



1st Quarter 2002 Market Commentary

As I discussed at our 19th Annual Investment Conference on Friday, April 26, 2002, the most noteworthy financial event of the past year has been the collapse of corporate earnings and the resultant upward explosion of price-to-earnings ratios. The most recent twelve-month earnings for the companies that comprise the S&P 500 are \$24.69, more than a 50% decline from the \$50.00 of the same time one year ago. Because stock prices have not fallen as precipitously as have corporate earnings, the market's PE ratio has exploded up to the mid-40's, about three times the historical average and about twice the level at which bull markets have peaked over the decades. Analysts remain confident that earnings will bounce back strongly in 2002, but the year is off to a poor start with earnings continuing their declines in the first quarter. If analysts' targets are to be met for the calendar year, there will have to be a remarkable turnaround beginning right now. Corporate CEO's, unfortunately, do not share the analysts' optimistic enthusiasm. Very few major corporate chieftains are yet seeing evidence of any significant pickup in their businesses.

Despite two years of losses, most investors remain confident that things are soon to improve. Should a recovery be slow in coming, that optimism could be dashed. If investors attempt to find justification for market PE ratios in the 40's, they may instead stumble across reasons to sell and lessen their portfolios' risk burdens.

As longstanding clients know well, we have pointed out for years that the major stock market declines throughout history have begun from levels of overextended PE multiples, none, however, as high as today's. Only this year have researchers quantified the probability of future stock market returns from various levels of price-to-earnings ratios. Seattle University professors Ruben C. Trevino, Ph.D., and Fiona Robertson, Ph.D., reviewed nearly a half-century of data from 1949 to 1997. They published their results in the February 2002 issue of the *Journal of Financial Planning*. Their very clear conclusion was that the higher the initial PE ratio, the lower the average long-term return. While PE ratios had little influence on shorter-term returns, there was a very significant reverse correlation over longer five to ten year periods. The regression equation that resulted from their research is:

$\text{Expected five-year average stock return} = 20.67 - 0.57 (\text{current PE})$

Using the PE ratio of 43.6 at the market's close on April 26, the expected five-year average stock return is -4.18%. In other words, the data from most of the past half century would suggest that the most likely returns from stocks will be an average loss of 4.18% in each of the next five years. If that occurs, the value of a \$10 million portfolio invested in stocks would be reduced to about \$8 million by April 2007, assuming no contributions or withdrawals.

The authors do caution that, while the reverse correlation between PE ratio levels and subsequent long-term stock market performance was strong throughout the range of PE ratios, there could be no assurance that the relationship would hold for readings outside the range of the sample universe. The current PE reading of 43.6 is clearly outside the range of any sample in U.S. history. In fact, the only similar precedent from any established world stock market was the lunacy that prevailed in Japan in the late-1980's, and the Japanese are still digging out from the rubble of that market collapse.

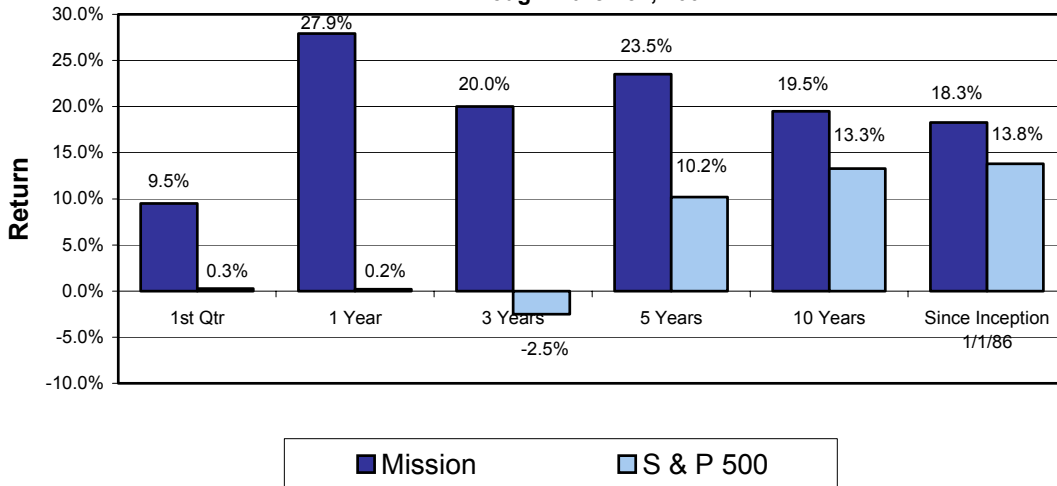
With the U.S. stock market virtually at its most over-valued level ever and with earnings still declining, it is hard revving up much enthusiasm to become more bullish. Factor in the remaining presence in the world of terrorists with the avowed intention of killing large numbers of Americans in their homeland and we remain content to maintain our portfolio holdings in equities at relatively low levels.

