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To: Clients of Financial Advantage
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Investment Policy Implications of Terrorist Attacks in US

Together with you and all the citizens of our remarkable country, we have been watching in profound sadness this past few days as our society wrestles with the tragic consequences of damage inflicted on us by an unseen enemy.

Relatively few of us across this vast continent have been in a position to offer practical assistance to those most in pain. But the families, neighbors, volunteers and professionals who are binding our wounded and burying our dead have made all of us proud to be Americans.

Our responsibility to you

It is tempting, perhaps, to watch the news reports over and over, and to keep repeating our anger and fear to one another. However, as one government official observed, after we have prayed, the most forceful possible response is for all of us to return to our daily responsibilities with all the personal excellence of which we are capable. In this way we will put the lie to those who would hate us and try to diminish the freedom for which so many of our ancestors have sacrificed.

As your financial advisors, we consider it *our* daily responsibility as well as privilege to exercise vigilance over your life's savings, and in so doing to make every effort to protect and enhance the quality of your life. To that end, we have been meeting and thinking deeply about the short- and longer-term implications of the recent terrible events on the commerce of our land and on the free markets in which we all participate as consumers, citizens and investors. We offer herewith our early observations, and we welcome your questions and your insights as we pursue our daily responsibility to you with all the excellence we can muster.

Your accounts are safe

First of all, we want to assure you that the primary investment custodian for our client accounts, Charles Schwab, has experienced no disruptions to its database, its workforce or its ability to conduct its business. Schwab has invested heavily in elaborate back-up systems in various locations around the country, which is one reason we have selected them for our clients. Your records and your investments are completely in tact.

A first week decline would be natural

Certainly, serious damage has been done to the communications structure of not only the US but also the global financial markets, and the financial industry appears to have lost thousands of dedicated and experienced professionals. In the short run, this sad result of the terrorist aggression will have undeniable negative consequences in both broad economic activity and in the financial markets themselves.

For a while, there will be less depth to the securities and commodities markets as investment and trading companies labor to replace their infrastructure and to rebuild their staffs. Daily information may not be as nearly flawless as we have come to expect from our highly sophisticated markets. Particularly in the equity markets, which had already been in a bear market swoon, these new operational stresses are likely to exaggerate existing concerns about valuations and a global recession, so it would not be a surprise for the markets to be weak as they reopen next week. These structural issues will be overcome in a reasonable time and ought not unduly concern us as investors.

The current stresses are quite different from past dramatic events that have unsettled our investment markets. Nevertheless, the record of the market's response to other fears does provide some insight into the resilience of a free marketplace where buyers and sellers work out their perceptions of the impact on future values.

The following list was prepared by The Leuthold Group in Minneapolis, Minnesota.

	Percentage change for selected time period following event					
Event	**Date**	**1 day**	**2 days**	**3 days**	**1 week**	**1 month**
Pearl Harbor	12/07/41	-3.76%	-6.87%	-6.87%	-6.33%	-3.43%
Ike Heart Attack	09/23/55	-6.12%	-3.99%	-2.38%	-3.79%	-5.46%
Cuban Missile Crisis	10/22/62	-3.83%	-0.68%	-1.62%	0.23%	10.70%
JFK Assassination	11/22/63	3.98%	3.79%	5.20%	5.20%	6.03%
Beirut Embassy Bomb	04/18/83	-0.03%	1.23%	0.82%	0.04%	2.85%
Iraq Invades Kuwait	08/02/90	-3.00%	-5.93%	-5.82%	-4.38%	-9.12%
World Trade Bomb	02/26/93	-0.07%	1.26%	2.29%	0.85%	1.23%
Oklahoma City Bomb	04/19/95	-0.02%	0.62%	1.49%	1.44%	2.73%
AVERAGE	**ALL**	**-1.61%**	**-1.32%**	**-0.86%**	**-0.84%**	**0.69%**

Dramatic events of national import do not occur in a vacuum. Rather they explode on the current scene, and their impact on our securities markets are unavoidably influenced by the internal market characteristics of that era, such as valuation and the general environment of optimism or pessimism regarding the future. These realities influence the intensity of investors' reaction to sudden, disruptive developments. So the record of how markets reacted to shocking or frightening events in the past is certainly relevant, but it does not necessarily point to the outcome in the current circumstances.

