

Market Perspectives

An Investment Advisory Firm, Established in 1987

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Mutual Fund Industry Under Fire

"It's déjà vu all over again!" - Yogi Berra

The mutual fund scandal dominating business headlines of late certainly gives one a sense of déjà vu. Just two years ago Wall Street was rocked by seemingly endless allegations of corporate fraud and malfeasance. From Enron to WorldCom, Global Crossing to Martha Stewart; investors were left wondering which company would fall next. After nearly two years, with many of the cases still pending in court and the controversy beginning to subside, investors were comfortably settling in to enjoy an improving economy.

Enter Eliot Spitzer. The New York State Attorney General rattled Wall Street yet again in September when he alleged that Bank of America helped Canary Capital (a New Jersey-based hedge fund) trade several of the bank's own mutual funds after the market's close, an illegal practice known as "late trading". This initiated a series of investigations by the SEC and other state prosecutors into the conduct of mutual fund companies. As the allegations mount, the term "scandal" has once again moved to the forefront of business headlines, this time applied to an industry designed to protect investors from scandal by diversifying risk across numerous holdings.

The activities under scrutiny center around two different practices, "market timing", and "late trading". Market timing describes the process of moving quickly in and out of mutual funds to take advantage of the short-term volatility of the stock market.

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Focus on the Economy

Casual observers of the media's parade of economic commentators may have recently noticed that the forecasts provided by the 'talking heads' are contradicting each other even more frequently than usual. A random click of the television remote is as likely to produce a pundit extolling the virtues of a strengthening U.S. economy as it is to find one delivering a particularly gloomy forecast. Opinions on the direction of the economy will always differ due to sharp ideological and philosophical divisions among economists; however, the differences are especially striking right now. This is because short-term prospects for the economy have rarely been brighter, while at the same time there are a number of significant factors that could potentially threaten prosperity in the long-term.

With the help of nearly unprecedented levels of fiscal and monetary stimulus, the U.S. economy is roaring back to life after several years of rather modest growth. Revised numbers indicate that the economy grew at an astounding 8.2% annual rate in the third quarter, the highest quarterly rate in 19 years. The labor market has lagged throughout the economic recovery, but now appears to finally be improving. By the last week of November jobless claims had slipped to their lowest level since January 2001. A big reason it has taken so long for the labor market to catch up to the rest of the economy is that robust productivity gains have allowed companies to meet higher demand without initially adding to their payrolls.

Additionally, with a strong fourth quarter, equity markets have extended their broad-based rally into a third consecutive quarter, an accomplishment not attained by the S&P 500 Index since the second quarter of 1999. Improving employment prospects and a rising stock market positively impact consumer sentiment and are likely to buoy spending in the near-term.

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Consumer Debt Continues to Pile Up

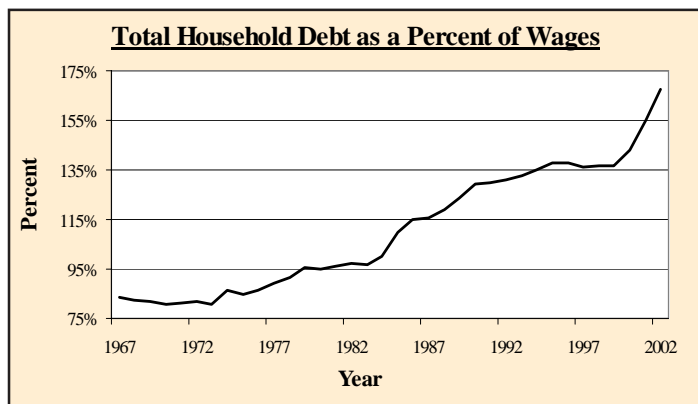
With their seemingly boundless propensity to consume, Americans propped up the world economy over the past three years, saving it from falling into a deep recession. Most people probably did not realize that conspicuous consumption was so heroic. However, regardless of their intent, and defying conventional wisdom, Americans bolstered the global economy as they fearlessly spent their way through wars in Afghanistan and Iraq, ongoing threats of terrorism, and three years of declining equity markets.

