

Market Perspectives

An Investment Advisory Firm, Established in 1987

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A Winning Strategy for Any Market

Marked by its persistence and severity, the bear market of 2000–2002 has led many investors to question the conventional wisdom of building wealth through stock ownership. The media gleefully pounced on this investor concern, evidently preferring to tell sensational horror stories of investors losing seventy-five percent of their portfolios than to actually provide balanced reporting of events in financial markets. Listening only to the media, one would think all investors were trapped by an unavoidable market decline brought about by overpriced equities, deteriorating economic conditions, global terrorism, and concerns about corporate governance. While it is true that trillions of dollars have been lost to the current market decline, not everyone’s portfolio has been devastated. Though the media has ignored them, many investors have successfully navigated this challenging market environment. They did so by employing three principles that have been critical to the success of Zemenick

“Though the media has ignored them, many investors did successfully navigate this challenging market environment.”

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Focus on the Economy

The subject of the health of the American economy is of paramount importance today, as the five percent growth rate in the first quarter has been replaced by a 1.1% rate in the second quarter. This, among other things, has left many concerned about the risk of a return to a recession in the near future.

A 19% decrease in the S&P 500 from 7/5 to 7/23 has been a frequently cited indication of impending economic disaster. This certainly is a potential problem, as falling stock market wealth continues to punish consumers, whose collective spending has been one of the few consistent pillars of economic strength in recent years. However, fears have been alleviated somewhat by a recent stock market recovery. Even if recent stock market gains falter, all is not necessarily lost. As Paul Samuelson, the 1970 Nobel Prize winning economist said, “The stock market has predicted nine out of the past five recessions.” Obviously, not all stock market declines coincide with recessions.

There is other evidence that consumer spending could weaken. In August, consumer confidence fell to a nine-month low of 87.9 from 88.1 in July, according to the University of Michigan’s survey. At the same time, two other measures of consumer strength gave conflicting results. Housing starts dropped 2.7% in July while retail sales rose 1.2%. Much of the increase in sales can be attributed to a jump in auto purchases brought on by a return to 0.0% financing, though they still increased 0.2% excluding autos. Taken together these numbers seem to be indicative of a loss of positive momentum in the economy rather than an outright decline.

Because of the virtual absence of inflationary price pressures, the Fed recently decided to leave its benchmark overnight bank lending rate at 1.75%, a 41-year low. Policymakers commented that, “The risks of an economic slowdown outweigh the threat of inflation,” indicating that rates could be reduced at subsequent meetings if necessary. Though conditions have declined since the first quarter, a recent stock market recovery, aggressive Fed policy, and a lack of inflationary pressure should provide a reasonably good framework for further economic recovery ■

A Winning Strategy for Any Market

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& Walker, Inc.; diversification, discipline, and professional management.

Most investors have a general understanding of the concept of diversification, but not everyone realizes that it must be applied on multiple levels. First of all, a portfolio should be allocated between stocks, bonds, real estate, and cash. This insulates investors from suffering large net losses to their portfolios given a drop in any particular asset class. For instance, though the stock market has produced abysmal returns since the beginning of 2000, both bonds and real estate were able to earn impressive annual returns (see Annualized Asset Class Returns below). Those who ignored the principle of diversification clearly missed a tremendous opportunity to mitigate the negative impact stocks most likely had on their portfolios in the last three years.

Taking diversification a step further, investors must be sure to adequately allocate the equity portion of their portfolios to the different sectors (large cap, small cap, value, growth, and foreign). The pie chart in the opposing column summarizes Zemenick & Walker’s currently recommended equity allocations. Because no individual sector consistently outperforms the others, it is essential to broadly invest across these sectors in order to benefit from the periodically strong performance of each one, as well as to be protected from periods of significant underperformance. For example, large cap growth stocks surged in the late 1990’s, led by technology companies. Investors allocating a portion of their portfolios to this sector were able to benefit from several years of extremely high returns. However, when the bubble popped in early 2000 and large cap growth plummeted, investors who had also invested with certain managers in the value sector were still able to earn net positive returns for their equity portfolios.