There are several indicators that are also making us cautious on the interest rate front. Despite the weak corporate profit environment, interest rates appear to want to work higher. Oil prices have moved back up; the Commodity Research Bureau's index of inflation has climbed about 9% in the past six months; and gold, historically an inflation indicator, has been rising for more than a year. The Federal Reserve's next move is likely to be toward higher short-term rates. In summary, we believe that we will have the opportunity to buy bonds with higher yields out a few quarters.

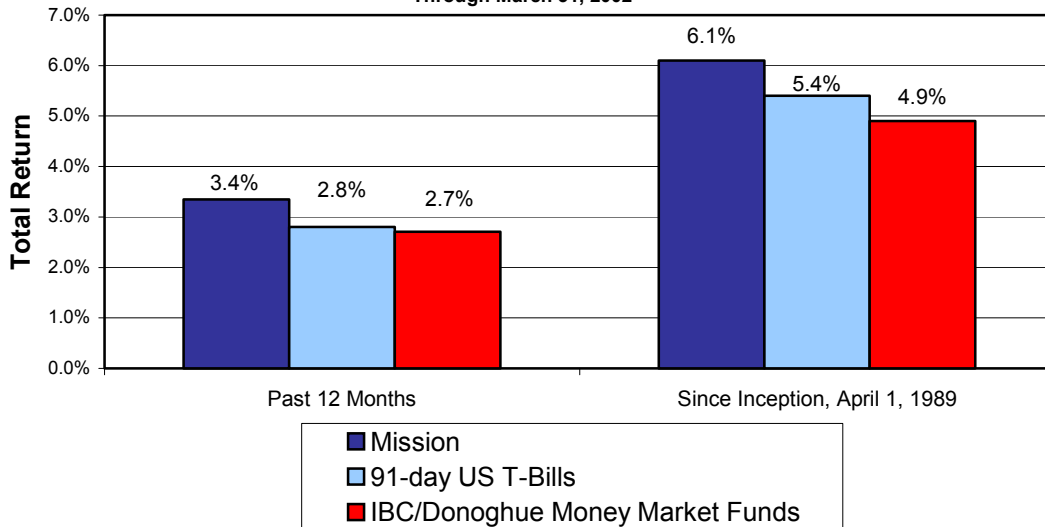
Despite the tough environment, we are pleased to report again that all of our clients' portfolios for which we have asset allocation discretion have continued to grow. The stocks that we purchased, limited as they are, have performed well, and we have actively worked to maximize the return on the non-equity assets. We look forward to the opportunity to invest more aggressively in equities as appropriate for specific clients, but we expect that will happen at significantly lower stock market levels.

Thomas J. Feeney
Managing Director and Chief Investment Officer

**Mission Equity
Performance Results
Through March 31, 2002**



**Mission Cash Management
Performance Results
Through March 31, 2002**



Past Performance May Not Be Predictive Of Future Performance