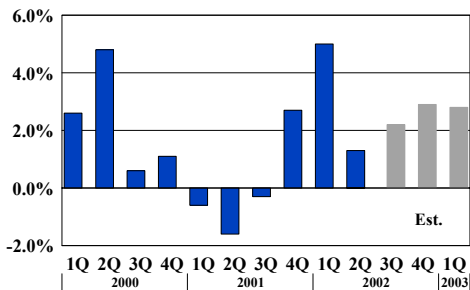


## Third Quarter 2002 Highlights

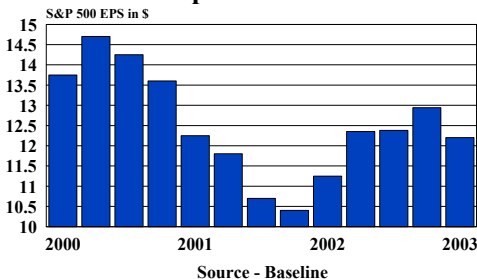
October 2002  
Issue 12

### Gross Domestic Product/% Chg



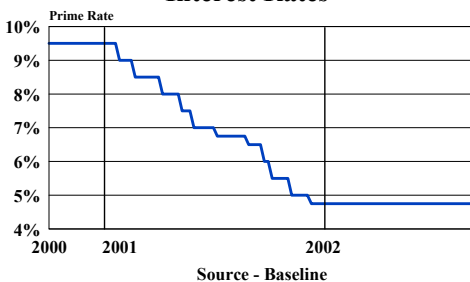
The Economy Has Weakened A Bit

### Corporate Profits



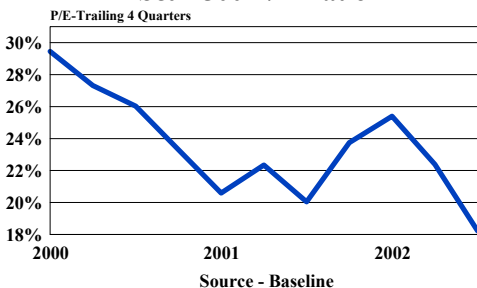
But Corporate Profits Remain Firm

### Interest Rates

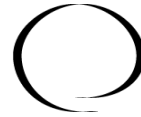


As Interest Rates Hit 40 Year Lows

### S&P 500 P/E Ratio



The Market P/E Now Looks Attractive



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## Stocks in Times of War and Corruption

By Charles D. Osborne  
&  
Robert C. Gillooly

The severe and extended stock market decline has led many people to second-guess the value of equities for the long term. While we understand these concerns, we urge investors to remain committed to equities through this turbulence. Alternative investments, while much in vogue lately, can be fraught with risks and liquidity issues that should be evaluated closely. Short term trading and market timing have rarely proved to be effective in the past. We have looked at the alternatives for long-term investors, from venture capital to real estate, and we feel that despite the last three years, a

*diversified portfolio of common stocks will be the most rewarding from this point.*

Stocks do well in good economic climates, and in most times economies are growing. That is not the case right now. We currently are in a period of stagnation and uncertainty, but history has shown us that these times do not last. In the last sixty years we have had less than ten years of recession and fifty years of growth. The basic drivers of that expansion are still in place. Population growth in the U. S., free trade around the world for the most part, and a capitalist system that rewards the entrepreneur, all drive our economy forward. On the average, stocks returned 10% during this period, better than bonds, real estate or cash.

What is different this time? A stagnant economy, lingering questions about corruption in corporate America, and the threat of war with Iraq. Though these issues are in the headlines today,

there are many episodes of economic dislocation, corporate malfeasance and geopolitical risk in the past—importantly equity markets have anticipated and recovered from these periods in the past and we believe they will do so in the future. The potential loss of wealth and negative market sentiments surrounding these transitory events will clearly cast a pall over consumers and business decision makers. Though this new set of variables is worrisome, and will surely slow any recovery under way, there are many other reasons for long term investors to take heart.