In fact, this proclivity for spending is not a recent phenomenon. Growth in spending by consumers has significantly outpaced increases in wages for decades. Spending increases in excess of income growth have been financed by debt, which is evident from the graph below. It shows that total household debt increased from less than \$400 billion in 1967 to over \$8 trillion in 2002, an increase of over 2,000%. Over the same period of time, wages rose only about half that much.

Heavy increases in spending combined with relatively slower wage growth have resulted in households becoming increasingly leveraged. The graph to the right illustrates this trend from another perspective, the growth in total household debt as a percentage of wages. Since 1967 total household debt has risen from about 84% of wages to over 167% in 2002.

Many people point to this as one of the greatest potential dangers to long-term U.S. economic growth, perhaps even more threatening than the federal deficit and aging of the baby boom generation. The fact that household debt has risen significantly both in absolute terms and relative to wages is not in and of itself a cause for concern. However, one thing is certain; this trend cannot continue indefinitely. Debt levels do not necessarily have to fall, but at the very least, growth in borrowing by consumers must eventually slow to allow wages to catch up.

There is some evidence that consumers are beginning to reach

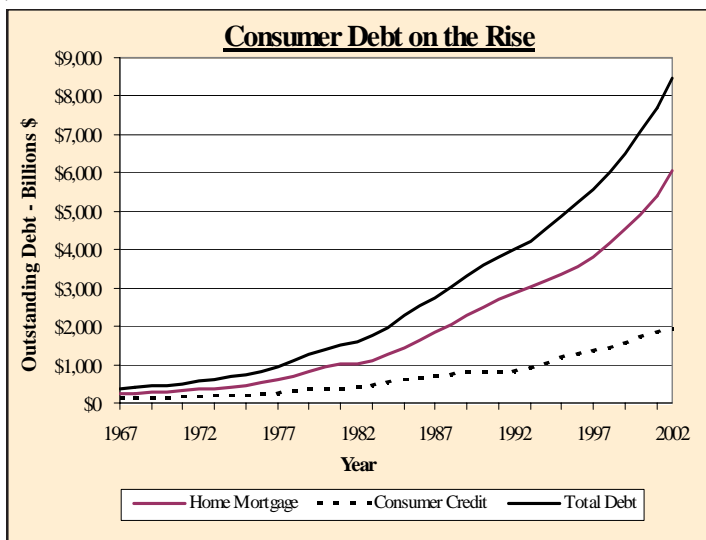


their breaking point. According to the American Bankruptcy Institute the second and third quarters of this year were the two largest in history for personal bankruptcy filings with 440,257 and 412,989 respectively. It should be noted that bankruptcies typically lag the economic cycle, so that it would be expected that they would be relatively high now as the economy is just beginning to recover.

Expected or not, high levels of debt could present a major problem if consumers begin to collapse under the burden of their debt service. Right now, with interest rates well below long-term historical averages, the cost of servicing increasing levels of household debt is bearable. As interest rates rise the service payments for variable rate debt (associated with some mortgages, credit cards, and other types of consumer debt) would rise dramatically and many consumers could suddenly find themselves in trouble.

Though economists certainly are concerned about the welfare of consumers, their real fear is not so much the impact that debt and bankruptcies could have on consumers themselves, but what effects it would have as it flows through to the rest of the economy. Consumer spending is an essential driver of growth. To sustain an economic expansion consumer spending must remain strong. Highly leveraged consumers would not even have to cut back on spending to harm the economy. If spending simply failed to grow for an extended period of time it could be damaging enough to push the U.S. towards recession. The results could be catastrophic if consumer debt became such a problem that spending dropped significantly.

