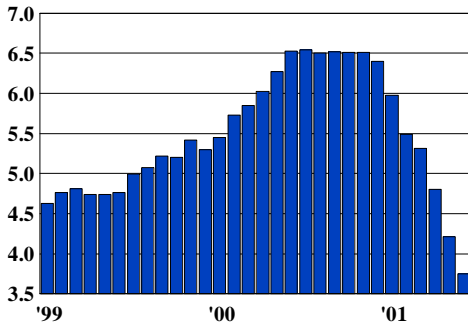


Second Quarter 2001 Highlights

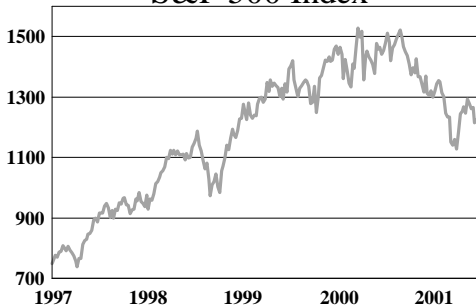
July 2001
Issue 8

Federal Funds Rate



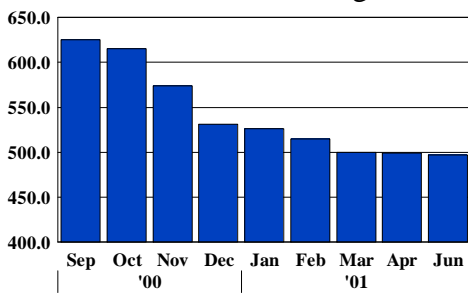
The Fed Cut Rates For A Sixth Time

S&P 500 Index



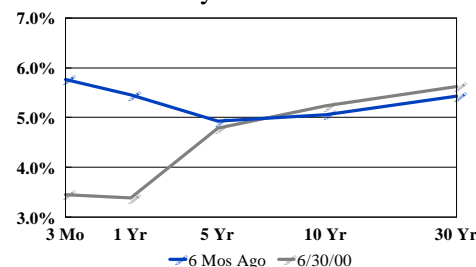
But the Market Lags

Dow Jones Est. Earnings 2001



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Timing Isn't Everything - Or Is It?

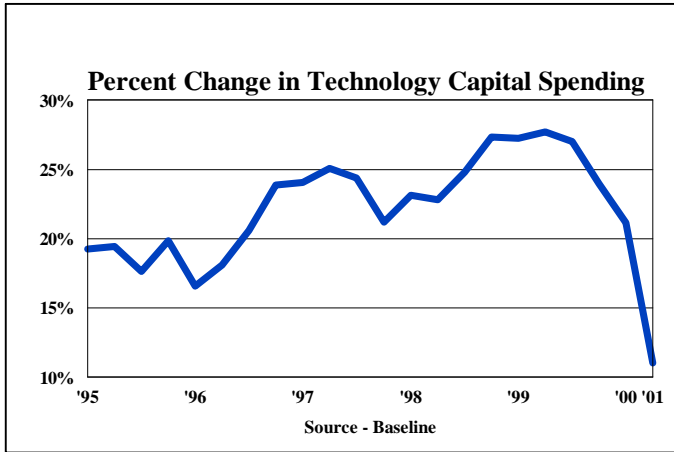
By Robert C. Gillooly

Over the past decade the idea of trying to time the stock market has been wholly discredited. Whether it was the 1987 crash, the Biotechnology Craze, or the now famous Internet Bubble, most investors have come to grips with the difficulty in attempting to predict these market movements. It is widely accepted by investment professionals and the investing public alike that you are better off not trying to time the market. Yet even so, it happens all the time but perhaps now it just comes in a different form.

Even though we may not like it (or admit it), the fact of the matter is that our job calls for us to make a certain amount of market timing type of calls. We are not talking about trying to predict the value of the Dow Jones, NASDAQ, or S&P 500, rather many much

smaller decisions hidden within the overall market. Just as a growth stock manager needs to know what the value managers are doing, long-term investors need to know what the market timing and momentum people are contemplating. This opens up a wide array of new variables to consider even though we think some may be of minimal importance. In other words, not any one of these elements are enough to tip the market scale in one direction or another; taken together they do give one a sense of why things started when they did and when we should pull out of this economic slowdown. We have attempted to classify these variables into four categories and touch upon them in order of importance: Economic Fundamentals, Calendar Anomalies, Market Liquidity, and Political Events.

