Client Bulletin
October 2003

Economic & Market Update – The California recall and fixing the budget in Sacramento has been big news. Hopefully our new Governor Schwarzenegger will shake things up and make a difference. Even though California businesses are reluctant to hire new employees, the national employment report released last Friday brought good news showing that employers have added to payrolls for the first time since January. The Fed continues to be accommodative by keeping the short-term fed funds rate unchanged at 1% and the fiscal stimulus from the tax cut legislation is also spurring consumer spending and business investment. All the corporate cost cutting and productivity gains in recent years look to be paying off as very few companies have preannounced negative earnings guidance. Money continues to gravitate back into stocks pushing prices higher. The most speculative small company stocks had the best showing last quarter, bringing back memories of the late 90's bonanza. Amidst all the euphoria, insider stock sales are way up. Margin debt has moved higher and credit card debt is still climbing. The U.S. current-account deficit, as a percent of GDP, remains at an all time high, reflecting wide trade imbalances and making the dollar susceptible to further moves to the downside. Foreigners, primarily in Southeast Asia have been happy to finance our trade deficit by buying Treasury bonds. Asian central banks, including China and Korea, have also been propping up the dollar through official currency intervention. Despite this effort, the greenback has slowly been losing ground to the euro and yen. This has been beneficial to U.S. investors in foreign assets. A weak dollar can benefit U.S. exporters as foreigners use their stronger currency to buy more dollar-denominated products. The disadvantage is that it costs us more to travel abroad, and if the slide should deepen, foreigners may chose to sell our bonds, which would depress the price of Treasuries and put upward pressure on interest rates.

Mutual Funds – In early September, New York Attorney General Eliot Spitzer, filed a complaint alleging that hedge fund Canary Capital was able to secure special trading privileges not available to other shareholders in certain mutual funds. He alleges that fund companies permitted "late trading" and short-term trading in and out of some of their funds, allowing the hedge fund to profit at the expense of remaining shareholders. Mutual fund firms named in the complaint included Bank of America's Nations Funds, Bank One, Janus, and Strong. We are shocked and angry about these developments as they raise questions about the integrity of the fund industry. However, we do believe that the great majority of fund companies work diligently to restrict disruptive activity that might adversely affect shareholders. Our holdings in the affected fund families are confined to small holdings in the Janus family. Although there has not been any material adverse share price movement in our Janus holdings, this issue comes on top of the departure of some key personnel. We have chosen to hold the funds for the time being as we continue to evaluate all the evidence. However, we are actively searching for replacement candidates due to the apparent ethical breach of fiduciary duty.

Equities – Both domestic and international stock prices moved solidly higher during the last three months. The largest gains were in U.S. small company and international stocks. Growth dominated value as the technology sector roared back. Can stock prices continue to move higher, or is this just a bear market rally that is bound to fail? Barring cataclysmic events like an act of terrorism, or another severe blow to the economy, stocks appear poised for more gains. Short-term projections can be tenuous, but technical analyst Ian McAvity of Toronto-based Deliberations Research has done some interesting historical work by charting the U.S. stock market since its peak in 2000 against the stock market in 1929, the Japanese stock market in 1989 and the gold market in 1980. All these post-bubble periods unfolded along uncannily similar lines, leading him to conclude that the bull-market move that started in March of this year will last into the second quarter of 2004. We've always found it difficult to time the market, preferring to focus instead on selection by holding a variety of securities with a value emphasis.

International stock funds appear poised for continued gains based on accelerating economic growth and the weak dollar. **First Eagle Overseas,** SGOVX has shined with its deep value approach. The fund was early to move back into Japan but has been reaping the rewards. Holding 5% of the portfolio in gold securities for insurance has also been beneficial. We buy this load fund at the net asset value through Schwab Institutional. The emergence of China as an economic powerhouse has rekindled interest in the Pacific Rim. The Matthews fund family specializes in only that area of the world. The **Matthews Asia Growth and Income Fund,** MACSX is a conservative way to play the Southeast Asia theme. The fund allocates 60% to common stocks and 40% to convertible bonds and other fixed-income securities. Hong Kong is the largest country representing 38% of the fund, followed by South Korea, Singapore and China. *Morningstar*, the authority on mutual funds says "we continue to think this fund is a terrific way to make a play on emerging Asia without incurring a lot of risk." **Matthews Pacific Tiger,** MAPTX is a higher octane version devoted entirely to stocks with similar country weightings.

