



## **QUARTERLY REPORT**

### **First Quarter 2003**

The first quarter of 2003 continued the stock market decline that has now become the worst bear market since the Great Depression of the 1930's. The S&P 500 lost 3.2% in the quarter and is down by 24.8% over the past twelve months. The bear market reached its third anniversary at the end of March with the S&P 500 down 43% from its bull market high. In the same period the NASDAQ Composite lost 77% of its value.

We are pleased that our clients' portfolios typically were fractionally above or below break even for the past year and, remarkably, had double-digit positive returns for the cumulative three-year period in which fortunes have been lost around the world.

As we write in late April, the S&P 500 is rising in its ninth rally of 10% or more since the bear market began three years ago. In each of the first eight rallies, enthusiasm grew, and "underinvested" investors fretted about the risk of missing the beginning of the next bull market. In retrospect we know that each of those earlier rallies proved ephemeral and ultimately punished those who committed more capital to common stocks.

The premier example of the penalties that can result from premature anticipation of a new bull market is the Japanese Nikkei average over the past 13 years. Eleven rallies of 20% or more have renewed bullish enthusiasm intermittently since 1990. Unfortunately, persistent market declines have ultimately nullified each of those rallies, and that market today rests at a 20-year low, down 80% from its bull market high at the end of 1989. Huge amounts of investor capital have been lost.

The comparison is not meant to equate the U.S. and Japanese economies, but there were great similarities to the absurd overvaluations that characterized both markets at their respective highs. What we have experienced in watching the Nikkei implode is that, despite periodically improved business conditions, Japan has been unable to arrest the 13-year bear market with stock valuations remaining far above their historic norm.

In concert with the three-year, 43% decline in the S&P 500, U.S. corporate earnings have experienced their worst collapse since the Depression. Consequently, stock valuations, as in Japan, remain ridiculously high. At over 28 times earnings at quarter end, prices for the S&P are nearly twice their historical average level relative to their underlying earnings. That doesn't mean that a rally from here can't last for several quarters. It could, but such a rally would be successful speculation, not sound investment. And we are investors.

Our research into price-to-earnings ratios and subsequent returns from 1926 to present provides incontrovertible evidence that over every time period from one to twenty years, investors do far better than average buying stocks when the market is cheap. Conversely, when prices are expensive, even far less expensive than they are today, the probability of well below average returns is high. This is a probability business, not a certainty business, so at current price-to-earnings levels, the probabilities favor conservatism, not aggressiveness. It is highly probably that the bear market that began three years ago will not end until the market reaches levels of serious undervaluation. That is how the U.S.'s major bear markets have always ended. They have never ended at levels of overvaluation like today's. That will probably take several more years, interrupted in all likelihood by additional impressive looking rallies. Trying to trade those rallies for profit is a highly problematic endeavor. Unless your timing is good getting in and getting out, you will not make money adding to stock holdings until the next major bull market begins.

We at Mission have for years made the case for using a formularized approach to determine the level of a portfolio that should be allocated to equities. In keeping with the powerful evidence of history, our approach is to remain at the lower end of our equity risk tolerance when valuations are near their historic highs and increase equity exposure incrementally as valuations become more favorable. Such a formularized approach removes emotion from the investment decision and eliminates any market timing decisions. If investors had religiously followed such a formularized approach through the past 80 years, they would have been somewhat underinvested in a few rallies from levels of serious overvaluation, most notably in the late-1990's. They would, however, have preserved the vast bulk of their capital in this century's serious bear markets and would have been heavily invested in stocks at the inception of every major bull market. This would have been far more successful than the traditional fixed asset allocation approach followed by most investment programs today.

We are extremely pleased to have preserved our clients' money so far through the second worst bear market in U.S. history. We look eagerly forward to the opportunity to be more aggressive in buying securities with sound valuations. In a world at war with terrorism as a latent threat, we remain vigilant should a severe market shock provide such a condition very quickly. On the other hand, we remain patient should valuations continue excessive for some time to come. It is important to remember that there will always be another good market; but investors lose their opportunity to profit substantially if they dissipate too much of their asset base before the new bull market dawns. We expect our clients to profit handsomely when markets begin to rally from historically attractive levels of valuation.

Thomas J. Feeney  
Managing Director and Chief Investment Officer  
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