> *Prices are established at the margin. In the first week of trading after the attacks, it is natural to expect that marginal decisions will be, at least at first, to sell. We are little concerned about the first week's activity. Our typical client portfolios have had below average allocation to stocks before the tragedies. We do not expect to make major changes during the first week's emotional trading. Our focus as investment advisors is on capital preservation first, and reasonable returns second, both with a longer-term perspective.*

Short run economic disruptions

US consumer confidence data collected up to the day *before* the terrorist strike indicated continued deterioration in shoppers' buying expectations; this week's national tragedy is very likely to make the picture even less encouraging, at least in the short run. The chief economists of Wells Fargo and Deutsche Bank both said publicly that there is now no doubt that the US *is* in a recession and that Euroland is probably right behind us on the downhill part of the business cycle. Japan's GDP fell in the latest quarter and its banks report rising loan defaults. So a consensus is building among economic seers that we seem to be on the threshold of the first coordinated global recession in a quarter century.

A recession is a normal part of the economic life of a free society. It is not something to dread. Industrial production "recedes" because it has gotten ahead of consumption patterns. Producers scramble to reduce operating expenses in line with their reduced sales, and this usually involves layoffs. Layoffs, naturally, impact consumption, especially when consumers' balance sheets need repair, as is the case today, because borrowing has been rising while savings have been low.

In all likelihood, the US economy would have slid into a corrective recession without the dislocations of the terrorist attack. The domestic economy needed to correct financial excesses, recoil its springs, recharge its batteries. It is all part of maintaining our long-term financial strength.

Each recession is different. This one will have certain characteristics that result from the patterns of the last growth spurt; for example, we have already seen technology capital spending fall dramatically. Doubtless there will be other characteristics of this downturn directly related to the impacts of terrorism.

Among industries likely to suffer increased short-term financial stress because of this week's mayhem are <u>property and casualty insurance</u> (especially re-insurers), the <u>airline</u> and <u>lodging</u> industries and <u>securities</u> firms. A recession typically dampens demand for <u>oil</u>, however, oil prices may remain high anyway due to the greater sensitivity of our middle-east relationships. Corporate layoffs typically rise when recessionary forces are gaining momentum. If this is the case, the homebuilding industry, which has held up so well, may at last turn down; homebuilding is one of the most important drivers of consumer spending.

These are short-term issues. A far more important challenge to us in shaping our investment policy will be to identify *long-term* shifts in the spending and investing inclinations of the members of our complex free society that are likely to take place as a result of the way we deal with the terrorist threat.

> *Capitalism, which is our economic system of choice, revolves around the allocation of scarce resources by the millions of owners of private property rather than by a central power such as the State or a King.* ***Scarce resources*** *include land and buildings, minerals, talent, labor and money, both cash and credit.* ***Allocation*** *takes place when resource owners (everyone from industrialists to wage earners) make decisions about what to buy or not buy, how much to spend and how much to save, and in which kinds of assets they prefer to invest for future returns.*
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> *It is very, very early to expect profound insights into how the occurrence of a mass murder in our country and the heightened risk of future sabotage will influence the behavior of several hundred million people in these matters. But it is not too early to begin examining the range of possibilities.*

Silver linings

We have mentioned some of the obvious short-term disruptions. But there is also a real possibility that the terrorist attacks on the symbols of American freedom may have stirred a sleeping tiger. They might actually galvanize the populace into a new wave of unity, of seriousness of purpose, of personal productivity and even kindness that energizes the whole economy with renewed confidence. If statesman-like conduct on the part of our political leaders reinforces the favorable signs of the first week, we may surprise ourselves!

It is also conceivable that we could experience early and dramatic strides against terrorism in a way that restores our national sense of security and frees us psychologically to shift the focus of our energies beyond the basic need for personal safety. Whether this happens early in the recovery process or takes a longer time to develop, as specialists expect, a general sense of safety is a necessary condition for economic growth and rising productivity. Not a sufficient condition, but a necessary one. Hence, any signs of a durable improvement in our sense of personal security could set the stage for an economic renewal and an upturn in investor enthusiasm of major proportions.

Long-term trend implications

The destruction of the World Trade Center and the murder of thousands of our fellow citizens by a handful of fanatics has so dramatically demonstrated our *vulnerability* that we will almost certainly experience some shift in our personal and collective priorities. It will not be business as usual for a long, long time.