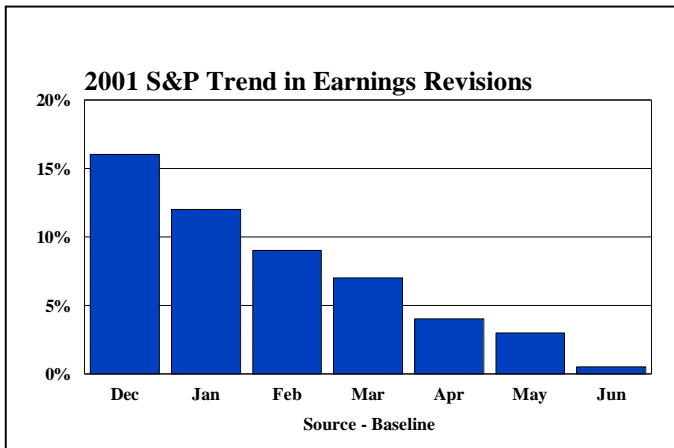
As far as economic fundamentals are concerned, perhaps the number one reason we have entered an economic slowdown is due to the sharp decrease in capital spending by corporations, particularly in the technology area. Investment by corporations slowed so much, so fast, that analysts had to ask 'who turned the faucet off'? The more practical reason may be simply that U. S. corporations were investing in



“Capital spending continues to decline.”

technology over the past 5 years at an unprecedented and unsustainable rate. The Y2K scare, the conversion to the Euro, the fiber optic Internet build-out, and the e-commerce spending spree all were somewhat unusual events that may have stressed technology budgets. These events were not just expensive, but they took a great deal of time to complete. Utilization is now the key word, as CEO’s want to get a return on their investment from these projects.

So when will the spending begin again? A company’s willingness to open up their checkbook may relate to their fiscal or calendar reporting year. The current mode for these companies seems to be one of cost cutting and re-trenchment, which does not play to increasing capital spending budgets. If a corporation is measured by their reporting year, they may be hesitant to make matters look worse via technology spending if it is not mission critical. Does this mean that the nozzle will be turned back on in the first quarter of next year? Not necessarily, but it does



open the door for spending based on new, fresh budgets.

Let’s not forget about the timing of the most important economic variable of all-the interest rate reductions by the Federal Reserve. Common thought is that it takes the economy approximately nine months to feel the effect of lower interest rates. So if we retrace time and note that the first rate cut was back in January 2001...this should play out to show economic improvement beginning in September or October of this year.

To further retrace the calendar, the ugly bottoming of the market in April 2001 can be explained. Most of the downside credit is attributable to poor corporate profits, but let us not forget what time of year companies coincidentally reported their poor results. This took place right in the middle of tax season. Year 2000 was one of the biggest years in market history in terms of realizing capital gains and when April 2001 came around there were many investors who had to sell stock out of their accounts to help pay Uncle Sam. What could bring us out of this calendar funk that we have been thrown into? It could be as simple as companies having easy earnings comparisons to measure up against in the fourth quarter. Last year Q4 was the first sign of economic weakness, so this may give Wall St. analysts a chance to issue some ‘buy’ ratings with more flowery numbers.

Analyzing market liquidity is really another way of tracking mutual fund activity. In years past, many funds would engage in ‘window dressing’ which was the practice of buying all the good stocks right before quarter end so they could show them in their portfolio. In a down market, the term ‘reverse window dressing’ may be in play as funds tend to sell their losers two to three weeks prior to the end of a quarter so as not to exhibit the bad stocks they own. Unfortunately, this period coincides with the time that many companies will pre-announce negative earnings results, hence magnifying the selling pressure. An anomaly of this nature is usually very short-term and consequently not worth trying to capitalize upon, but the tax-loss selling season is an area where we need to pay attention. There certainly are plenty of candidate stocks this year so we need to be aware that the selling pressure on some of the downtrodden names might continue until after the tax loss season.

Take one final look back at what catalyst could have propelled the market into a downward spiral. Think back to that incredible drama of the presidential election and the uncertainty that surrounded it for about two months’ time. One thing is for sure, the stock market does not like uncer-

tainty whether it's corporate profits, interest rate cuts, or election results. This political event may have been that extra push that was unexpected and required to send us over the edge. Can the politicians make up for all this? Well, they are trying to do something and it is coming in the form of a summer tax refund to most Americans. The dollar amount will not be huge, but the implications it has on consumer confidence may be just enough to lift us up to the next level.

When one takes all the above mentioned market chronicles together, it provides a basis to conclude that the 3rd and 4th quarters of this calendar year should show economic improvement. If you take any one of these elements independently, the results from the actual events are likely to be inconsistent and therefore not very meaningful. This is the shortfall of trying to time the market. Most of the data available will turn out to be noise and consequently you will lose sight of the forest within the trees. So when is this type of data useful? This is a more difficult task, but we use it to assist in entry and exit points for stocks already targeted for purchase or sale. The key idea to remember is that we focus on stocks relative value versus the market, as opposed to trying to figure out the fair value of the S&P 500, for instance.

So in the end the question is this: How do we apply all these variables outlined above? Answer: We extract the fundamental data presented to verify there is still just cause to invest in the stock market. This begins with things like forecasting capital spending, monitoring the progress of interest rate cuts, and ascertaining what type of financial impact a new tax plan and refund will have on stocks. Our conclusion is this: capital spending will gradually come back, interest rate cuts should begin to show signs of kicking in relatively soon, and the politicians are making progress to help stimulate our tepid economic growth. It is just a matter of time.