It would be easy to use this argument to support a negative outlook for the U.S. economy. Though we are cognizant of the potential problem, we do not believe that its progression is inevitable. In any case, just when household debt becomes *too* excessive is somewhat subjective. However, the danger is real and, ultimately, if consumers continue to borrow at their current pace this issue has the potential to have an enormously negative impact on the economy at some point in the future. In a suddenly weak labor market or in the presence of sharply rising interest rates, over-leveraged consumers may drag the economy down with them as they are overwhelmed by their debts ■



Focus on the Economy

Continued from Page 1

Despite these undeniably positive factors many economists are concerned about the long-term direction of the U.S. economy, due to several troubling trends. First of all, consumer spending grew steadily through the previous economic downturn and continues to rise today. Much of this growth was facilitated by consumers taking on progressively higher levels of debt as well as refinancing mortgages. This is an unsustainable trend, as we discussed in detail in, *Consumer Debt Continues to Pile Up*.

The federal government has also embarked on a much-publicized spending binge the past few years, taking the budget from a surplus

to a near record deficit as a percentage of GDP. Any discussion of this subject is typically tainted by partisan rhetoric. However, when they are able to cast aside their political ideology, most people agree that this fiscal deterioration will put significant pressure on the federal government and, consequently, the economy as a whole, as federal entitlement programs such as Medicare and Social Security are seriously tested by the aging baby boom generation.

As a whole our view of the U.S. economy is reasonably optimistic. Barring an unforeseen catastrophic event, the fledgling economic expansion appears to be positioned to solidify in 2004. While we share the concerns of those who point to the long-term challenges facing the U.S. economy, we believe it is premature to conclude that their pessimistic scenarios will come to pass ■

Mutual Fund Industry Under Fire

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Because most mutual funds market themselves as long-term investment vehicles, market timing is frowned upon due to the negative impact of short-term trading on mutual fund portfolios. For instance, large cash additions can depress mutual fund performance, and large redemptions could force portfolio managers to sell stocks to cover cash requirements, further impairing performance and possibly generating tax burdens. Such activity obviously hurts long-term investors. Thus, most mutual funds include a restriction on market timing in their investment policies.

Late trading is an easier concept to understand. Given the opportunity to trade after the market close, late-traders can take advantage of news not available prior to the closing bell. The inequity is obvious. Nevertheless, some fund companies did allow privileged clients to benefit from market timing and/or late trading, bringing their honesty and integrity into question.

Yet unlike two years ago, when the stock market decline accelerated due to corporate fraud, the market has proven quite resilient during the fourth quarter, despite the mutual fund scandals. Surprising as this may be, it is certainly not comforting news to those mutual fund companies entangled in the controversy. For instance, shortly after news broke that Putnam Investments had permitted fraudulent trading activity, company president and CEO, Lawrence Lasser, was forced to resign. Furthermore, Putnam Investments admitted that during the first ten days of November alone, \$14 billion was pulled from the company, representing some 5% of total assets. Not surprisingly, Putnam is not the only fund family suffering executive level shakeups as a result of the regulators' investigations. The co-founders of Pilgrim Baxter & Associates, Gary Pilgrim and Harold Baxter, resigned after allegations surfaced of improper trades within their PBHG family of mutual funds. Richard Strong, founder of Strong Capital Management, also stepped down as chairman of the company's

“Putnam Investments admitted that during the first ten days of November alone, \$14 billion was pulled from the company”

mutual fund group after illicit trading was uncovered within his company. *BusinessWeek* reported that as of mid-December, 15 mutual funds, 12 brokerage firms, 4 banks, and dozens of individuals have thus far been tied to the trading scandal. These numbers will likely grow as regulators continue to review information requested from additional sources.

With new allegations expected to surface, are any mutual funds safe? While it is impossible to say with absolute certainty that any one particular fund company is above reproach, we have identified several indicators of the integrity inherent in a mutual fund company. When approving an equity manager, we believe management should possess most, if not all, of the following traits.

First, and perhaps most importantly, we believe the objectives of fund managers should be aligned with those of our clients, meaning they should share a long-term investment horizon. A good barometer of their alignment with shareholders is investment in the funds they manage. We believe, in general, managers will be less likely to jeopardize fund performance if their own money is invested in the mutual funds they run. Additionally, low turnover rates and diligent research and selection processes indicate that managers have conviction in their holdings, further emphasizing their commitment to long-term investing.