One very likely result of feeling our vulnerability as we have never felt it before is an acceleration of the trend to *decentralize* the activities of government and business. This could have major implications for the disbursement of population densities among cities, suburbs and more rural areas. Important shifts of this nature always imply investment opportunity as well as its opposite, creative destruction of obsolete infrastructure.

If the desire to travel, for example, is diminished by safety concerns, the air travel and lodging industries may have all the capacity they will need for quite a while. They could suffer from low utilization and poor pricing, even as the cost of delivering a safe travel experience will be rising. Some balance sheets may need corrective surgery. The financially strongest companies may be in a position to gain market share over the long-term.

Center city office and residential properties, similarly, could find themselves operating in long-term oversupply situations, while demand for smaller and more remote facilities could mushroom. This could have implications for some REITs. Commercial properties are usually financed mostly with debt; credit quality could become a greater concern in this field.

But decentralization could also re-stimulate demand for high tech communications infrastructure and services (for example, teleconferencing and internet-based transactions). Broadband may get a new lease on life! Demand is likely to soar for disaster planning and security services of all kinds, and for technology related to data redundancy. Information management will take a giant step in complexity, which may well stimulate the trend to outsourcing this responsibility.

If a search for safety drives businesses and residents to the suburbs, auto-related outlays could gain, perhaps at the expense of mass transit budgets. Cities could find themselves hard pressed to fund services such as hospitals, schools and public assistance. If there is an exodus of the cities' tax base of business and prosperous residents, it is conceivable that urban America could increasingly become a hotbed of social unrest. The situation may increase pressure for regional political structures encompassing cities and suburbs.

Another area of uncertainty is the future of globalization, which has been such a potent economic force in the past decade. A continuing sense of vulnerability to terrorism is likely to exert a huge influence on the relationship between nation states. It could bind us all closer as allies against a common threat; the early signs in that regard are, I think, encouraging. But it could also increase suspicion and mistrust between leaders. Stephen Roach, Chief Economist at Morgan Stanley, worries that the world may "lose its appetite for cross-border connectedness." He points out that he hopes this concern is ill-founded, but that "the risks of it certainly rose last week."

Also up for grabs is the role of government in society, the degree to which we are willing to delegate more authority over our lives and the ways that we will pay for its services. In this regard, life in America may never be the same. It seems likely that we will choose to sacrifice some convenience and privacy in the hope that more diligent surveillance will hamper the activities of subversive forces.

Though often imperfect in its implementation, our society is based on the rule of law and thoughtful regulation of market activities. An abundance of reliable information and a minimum of bureaucratic corruption make our financial markets attractive to investors the world over. However, as government involvement grows, the cost to entrepreneurs and consumers increases; the greater the cost of government, the slower will grind the wheels of commerce. It seems likely that government involvement in our daily lives is about to increase measurably, and our freedoms to be diminished. At first blush, this does not seem a plus for future economic growth prospects.

The importance of free markets

Within days of the Trade Center attack, the internet was littered with emotional advice along the lines of, "Don't give in; Buy stocks!" Supposedly someone conducted a poll indicating that 99% of investors are pledging not so sell when the market opens, believing it would be somehow unpatriotic to contribute to a market decline.

We Americans *do* want to be strong and united, and we would like to make sure that our economy and markets do not crumble under attack. But reality is always a multi-dimensional thing, isn't it? There is patriotism, money, faith, love, feeling, facts. All those things are part of our personal reality. At times such as this week, when our normal order is destabilized, the pieces of our reality tend to become rearranged in an unusual fashion that temporarily results in a change of behavior. People wanting to make investment decisions based on patriotic impulses, for example.

Suppose that you decide to go ahead and buy that new car that you had only been casually thinking about, as a way of thumbing your nose at an enemy who would like to throw us into a depression. That's fine. It's absolutely fine. But are you going to pay $40,000 for a Saturn or $90,000 for a Cadillac out of patriotism, or to help out the auto industry? No, of course not, because these cars are only *worth* about half those amounts. Rather, you will do your comparison shopping as you always do, and you'll try to pay no more than the car is worth in a competitive market, right? And that's they way it's supposed to work.

