January, 2003

Dear Shareholders and Tax Clients,

Happy New Year! We've been looking forward to 2003, as the years 2000, 2001 and 2002 have been difficult for millions of investors. ***The first part of 2003 has been positive, with most of the major market averages being up between 3% and 5%,*** *other than the bond market and real estate investment market, both down less than 1%. Most of the indexes have increased between 6% and 20% since the bottom of the bear market on October 9th, 2002.*

Inflation continued to be stable in 2002, with the consumer price index increasing 2.4%, after a 1.6% rise in 2001. Your after-tax, after inflation total return, although probably negative for 2002, was helped by a low inflation rate. A few other important items to mention is college tuition costs rose 7.0%, medical costs rose between 5.0% and 9.8%, and cost of computers and accessories dropped 22.1%.

While preparing our quarterly letter and gathering our numbers, Marilyn noted that she remembers when a first class stamp was three cents (and she's not even eligible for social security yet!). We are putting 37-cent stamps on our letters today. The key point is that in many of our lifetimes or our family's lifetime, we could be putting $1, $2, or even $3 stamps on letters. ***We must all plan and prepare for 100%, 200%, or even 500% increases in day to day living costs over a long period of time****. No one will keep up with long term inflation investing at two percent (before inflation) in a money market fund or under a mattress before or during retirement.* ***A diversified investment portfolio that includes a major portion in equities (stocks) held over a long period of time will continue to make the difference****. A little short term pain along the way is part of our long term reward.*

The final three month period included what appears to be the bottom of the almost three year bear market. On October 9th, the S&P 500 was down 49.1% from its peak on March 23rd of 2000, and 32.3% for the year 2002. The NASDAQ was down 77.9% from its peak on March 9th, 2000, and down 42.9% for the year 2002. ***Officially for the year 2002, the S&P 500, the most widely used financial benchmark, had a total return of negative 23.4% after falling 13.0% in 2001 and falling 10.1% in the year 2000. The NASDAQ fell 31.5% for 2002 after losing 21.1% in 2001 and losing 39.3% in the year 2000.*** *Most of the other major market indexes have struggled as well. The Europe and Far East Index fell 17.4% in 2002 after a 22.4% decline in 2001 and a 17.6% decline in 2000. The Emerging Markets Index gave up 7.1% in 2002 after losing only 2.8% in 2001 and* *backtracking 28.0% in 2000. The Russell 2000, an index of small company stocks, which has fared the best the last 80 years, struggled as well with a 22.6% drop after gaining 2.1% in 2001 and losing only 4.2% in 2000.*

***Among the carnage of the major indexes, there have been some brighter spots**. The REIT (real estate) Index, which includes investments in diversified commercial properties and some multi-family apartment buildings, added 3.6% in 2002 after a 12.8% gain in 2001 and a 26.8% gain in 2000. Remember that this index struggled considerably from January of 1998 until April of 2000. The Lehman Aggregate Bond Index, the best measure of the overall bond market, had a total return of 10.3% in 2002 after an 8.4% increase in 2001 and an increase of 11.6% in the year 2000. The High Yield Bond Index lost 1.4% in 2002 after gaining 5.3% in 2001 and losing 5.9% in 2000.*

As I've mentioned before, chasing returns from here on won't work. Even the so-called safe haven of bond funds is not safe at this point with the current interest rate environment.** The General Bond Index had negative returns in 1986, 1994, and 1999 – and looks to have some downside and little upside over the next three years, especially if interest rates increase. **Remember the Aggregate Bond Index has had a 5.71% average annual return over the past 17 years, and that's before taxes and inflation, and in a <u>much</u> higher interest rate environment.** I would expect anywhere from 0.7% average annual total return to a 5.3% annual return over the next three to five years. Losing money in a bond fund over 3 to 5 years is very remote, but the possibility is still there. **Chasing returns does not work, diversification does**. I would look to add High Yield Bonds to a diversified portfolio, as the chance to rally appears much better in this index, with very little downside risk. **The bottom line – don't expect bonds or bond funds to do nearly as well as they have over the next three to five years – even longer.

*The key factor is what will occur in the financial markets from this point forward – not what has happened in the past. We need to remember that markets go in cycles, and time heals all short-term turmoil – but often it takes time. Diversification and patience are the key fundamentals in every market cycle. For instance, having up to 10% of your portfolio in Emerging Markets over the long term makes sense – there's definitely some upside of between 9% and 13% each year over the next 3 to 5 years. A portion of your portfolio in bonds and cash equivalents is always important to have to satisfy goals for everything from emergency funds to risk reduction. **There's been no better time to invest since early 1997 – almost SIX years ago**. A couple of years ago, people would have been running to have the opportunity to invest at these levels. Make no mistake about it, many financial markets are on sale – the key question is how long the sale will last.*

*Tax wise, there are some positives for 2002 and into 2003. There is a new 10% tax rate for single taxable income from $0 to $6,000 and also for married taxable income from $0 to $12,000. The maximum contribution limits for Roth IRAs and Traditional IRAs have gone up as well, from $2,000 to as much as $3,500 for the tax year 2002. If you have earned income and are age 50 or older, the limit is now $3,500 vs. $3,000. **If you haven't considered adding to your Traditional IRA or Roth IRA, you have until April 15th to do so for the tax year 2002**.*

The interest rates, as you know, have been dropping further as well – and will most likely not get much lower. The prime rate is 4.25%, and mortgage rates are the lowest in nearly 40 years – **an excellent time to take action if your mortgage interest rates are 7.0 % or higher, depending on your time horizon and other goals.** Another positive is that consumer debt has actually decreased over the short term. November and December figures show short term debt has decreased. More people are comfortable paying down any credit card debt, generally from 4.9% to 18.0%. That is a guaranteed return – so consider doing so with zero risk, which is tough to beat. Another thing to do without risk is paying down extra on your mortgage. Even though interest rates are low, and 'after tax' rates are as low as 2.73%, that is a guaranteed return as well.

It's important to stay positive and focused on a game plan going forward. Again – the markets historically recover. **Like every year, there is an average expected return in a diversified portfolio (7% to 9%) with a worst case scenario (-15%) and a best case scenario (25%).** There is a 5% chance of further downside of –15%, and a 5% chance of greater upside (+25%). **Expect a positive return of 7% to 9%, and prepare for both best and worst case scenarios**.

We are encouraged by what has happened in the last few weeks, and continue to have faith in our financial system and conviction in our investment philosophy. Our annual disclosure Form ADV, Part II is available for viewing at your request, as always. If you have any questions, or simply wish to chat, we are available anytime. Thank you for your business. It's a pleasure to serve you.

Sincerely,

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