For individual stocks we continue to diversify across different industries looking for companies that have experienced recent trouble which has knocked down the share price. We look for earnings that are turning higher and low debt on the balance sheet. We also seek to identify a catalyst that will lead to a higher share price. Recent buys include **Alcoa**, AA - $28.19, a cyclical play on the stronger economy; **Johnson & Johnson**, JNJ - $50.10, a blue chip that is down due to patent expiration and competitive threats. But we believe that their new drug-coated stent will reinvigorate earnings and allow the company to continue its string of increasing the dividend each year for 41 consecutive years. Another new holding is **California Pizza Kitchen**, CPKI - $18.05. A top management change has brought back the original two co-founders to turn things around for this quality chain known for their unique menu.

Bonds / Fixed-Income – The vast majority of fixed-income securities dropped in price as we started the quarter with interest rates headed higher. Expecting further price weakness we chose to lock in profits on our high yield and emerging market bond holdings. A portion of the sale proceeds was invested into the **Metropolitan West Strategic Income Fund,** MWSTX. This new fund is designed for maximum flexibility as to the types of securities they may buy and is managed by a talented team of seasoned veterans. We have let some excess cash build up as we continue our search for competitive yields without exposing the principal to undue risk.

Individual convertible preferred securities have been good to us with their generous quarterly dividends, appreciation potential, and hedge against higher interest rates. The conversion feature makes these securities less interest rate sensitive compared to bonds, as the preferred price will track the underlying common stock. The trick is to buy the preferred when the common has been under pressure. Last quarter we established a position in **Alltel**, AYZ $48.75, 7.75% yield. This Little Rock, AK regional phone carrier is successfully integrating DSL internet and wireless service with its core operation.

One REIT we continue to like is **Plum Creek Timber**, PCL $26.50, 5.25% yield that has been taxed only as long-term capital gains. Although lumber prices are down due to Canadian imports, the company is expanding another revenue stream through joint venture development agreements on some lakefront holdings. The CEO is a former auditor from GE that engineered last year's $3.6 billion merger with Georgia-Pacific's timber operation. The company has $200 million in cash, a reasonable 40% debt to capital ratio and has been buying in stock.

Tax Planning – We will be reviewing all regular brokerage accounts for taxable clients during the 4th quarter to analyze realized and gains / losses year-to-date. Typically, we look to harvest losses to offset any gains and generate up to $3K of excess loss if possible to offset ordinary income. Please let us know if you have any other outside activity that will materially impact your income tax. For IRA owners over age 70 ½, we will confirm that you have received your required minimum distribution for 2003.

The 2003 tax act reduced the top federal tax rate for long-term capital gains from 20% to 15% for gains realized after May 5, 2003. In addition, corporate dividends received by individual investors are generally taxed at that same level retroactive to January 1, 2003 (minimum holding periods do apply). Taxpayers in the lowest two brackets are subject to a rate of only 5% on dividends and L/T gains. In 2008, for one year only, that rate goes to 0% for the low bracket taxpayers. This represents a unique planning opportunity to shift appreciated assets to children over the age of 14. The asset could be sold and taxed to the child with no capital gains tax. If the funds will be used for college, the proceeds could then be deposited into a 529 college savings plan where the accumulation and future payouts are entirely tax free. There are limits to these techniques, so please consult with us and your tax advisor prior to taking any action.

Estate Planning – Many clients have set up revocable living trusts in order to avoid probate and keep their affairs private. One critical element of this process is to physically change title on each of your assets into the name of the trust. If you have refinanced your mortgage in the last year, the lender may have required that you remove your property from your trust. To confirm how title is held you can check the name on the property tax bill, contact your lender, the county recorder, or ask your attorney to run a title search. If your property has been removed from your trust, simply instruct your attorney to prepare a new deed to transfer it back in.

Scott Walker
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