Well, shouldn't the same be true for investing in securities? It's fine if you want to buy 100 shares of General Electric, but will you buy it at (last week's price) $39 because it *feels* like the American thing to do? Even if you judge that it is only worth $25? Or suppose you already own GE at 39 and your appraisal of the business outlook suggests that it is worth only 25, will you sell it? Or will you hold onto it so that nobody can say you were panicked into selling?

Having free markets is a great big chunk of what the American way of life is about, and why it has worked so well. That's why the World Trade Center was such an obvious symbol to our enemies. I think it is important for all of us to keep in mind that it is the *essential nature* of free markets for buyers and sellers to be freely making decisions in what they perceive to be their own best interest (which, of course, includes the best interest of those with whom they share an affinity of interests such as family, business or employer.) It's the competition in buying and selling that establishes values. Because we can depend on buyers and sellers both making keen-eyed judgments, we have rational markets that form the foundation for business decisions, for allocating scarce resources such as money and talent, and for making important life decisions such as where to live and what kind of work we do.

Our enemies can make the mistake of thinking that money and markets are instruments by which one class oppresses another. We know better. We understand that the existence of truly free markets assures our personal freedoms to the advantage of all of us.

If securities prices should slump dramatically in the first few weeks after the terrorist attacks, no investor should sell securities *because* prices are falling. Conversely, if prices should rise suddenly, we ought not view that as a reason to pile in, hoping for a profitable ride or a patriotic high. Rather, as in normal times, we want to make our investments based on decisions first about our preferred portfolio structure and next based on what we believe is a fair value of each security we select.

Investing is serious business, and an important personal responsibility. When you invest your hard-earned savings you provide the capital that supports businesses that provide employment. Business profits and employees' wages, in turn, pay the taxes that provide defense and the legal protection of our freedom to pursue happiness for ourselves and for our loved ones. Making investment decisions as well and as rationally as we can has important consequences on the quality of life in these United States.

Fixed Income Outlook

Believe it or not, bonds are really the heart of the financial markets. There is more capital invested in bonds than in stocks (don't forget, national and state governments issue billions of dollars worth of bonds but no stocks), and the return available from fixed income securities is a key determinant of the return required by shareholders.

Today, the current yield on 30-year treasuries is about 5.35%. The earnings yield on stocks in the S&P 500 is 3.4%. If we use the S&P's peak earnings instead of the recently-depressed earnings, one could say the earnings yield is more like 4.75%.

How do these stack up against the historic average relationship between stocks and bonds? Over 75 years of US financial history the average long treasury bond yield has been something like 5% and the average earnings yield for shares has been around 7% (that is, a little over 14 times earnings). The bond yield has averaged considerably less than the earnings yield on stocks. *At this moment, the reverse is true.* From the narrow perspective of this data set, history suggests that stocks remain expensive while Treasury bonds, while not a screaming bargain, are at least attractively priced.

Of course "risk-free" Treasuries are not the whole bond market. There are also tax-exempt (municipal bonds) and corporates as well. Corporates have sported yields well above treasuries, farther above treasury yields than the historic average "spread" between the two. The first week of trading may well increase this spread because of perception that credit risks are increasing. This could present opportunities to make rewarding fixed income investments.

Stock Market Outlook

We Americans are an optimistic lot. We are proud of our can-do spirit, and our history of success as a nation reinforces our optimism. Our instinct in the face of an attack such as last week's is to link arms as fellow citizens and face down the enemy with absolute conviction that they will rue the day they ever thought of coming against us.

But psychology teaches that the flip side of a strength is usually a weakness. There is a way in which our native optimism may also be our potential vulnerability. It will be very important for us not to underestimate this very different kind of enemy, to brace ourselves for what may be a protracted and very costly confrontation, and one that could alter our way of life and inflict considerably more pain before we finally overcome it.

The war that our leaders have declared on terrorism, and which we ardently desired that they declare, will be unlike the World Wars or even Desert Storm. This one began on our soil, a very significant difference, and we can neither name nor locate the enemy. We learned on September 11 that it is far easier to destroy than to build, and this fact will not change with either the execution of co-conspirators or the bombing of the Taliban.