Along with diversification, discipline is an essential part of an investment strategy. Warren Buffett may have best summarized this when he said, “My favorite holding period is forever”. In reality it might not be possible for an average investor to remain

dedicated to a given investment strategy, but it is important that a plan is instituted with a long-term time horizon in mind. Investors have to both initially commit to diversified portfolios, and to overcome the sometimes significant temptation to chase after “hot sectors”.

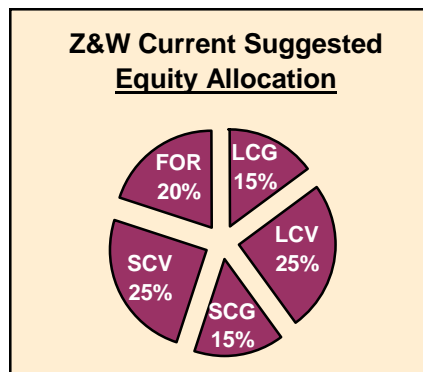
Chasing after returns in this manner often skews the fragile balance of a portfolio. Unfortunately for many investors, this is just what they did in the latter half of the 1990’s. After jealously observing the huge returns generated by tech stocks for a few years,

many once conservative investors abandoned their strategies and invested the majority of their portfolios in large cap growth stocks. They did so just in time to pile up huge losses during the current bear market. These are the investors that the media chooses to interview, whose portfolios were crushed over the last three years. Had they maintained disciplined, diversified strategies they could have avoided their catastrophic losses.

In addition to diversification and discipline, investors should utilize professional management to help construct portfolios that will be resistant to losses in tough markets. The value of professional management is clear, when one sees that the Russell 2000 Growth Index, an appropriate small cap growth benchmark, had an annualized return of (23.44%) from 12/31/99 to 8/30/02, while Baron Growth, a small cap growth fund, returned (0.22%), over the same period. Similarly, the S&P 500 BARRA Value Index, a traditional large cap value benchmark, had an annualized return of (9.71%) from 12/31/99 to 8/30/02, while Clipper, a large cap value fund, returned 17.34%.

It is important to recognize that many money managers often underperform their benchmarks because of the management fees and trading costs associated with their services. However, there are a number of managers, whose expertise easily compensates for these costs, allowing them to consistently outperform their benchmarks. Obviously, the selection of talented, professional managers is nearly as important as the initial decision to diversify.

In the end, there is no strategy that guarantees the investor will make money. Risk is inherent in investing; in some markets investors will lose money, regardless of the strategy employed. However, in the long run, if an investor continuously maintains a disciplined investment policy as well as a portfolio that is adequately diversified among both asset classes and equity sectors and complements this with strong professional management, then he or she will be in the best possible position to earn strong returns in bull markets and avoid steep losses in bear markets ■



Annualized Asset Class Returns

12/31/99-8/31/02

<u>Equity</u>		<u>Real Estate</u>	
DJIA	(8.50%)	NAREIT Index	18.69%
S&P 500	(15.13%)	<u>Fixed Income</u>	
NASDAQ	(34.36%)	1-7 Yr Munis	6.95%
Wilshire 5000	(16.09%)	1-7 Yr Treasuries	9.76%
EAFE	(18.91%)		

Standard & Poor's Unveils New Corporate Earnings Definition

Financial textbooks teach that markets are both efficient and transparent, and thus stock prices reflect all available financial information. Painfully, many investors have learned that financial markets are anything but transparent, as investigations at Enron and WorldCom have exposed shocking accounting irregularities. In response, investors are growing ever more suspicious that the earnings of America's largest companies, which have long been a staple for investment decisions, have been grossly inflated.