We also believe it is essential for managers to offer a high level of transparency. Willingness to openly and honestly communicate with investors is critical to establishing the level of trust required for confident investing. Moreover, we feel fund managers should focus on their strengths, rather than trying to be all things to all investors. Consequently, we have historically preferred small boutique mutual fund families centered around core groups of managers concentrating on specific sectors of the market. In contrast, some fund families have made a practice of churning their own mutual funds. In other words, underperforming funds are merged with superior funds and replaced by new investments focused on the hot sector of the moment.

Finally, we look for managers willing to close their funds to new investors when a run-up in assets hampers the ability to effectively manage the fund. The unwillingness to close a fund under such conditions ignores the interest of shareholders ■

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, Zemenick & Walker eliminates potential conflicts of interest, giving clients a disciplined, business-like approach to the investment of their capital ■

By the Numbers

<u>Interest Rates</u> (Mnthly data since 1970)	<u>High</u>	<u>Date</u>	<u>Low</u>	<u>Date</u>	<u>November 2003</u>
Federal Funds Rate	20.00%	May-81	1.00%	Nov-03	1.00%
3-Month T-Bill	16.30%	May-81	0.92%	July-03	0.95%
10-Year Treasury	15.32%	Sept-81	3.33%	June-03	4.30%
30-Year Mortgage	14.67%	July-84	5.23%	June-03	5.93%
<u>Stock Indices</u> (Daily data since 2000)	<u>High</u>	<u>Low</u>	<u>12/15/03</u>	<u>% from High</u>	<u>% from Low</u>
DJIA	11,723	7,286	10,023	(14.50%)	37.56%
S&P 500	1,527	777	1,068	(30.06%)	37.46%
NASDAQ	5,049	1,114	1,918	(62.01%)	72.20%
Wilshire 5000	14,752	7,343	10,385	(29.60%)	41.43%
EAFE	1,774	857	1,240	(30.10%)	44.70%

A Shot in the Dark

'Expert' Predictions of 2003 Return for S&P 500

		Actual S&P 500	
		Return as of 12/15/03	
		21.72%	
<u>Strategist</u>	<u>Firm</u>	<u>2003 Target</u>	<u>Difference</u>
Edward Kerschner	UBS Warburg	16.50%	(5.22%)
Stuart Freeman	AG Edwards	25.03%	3.31%
Abby Joseph Cohen	Goldman Sachs	30.71%	8.99%
Tobias Levkovich	Smith Barney	22.18%	0.47%
Edward Yardeni	Deutsche Bank	25.03%	3.31%
Steve Galbraith	Morgan Stanley	16.50%	(5.22%)
Richard Bernstein	Merrill Lynch	(2.25%)	(23.97%)
Thomas McManus	Bank of America	25.03%	3.31%
Douglas Cliggott	B&P Research	(14.76%)	(36.47%)
Carlos Asilis	J.P. Morgan	(9.07%)	(30.79%)

Source: USA Today January 2, 2003

As the year draws to a close, many equity investors have enjoyed their most successful year in recent memory. Perhaps the same cannot be said for industry analysts who, each year, undertake what can only be described as an exercise in futility...trying to predict the market's return for the upcoming year. Though there are still 16 days remaining in the year, it is impossible to resist the temptation to see how they fared.

Looking at the table to the left, one can see the expert predictions were wide-ranging, with bull market cheerleader Abby Cohen of Goldman Sachs expecting the S&P 500 to rise nearly 31% and Douglas Cliggott of B&P Research forecasting a 15% decline. These two expert predictions had a difference of nearly 46%!

Obviously, some analysts came closer than others. Smith Barney's Tobias Levkovich, appears to have hit it right on. Does this mean he holds the inside track on market forecasting? Not at all. Levkovich predicted a 17.59% return for the S&P 500 in 2002. Instead, it posted a 23.37% loss for the year. Of course with thousands of analysts making such predictions, some will get it right occasionally, but with countless factors contributing to the market's return, it sure seems like a shot in the dark ■

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