I know little about war, less about psychology and virtually nothing about terrorism. I have studied the stock market for 37 years, which alone won't get me a ride on the subway, even assuming I wanted to ride on the subway! To say something wise about the psychology of investors confronted by a war on terrorism is hardly an assignment I would solicit. Yet there it is. So I must look to history and experience for guidance, and hope that we can avoid at least some of the mistakes of the past, and thereby add some luster to the memory of Santayana ("Those who ignore history…" etc.)

Following are a few of the principles of investing in stocks that I have come to rely on.

- A share of stock represents ownership in a for-profit enterprise. Ultimately, the value of that share to a potential purchaser is the value of the *business* it represents. In turn, that business is worth the discounted present value of its future profits as perceived by the purchaser. <u>Therefore, profits (earnings per share), or at least perceived profits, strongly influence the market price of a share.</u>

- General public concern that business profits may not be sustainable results in low share valuations as a multiple of profits (low p/e ratios). Widespread optimism that business profits will not only be sustained but *grow* results in high valuations of shares. <u>Therefore, the general state of optimism (or its lack) have a strong influence on stock valuations.</u>

- A person with capital to invest in the public markets has a choice to either *lend* his money to an enterprise (buy bonds) or to risk it all by becoming a part owner (buy shares). Since lending is generally less risky, a lender is willing to accept a smaller return on his money than what he would expect to earn as an owner. <u>Therefore bond yields, as an investment alternative, do exert an influence on stock valuations.</u>

- From time to time the level of optimism or pessimism among the investor class becomes so extreme that shares are bought or sold at prices having little or no relationship to a reasonable perception of future business profits. These are, at once, times of extraordinary *risk* and *opportunity*.

So, there you have it. Stock prices (we are speaking of the entire asset class, not of one particular stock) are a function of two things…the perceived future profits of businesses and the yield on bonds. The general state of optimism about the future, of course, influences both bond yields and the perception of future profits, so the emotional condition of the market is of vital concern. If, as most observers expect, our nation's war on terrorism increases fear and diminishes optimism and confidence, it may eventually result in shares of worthy companies selling below the discounted value of their future profits.

Getting a bead on "likely future profits" is harder than it might sound. It will be especially so if we are living and investing in an environment of increasing uncertainty about our economic future. Will past benchmarks, for example, be appropriate standards against which to measure values? The short answer is, we think they will be valuable reference points. The range of experiences in the US markets over 75 years is so wide that both its extremes and its averages provide plenty of helpful norms.

During the period of exceptional investor optimism that ended in the spring of 2000, many historically useful guidelines were exceeded dramatically; in other words, they did not prove very useful in navigating the exploding bull market… in the short term. However, free markets are a self-correcting mechanism, and irrational price excesses do not tend to last. The old standards have been looking a lot more useful the past three months!
For example, during the heady technology growth period 1995-2000, companies making up the S&P 500 earned an average return on equity of 27%, compared with a long-term average of 13%. After-tax profit margins in 1999 got over 6%, at the very top of a long-term range of 3 1/2-6%.

These are very useful reference points because they help us understand the whole capital allocation process. When companies become so profitable, for instance, that everyone wants to be in their business, competition begins to increase and to bring profit margins and returns on equity back to where they are less enticing.

Before terrorism leaped onto our radar screen as a major investment variable, stocks were already in a process of correcting from an extremely overpriced situation. The unusually high valuations of 1999-2000 had reflected expectations of corporate profit grow way beyond our historic experience. Year 2001 profit warnings from a wide range of businesses already suggested that profit margins and returns on business investment were falling back into normal range and valuations were beginning to following suit.

Policy and the new realities

In the wake of last week's tragic events, the new realities in America include fear for our physical safety and concern that a rising cost of government could reduce our sustainable growth potential. Investor optimism, already in retreat from the ebullience of the 1990's, has just ratcheted down another notch or two. In addition, we may be facing a long return to normal (read "a long decline") in returns on capital. Investor optimism and perceived future profits are the key drivers of stock prices, and neither is ascendant at the moment.

An early dramatic victory against terrorism (not highly probable) could re-ignite optimism, but we would still be left to cope with the high pre-attack stock valuations relative to probable business profits and relative to fixed income returns. Our policy response is to watch for opportunities to shift treasury investments into high grade corporate debt when pessimism overstates the risks, and to continue patiently awaiting an opportunity to acquire shares in strong companies operating in sectors with reasonable visibility at prices that makes sense.

Thank you for your confidence in Financial Advantage.