Crooked CEOs? At the end of every expansion we discover shenanigans by business people from Billy Sol Estes in the 1960's to Robert Vesco in the 1970's and Mike Milken and Ivan Boesky in the 1980s. These people found it impossible to let go of the dream of profits forever, and manipulated corporate results. The extent of the current problem is large, but hard-working honest people run 99% of the corporations out there. Like economic stagnation, this is not a lasting problem.

Many investors are concerned about the most appropriate way to position their portfolios in the event of a war with Iraq. There are many questions that need answering such as, 'should I buy bonds', 'what kind of stocks should I own', and even 'should I even own stocks right now'? Unfortunately there are no clear cut answers to some of the above questions, but we will attempt to shed some light on this conflict at hand.

A common theme in uncertain times like these is a flight to safety. Buying bonds is one way to accomplish this and the instrument of choice is U.S. Treasury bonds. As prices for U.S. Treasuries have increased dramatically and yields have consequently fallen to forty year lows, what does an investor do now? If war erupts perhaps prices could be driven even higher. Although, if it is an extended conflict the costs will be enormous and this would spur inflation, which is bad for bond prices.

Bonds will also under-perform in an improving economy, which we believe will not be far off. So other than their safety characteristics, it is hard to get too excited about the prospects of bonds.

The same philosophy holds true for stocks. Many market pundits feel every portfolio should hold a very high percentage of oil related stocks. The feeling is that if we go to war the price of oil will spike thus creating additional profits for those companies. But what if the conflict is resolved quickly? Iraq might be allowed to sell more oil and the U.S. might be inclined to dump some of its' strategic reserves that have been accumulated. Both would create new supply on the market and likely lead to a fall off in oil prices. Once again, we choose to focus more on supply and demand as it relates to world economies. As economies improve, the demand for energy and oil will increase pushing up prices. If the world falls into another recession, production will likely fall off limiting demand for energy. In other words, we hold energy stocks not only for their defensive characteristics but for their growth potential along with the economy going forward.

The fear of the unknown as it relates to the stock market almost always has negative implications. Whether it revolves around the outcome of a presidential campaign, questions about corporate accounting practices, or the threat of war, the stock market does not handle uncertainty well. But long-term investors have come to understand that these are short-term issues and are resolved in due time. One potential long-term effect resulting from a war would be a return to budget deficits and consequently inflation. The stock market, however, has served as a hedge against inflation and has historically earned fair returns in this type of environment. It is much easier for a company to pass through prices on their products to consumers, which will be reflected in higher corporate profits leading to higher stock prices.

Studies on market psychology emphasize that investors expect the market to do what it has done most recently. If the market has been down, they expect it to go down, and the longer it stays down, the longer it will take to recover. This obviously has outweighed attractive valuations of many stocks, and only time will cure this perception unless there is an external event to spark a lasting rally.

So in this negative environment where do we put our money for long-term investments? The ten-year Treasury bond is below 4%, real estate is illiquid and commercial property is overbuilt. In addition, rents are coming down in many markets. Cash yields are very low, and cash is a temporary fix anyway. Foreign stocks generally follow the American market so they are not a good choice either. Gold is a solution to inflation primarily, and that is not a problem right now. Stocks with high yields can also be volatile, dividends can be cut and they will be discarded the minute the market starts to rally. There is little upside potential, although there is some false comfort. Small company stocks as a group may work well, but specific issues are subject to all the problems big companies have, without the benefit of proven products and services. Finally, hedge funds and short funds that have been in the news lately will prove to be niche styles that have most of their performance behind them. *As internet investing was a fad three years ago, shorting is becoming the new easy money fad.* Therefore, we come back to quality growth stocks.

We must remember that the stock market is not an entity in itself but a compilation of individual companies with varying outlooks for profit and sales. If I were Bill Gates (I'm not) and able to buy any company in the world, then I would be buying the highest quality growth companies available, because they are cheap and attractive. When you could pay \$65 billion for all of Home Depot, like you can today, and cash out your

entire investment in less than seven years, and still own all of the company, then prices are attractive. It would take you twice as long with a Treasury bond to get your cash out and similarly with most commercial real estate.