The Importance of Diversity

By Justin W. McNichols

Many individual investors, along with a slew of professional asset managers, have learned the importance of owning a diverse portfolio over the last few years. Time and time again investors place large bets on a single sector or two of the stock market, and find themselves with high volatility and low returns. During the latest technology

and telecommunications capital expenditure cycle, many investors shifted much or all of their assets into these two sectors. In this time period, every business magazine, TV channel, and newspaper article spoke about the New Economy, the never-ending technology infrastructure spending spree, and the fact that the Old Economy was dead. Using Osborne Partners' internal sector database, we calculated the performance of the two market sectors during the last two years. The results are below:

SECTOR	2 nd Half		1 st Half
	1999	2000	2001
Technology	+74%	-48%	-18%
Telecom	+51%	-53%	-21%
S&P 500	+8%	-10%	-9%

If on July 1st 1999, you invested \$1,000,000 in Technology stocks, you would have about \$740,000 today. \$1,000,000 in Telecommunications stocks left you with \$560,000 two years later. Finally, \$1,000,000 in the S&P 500 resulted in about \$890,000 today. The investor who owned only one or two sectors enjoyed nine months of outperformance only to see the portfolio dramatically under perform over two years.

Since the inception of our firm, we believed in building very diverse portfolios to reduce volatility and risk. How do we construct a diverse portfolio? We use three steps.

- We first divide our stock universe into 10 sectors. The sectors include Basic Materials, Capital Goods, Consumer Staples, Consumer Cyclical, Business Services, Energy, Financials, Healthcare, Technology, and Telecommunications.
- Next the sectors are subdivided into industries. For example, Technology contains Hardware, Software, Networking/Storage, and Semiconductors/Equipment.
- Finally, we perform company specific quantitative and fundamental research within each industry. The highest quality companies selling at excellent absolute and relative values are selected for portfolios.

The result is a portfolio of fundamentally strong companies, in many different industries and sectors. Although our strict discipline may not enable us to find acceptable companies in all 10 sectors at all times, portfolios will typically have exposure to at least 7-8 of the broad sectors.

Every three to five years, the market teaches investors a painful lesson about the importance of diversity. Whether

the hot sector of the moment is Energy (in parts of the 1970's), Biotech/Healthcare (in the late 1980's), Consumer Cyclical (in the early 1990's), or the recent Technology/Telecom spike, a diverse portfolio is consistently less volatile and has a lower risk component, without sacrificing growth potential.

Does the Cost of Funding a College Education Scare You?

By Shannon S. Gallo

For most people, funding a college education has become a major investment goal due to rising costs. It is projected that by 2019 the four year cost of attending a private institution will be \$200,000 and \$80,000 for a state institution. It seems there has not been great alternatives to saving for a child's education other than the traditional UTMA taxable account or an Educational IRA, until now. With the passing of the Tax Relief Act exempting Federal Tax on 529 Plans, these Plans are gaining more and more recognition as the college saving plan of choice.

529 Plans are investment savings plans that allow money to be set aside for college in a manner similar to a retirement account. How do they work? An account is established in Trust for a beneficiary with a donor making a contribution. The donor controls the account and decides how the funds should be invested based on the investment strategy and age of the beneficiary; the investment options range from aggressive growth to conservative bond funds. Withdrawals from the account are left to the discretion of the donor; they decide when funds are withdrawn and for what purpose. The investment grows tax-free until funds are needed and the earnings are then taxed at the state level based on the student's effective tax rate. States that do not already exempt investment gains are expected to do so after the Federal Tax Exemption goes into effect in 2002.

How are 529 Plans different from Prepaid Tuition Plans or Educational IRA's? Flexibility! Unlike Prepaid Tuition Plans that lock in the college costs and allow for schools only within the state, the funds in 529 Plans can be used to pay for higher education expenses at any accredited school within the United States. While Educational IRAs limit contributions, 529 Plans allow a greater range of contributions. Maximum contributions will vary depending on the beneficiary's age, estimated costs of higher education and the estimated earnings growth of the account. For example, California's TIAA CREF Program allows a maximum contribution of \$115,622 for beneficiaries born in 2000. Later, should the beneficiary decide not to attend college or has already completed college

and funds remain; a new beneficiary can be named.

Before making any gift, the donor should consider the gift and estate tax consequences. The contributions to 529 Plans are treated as gifts, therefore gift tax and generation-skipping transfer tax issues apply. 529 Plan contributions do qualify for the \$10,000 annual gift tax exclusion so most donors can make a fairly large contribution without incurring any gift tax. In addition, a lump sum gift of \$50,000 can be made for a beneficiary with the gift tax exclusion being taken over a five-year period. By making a larger contribution, the assets are removed at a faster rate from the estate and allowed to grow in the account for a longer period of time.

Though 529 Plans have many benefits, there are several things that should be kept in mind. First, contributions can not be made to an Educational IRA and 529 Plan in the same year. Second, 529 Plans do impact a student's ability to receive financial aid. Scholarship considerations should also be examined. Finally, similar to retirement plans, an "unqualified" withdrawal is taxed at the donor's ordinary income rate and a 10% tax penalty is assessed. Not all issues related to these Plans can be discussed in one article, however, it does appear 529 Plans are a great way to start saving and investing in a family member's higher education. If you are interested in receiving additional information or would like to discuss 529 Plans in greater detail, please give me a call.

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