

Enclosed is a newspaper article written toward the end of March outlining the bumpy ride that equity investors had experienced in the stock market during the first quarter of the year. As noted in that article, all stock indexes were down for the period. The Dow was off its yearend value by over 8%, the S&P 500 was down 12%, and the NASDAQ Composite declined more than 25%.

Even more telling was the fact that each of the individual industry sectors that comprise the broader stock indexes also weighed in with negative numbers for the period. Often in declining equity markets, there may be specific industry groups that provide some haven despite the overall poor performance of the market in general. Not this time; there was no place to hide.

The factors that propelled the continuation of last year's weak equity performance have been well publicized. A slowing economy, excess inventory, decreased corporate profitability, increased employee layoffs, waning consumer confidence, etc. Our article suggested that ongoing economic data for April would be mixed and corporate earnings warnings would continue. Such has been the case.

In addition to these negative economic fundamentals, there has been the inertia of downward market movement that began last year with the correction of overvalued market segments and the Internet bubble bursting. The combined result is that two of the factors that helped push stocks up; momentum and investor sentiment, have been applying pressure in the opposite direction.

Investor sentiment in February and March was particularly noteworthy for its negativity. Any good news (and there wasn't much) was met with skepticism. Disappointing news sent investors running for cover. This pessimistic tendency contributed to our decision to move most of our clients with balanced portfolios *below* their minimum equity level just before the mid-March meeting of the Federal Reserve Board. This was the first time we had ever breached policy levels due to market conditions.

Our view was that investors had created a lose-lose scenario for the Fed's anticipated interest rate move. A 50 basis point cut (which we suspected) would be seen as woefully inadequate. A much ballyhooed (but completely out-of-character) 75 basis point cut would essentially admit the Fed was well behind the curve and that the economy was much worse off than expected. Either option was sure to fan the fires of disappointment. The 50 basis point reduction occurred and the stock market limped out of March.

But is the worst over? Do we see some indications that the market has started to change for the better in a sustainable way as we exit the first month of the second quarter of 2001? Yes, with several caveats. Details in a moment.

First, let's address the question being kicked about in financial media, "Have stock prices bottomed?" Well, some stocks have and some stocks haven't. The concept of a predictable "market bottom" where overall stock prices suddenly reverse trend in wholesale fashion is a myth.

In truth, market tops and bottoms are recognized in retrospect. Someone is always prognosticating "now is the time" to either get in or get out. The person who in *hindsight* had called closest to when the market started and continued moving is deemed guru of the moment. Unfortunately, it's an honor destined not to last and the lengthy list of former market top/bottom seers has few repeat performers.

We do not believe market timing, i.e. wholesale jumps in or out at suggested tops or bottoms, is an effective strategy to grow return or reduce portfolio risk. Our approach is to make disciplined, incremental moves within each client's individually defined equity range between minimum and maximum endpoints. And for the first time this year we now see some reasons to increase relative equity exposure and have begun to do so. Why?

Let's look at the broader economic data. Concerns of a possible recession have been lessened by some positive news, such as gross domestic product growing at an annual rate of 2% during the first quarter, offsetting a generally dreary outlook. And, though consumer confidence numbers have been lagging for months based on many survey measures, consumers must be putting their money where their mouth isn't because home and automobile sales for the first quarter were at near-record levels. This is important because consumer spending on major goods, or lack thereof, trickles down to impact the entire economy. As an example, recent recessions have been without fail preceded by a collapse in the housing market.

There are other signs that some good may be catching up with the bad. For example, though corporate earnings for the month were decidedly negative, not all reports were as poor as expected. There were even a few unexpected bright spots. However, one caveat to remember is that companies recognized investors no longer had patience for any downside earnings surprise. Some firms adopted an apparent strategy to let gloom and doom prevail with analyst's forecasts, only to then report better than suspected numbers (though dismal compared to last year's figures) and delight the market. The comment that "perception is reality" has not been lost on Wall Street.

Also on the plus side, all major market indices moved up for the month of April. While still down for the year, a continuation of this gradual appreciation will help in setting a positive trend. Likewise, with stock prices low, bond interest rates falling, and *some* signs of economic/market stability on the mend, the relative return versus risk of quality equities looks more favorable and could continue to improve.

Does this mean we feel the economy will soon be firing on all cylinders or that another raging bull market is waiting in the wings. No. Prudence is still the watchword but perhaps that distant flickering light is indeed the end of the tunnel and not an oncoming train.

Outlined below are a few strategies currently being used to help build and preserve your assets in these challenging times. While each client situation is unique and addressed accordingly, certain guiding themes apply throughout our process.

- Equity diversification; by industry, management style, and market sector, remains a priority in our management approach. The value of this strategy was again clearly evidenced in the recent market downturn. A truly diversified stock portfolio was down for the period but still doing fine. A portfolio concentrated in certain industry sectors could have been decimated.

Earlier in 2000, we also shifted more weight toward top tier "value" style managers and reduced a slight "growth" style leaning. This helped temper overall portfolio volatility in the downward market, with several "value" holdings actually appreciating during the period. Presently, we maintain an approximate 50/50 portfolio weighting of "growth" and "value" styles in most equity portfolios.

When we have increased recent equity percentages, it has been predominantly through adding exposure to "value" style managers, with lesser emphasis being given to "growth" style management approaches. We will shade new equity exposure toward traditional "value" business sectors but will also look for opportunities in "growth" oriented stocks if the market becomes less defensive in focus.

- Our general bias is towards larger cap stocks. Mid/small cap stocks, particularly “growth” style, tend to fluctuate in volatile times and have not typically rewarded higher investor risk with proportionately higher long-term return. These were the first holdings scaled back when the markets began deteriorating last year. Most clients remain toward the lower end of their overall policy range for this category.

While overall exposure was reduced, mid-cap “value” exposure was increased during the past twelve months to balance our leaning toward “growth” in this category in 1999. We will increase exposure in this area as positive market conditions progress.

- In balanced portfolios containing equities and fixed income, we presently are at or below minimum equity exposure for most investors. As outlined earlier, our current bias is toward the possibility of gradually increasing this minimum exposure and we have made incremental moves accordingly.

As normal, we continue to phase into the desired investment exposure percentage when presented with large initial cash positions. This provides the benefit of averaging purchase prices as core stock and bond positions are being built. We are phasing in new equity purchases a bit more rapidly than we had during the past twelve.

- For large fixed income positions, we use individual bonds to better control maturity and issue quality. Often, an objective for the bond portion of a portfolio is tempering volatility. This goal is supported by our utilization of short to mid term maturity investment-grade bonds. Currently, the maximum maturity considered is approximately eight years. Our emphasis of investment grade bonds remains constant.

I hope this overview was useful in outlining just a few of the ways we continue to respond to ever-changing market conditions on your behalf. We truly value your business and our ongoing relationship. As always, please don't hesitate to call with any questions or if we can be of additional service.

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