Our counsel at this time is to upgrade the stock portfolio to the best quality companies and wait. We want nothing more than to own the best companies at the eventual bottom. *Prices are more than reasonable and the alternatives are uninspiring.*

We cannot predict the bottom or the top of any market, but we can compare valuations, historical circumstance and investor psychology. Our conclusion remains the same.

Timing the market does not work. If you sell and want to get back in the market, there are never any little bells that ring to tell you it is time. What will trigger that decision? If the market goes up 1000 points from here we may be looking at the same rally that happened in August, and you lose again. On the other hand, if the market goes down 1000 points you will not have the stomach to step up and buy. Do not make investment decisions on the direction of the market, but look to diversification in your portfolio that will allow you to participate in the growth of good companies.

## Charitable Gifting

*By Shannon S. Gallo*

As we begin the fourth quarter, many individuals will begin thinking about charitable gifting to various organizations. I thought it would worthwhile to mention a couple of other options available for individuals to complete their charitable gifting programs which can include using a *National Donor Advised Fund* or a *Pooled Income Fund*.

*National Donor Advised Fund* accounts can be an easy and convenient way of gifting but operate slightly different than *Direct Gifting* to the charity. First, an account is established on behalf of the individual donor from which to make charitable gifts. A minimum of \$10,000 in investable assets must be initially contributed to the account. If securities are contributed, the assets are immediately liquidated and the donor then invests the proceeds in one of several mutual funds available to grow tax-free. What makes contributing to a Donor Advised Fund unique is the individual receives a **full and immediate tax deduction** in the year the gift is made, even if a decision has not been made as to which charities will receive the gift(s). This can be very beneficial for individuals who make gifts close to the end of the year and do not necessarily have a specific charitable organization in mind. The donor is allowed to take the tax deduction and then make a gift from the account in the following year. Once the donor wants to make their gift, they simply call or log-on to their account via the website and advise the fund to make a gift on their behalf. The Donor Advised Fund facilitates notifying the charitable organization of the gift and delivering the funds. In addition, the donor names a 'successor donor' so upon their death if funds still remain in the account, the successor donor can continue making gifts/grants and carry on the original donor's legacy.

The *Pooled Income Fund* operates slightly different in that a \$20,000 minimum contribution is required to establish an account, as the funds gifted are meant to generate a lifetime income stream for as many as two beneficiaries, with the charity eventually receiving the gift. The account operates in a similar fashion to the *National Donor Advised Fund* with the two major exceptions. The first being beneficiaries are named to receive the income stream and the donor then receives a **partial tax deduction**, depending on the actuarial calculation of the income to be received. Secondly, upon the death of the last income beneficiary, the *Pooled Income Fund* will distribute the remainder of the account to the chari-

ties the donor has recommended.

Both the National Donor Advised Fund and the Pooled Income Fund provide tax benefits similar to a Charitable Remainder Trust or a Charitable Lead Trust, but at a much lower cost and the gifting can potentially be on a smaller scale. Even in those years when appreciation of equities is not a motivating factor to minimize long term capital gains taxes, the tax benefits of gifting can still be derived from selling a business, receiving an inheritance, having high income in any given year or holding low cost basis stock.

## Meet The Newest Additions To Osborne Partners

Kirk Michie recently joined OPCM to direct our client development efforts as Director of Marketing. Kirk has worked with both individual and institutional investors at Merrill Lynch, Bernstein Investment Management and Research, and Kayne Anderson Rudnick. He received a B.S. in Finance from the University of Southern California, and is a CFA Level II candidate. Kirk enjoys golf, competitive running, snow skiing, and has two daughters, ages 11 and 8.

Our newest Client Service Associate, Natalie Erickson, also recently joined OPCM after relocating to San Francisco from Minnesota. Natalie attended St. Cloud State University and received a Bachelor's degree in Geography. Prior to OPCM, Natalie was an Account Manager in the incentive marketing business. She designed programs for a company's sales force by providing merchandise, trips and promotional items. Natalie enjoys spending time with friends and family as well as reading, traveling, cooking and yoga.

Please join us in welcoming both of these individuals to our firm.