What has led to the mistreatment of corporate books and the resulting slide in investor confidence? Lack of a clear, consistent definition of a company's financial position says Leo O'Neill, President of Standard & Poor's. He contends that "the increased use of so-called 'pro forma' earnings and other measures to report corporate performance has generated controversy and confusion...". In response, on May 14th, Standard & Poor's introduced its refined "core earnings" definition. The new definition is an attempt to provide a standard, consistent number that more clearly reflects the ongoing earnings resulting from a company's operations.

Central to the new definition are three dramatic changes in the way companies currently report earnings. First, Standard & Poor's will begin treating stock option grants like other compensation, such as salary and bonuses. This change will have a substantial impact on technology companies that have relied heavily on stock options as an incentive to attract talent. For example, BusinessWeek reported in its May 27th issue that under the new core earnings measure, Cisco Systems' bottom-line loss for fiscal 2001 would have been (\$.35) per share, rather than it's reported (\$.14) per share. The second change removes pension gains from income. Standard & Poor's feels those gains stem from the performance of markets, not the companies' core operations. Blue chips, and other companies with large pension balances, will suffer the greatest consequences from this adjustment. For example, had it excluded pension gains from

its earnings, General Electric would have posted earnings of \$1.11 per share in 2001, as opposed to the \$1.41 per share that was actually reported. In its September 2nd issue, Forbes quoted figures from actuarial and benefits consultant Milliman USA, which said that last year the nation's 50 largest corporations

"The increased use of so-called pro forma earnings and other measures to report corporate performance has generated controversy and confusion..." Leo O'Neill, President, Standard & Poor's

lost \$35.8 billion on their pension portfolios, yet booked \$54.9 billion in profits. Third, Standard & Poor's will begin deducting restructuring charges from on-going operations. With the recent rise in mergers and acquisitions, restructuring charges have become more of a recurring event, rather than one-time charges. Additional adjustments to the way Standard & Poor's calculates core earnings will be the inclusion of write-downs of depreciable or amortizable assets, and purchases of research and development.

The adjustments being made by Standard & Poor's appear beneficial on the surface, but will they work? In all likelihood, the new definition will impact valuations more than earnings themselves. One worry is that if investors believe the market is truly overvalued due to higher multiples, they will sell. This could lead to short-term volatility in the market. However, don't expect to see any changes from the equity managers utilized by Zemenick & Walker. In a recent survey, the fund managers we recommend were asked their view of the changes taking place at Standard & Poor's and how those changes would impact their stock picking. In an almost unified voice, all replied that the changes would certainly clear the earnings picture. However, they also stressed that their analysts have always subjected companies to the same structured analysis being proposed by Standard & Poor's. Furthermore, Zemenick & Walker believes, as do many of our managers, that clearer earnings will ultimately increase their worth. In fact, over time, the new definition will probably help the economy by steering investors toward companies that generate real value.

Whether caving to Wall Street pressure, or out of genuine concern for their shareholders, many companies have followed Standard & Poor's lead. Until July, only two companies in the S&P 500 expensed stock options, Boeing and Winn Dixie. On August 13, Standard & Poor's released a list of 68 companies that will begin expensing stock options in 2003. A complete listing of these companies is available at www.spglobal.com. While financial markets will probably never be as efficient or transparent as financial textbooks claim, the new Standard & Poor's definition of core earnings takes a tremendous step toward clearing some of the fog surrounding our investments ■

Included in Definition of Core Earnings

- Employee stock options
- Restructuring charges from on-going operations
- Write-downs of depreciable or amortizable operating assets
- Purchases of research and development

Excluded from Definition of Core Earnings

- Pension gains
- Gains or losses from asset sales
- Impairment of goodwill charges
- Unrealized gains or losses from hedging activities
- Merger and acquisition related fees
- Litigation settlements

