different reasons during each separate bear market. Amazingly enough, the 'way' they rally is quite similar. If this is indeed a new cyclical bull market, it is very common to see over one-half of the total gain during the first few months. Investors on the sidelines for the first few months usually 'miss' half of the bull market gains.

From a portfolio management stand point, our Investment Team's belief in a more muted economic cycle going forward should give us the opportunity to patiently improve portfolios. After a nearly fully invested position in the spring, we will continue to trim positions that become fully valued, while using our discipline to add/swap companies that pass our internal quantitative and fundamental screens.

Proxy Voting Disclosure

The SEC recently enacted a new Proxy Voting Disclosure for Investment Advisors. A summary of OPCM's Proxy voting guidelines are as follows: Osborne Partners will not be obligated to vote, may refrain from voting and will not be required to direct the client's agent to vote proxies on behalf of the client, unless otherwise agreed to in writing. The only accounts OPCM will vote proxies for will be for those accounts that the Department of Labor has defined as ERISA accounts.

OPCM will vote with the company's management and their recommendations unless otherwise indicated. The quality and confidence the firm has in a management team is a major criterion used in the decision making process when stocks are purchased. A designated proxy administrator is responsible for voting all proxies and will vote in accordance with OPCM's pre-determined proxy policy for ERISA accounts.

Notice with respect to OPCM's position is also stated in OPCM's written agreement and ADV Part II. ERISA clients may contact Shannon Gallo to obtain information on proxies voted on their behalf at (415) 362-5637.