Our Mission

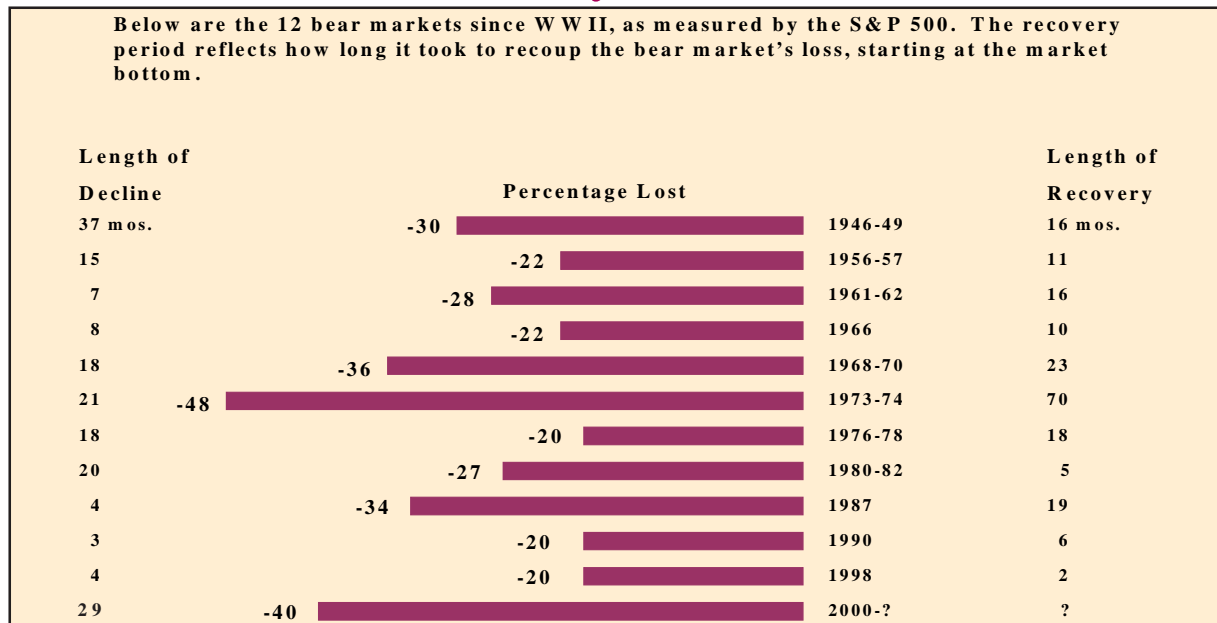
Zemenick & Walker is committed to providing superior investment advisory services to high net worth individuals, trusts, not-for-profit organizations, and retirement plans. As a fee-only, non-discretionary advisor, potential conflicts of interest are eliminated, giving clients a disciplined, business-like approach to the investment of their capital.

By the Numbers

<u>Interest Rates (Monthly Since 1970)</u>	<u>High</u>	<u>Date</u>	<u>Low</u>	<u>Date</u>	<u>Aug-02</u>
Federal Funds Rate	19.10%	June-81	1.73%	July-02	1.74%
3-Month T-Bill	16.30%	May-81	1.62%	Aug-02	1.62%
10-Year Treasury	15.32%	Sept-81	4.26%	Aug-02	4.26%
30-Year Treasury	14.68%	Oct-81	5.01%	Oct-98	4.93%
30-Year Mortgage	14.67%	July-84	6.29%	Aug-02	6.29%
<u>Stock Indices (Daily)</u>	<u>High</u>	<u>Date</u>	<u>08/30/02</u>	<u>% Change</u>	
DJIA	11,723	01/14/00	8,664	(26.09%)	
S&P 500	1,527	03/24/00	916	(40.01%)	
NASDAQ	5,049	03/10/00	1,315	(73.96%)	
Wilshire 5000	14,752	03/24/00	8,654	(41.34%)	
EAFE	1,774	01/03/00	1,003	(43.46%)	

A Half Century of Bear Markets

Below are the 12 bear markets since WWII, as measured by the S&P 500. The recovery period reflects how long it took to recoup the bear market's loss, starting at the market bottom.



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