



2nd Quarter 2002 Market Commentary

The S&P 500 declined by 13.2% in the June quarter and 18% over the past year. NASDAQ's respective declines of 20.6% and 31.9% were even more devastating.

* * *

Investors are beginning to feel the pain. Since following the stock market's progress became a dawn to dusk preoccupation in the late-1990's, large numbers of investors have gleaned their market information from financial television. Recently one of the better young announcers asked with incredulity in his voice: "We're going back to the prices of 1998 and 1997—is that possible?" It's understandable that someone who cut his market teeth on the quarter century long greatest bull market in U.S. history would fail to understand prices falling back to their levels of five years earlier.

Unfortunately, that lack of a longer perspective hides from most investors the recognition that past major bear markets have wiped away far more than five years of investment profits. The first great U.S. stock market overvaluation peaked in September of 1929. When that market bottomed in July of 1932 it had wiped out all price gains since 1914, an eighteen-year span. When the country's second serious overvaluation topped in the mid-1960's, stock prices traversed a series of mini-bear and mini-bull markets to their bottom at the end of 1974. At the trough, prices had dropped to their levels of 1958, a sixteen-year retreat. All the price gains of two of the past century's most productive decades (the 1920's and 1960's) were completely eliminated by the bear markets that followed them. Before the declines began in 1929 and 1966, it was virtually inconceivable that any serious damage could be done to fruits of those "new era" bull markets that had rewarded investors magnificently for so many years.

To put the current bear market into perspective, it is important to recognize that levels of stock market overvaluation became far more severe in this cycle than at the top of either of the prior great bull markets. Consequently, it would not be unreasonable for the market to repeat its patterns of the past. There is no necessity that this bear market wipe out the gains of the entire 1990's, but it would be foolhardy not to recognize that possibility. Should that unfold, the bulk of the declines lie ahead.

Just as investors in 1929 or 1966 could not possibly have known what economic, political, or societal conditions were about to unfold, we are equally ill equipped to see even our relatively near-term future with clarity. A wildcard in the current situation, unlike either of its predecessors, is the existence of organized terrorists with the avowed intention of killing large numbers of Americans in their homeland, a destabilizing influence at the very least.

Countering the optimistic forecasts of virtually all brokerage firm analysts, Warren Buffet casts a dark shadow. He has indicated, according to Business Week, that the “hangover effect” from the excesses of the late 1990’s may lead to economic stagnation through most of this decade.

* * *

Another phenomenon familiar to today’s financial television viewer is the analyst or commentator who marvels at the apparent disconnect between the falling stock market and the improving economic and monetary fundamentals. It’s the “Gee whiz, how can this be happening?” phenomenon. After all, the Federal Reserve has aggressively done its part by promoting very loose monetary conditions. Manufacturing is expanding. Jobless claims have dropped to their lowest levels in more than a year. Factory orders are rising, albeit slowly. Interest rates are near thirty-year lows.

The problem is a failure to recognize an even more important fundamental: price matters. Consider the following extreme example. Due to a severe shortage, the price of hamburger has risen to \$1,000 a pound. Over time the price declines to \$500 a pound, and your butcher substitutes prime filet mignon. Clearly the second situation is far preferable to the first, but it hardly represents good value. Despite the far improved “fundamentals,” the price still makes no sense.

The market experience of the vast majority of today’s analysts, consultants and portfolio managers consists of the recent portion of a 25 year bull market followed by two down years. Prior to the past two years, virtually every risk taken was rewarded. That longstanding, consistent record of success progressively emboldened consultants and portfolio managers to become increasingly aggressive. By the end of the 1990’s, stock valuations like price-to-earnings, price-to-dividends and price-to-book value reached levels far beyond anything ever experienced before. For reasons that we may never understand, except perhaps as the madness of crowds, such valuation levels lasted for years, and all but the most experienced investors came to accept them as somewhat normal, eventually even justifiable. So as not to be left out of the game, read “fired,” as stock prices marched higher and higher, consultants and portfolio managers suspended belief in principles that have stood the test of time. They substituted the newfound “metrics” that justified purchases of companies destined to live their short lives without ever sniffing anything as heady as profits.

Obviously the market of the past two years has applied a strong dose of discipline to investors who forgot, or perhaps never knew, the principles of value. Unfortunately, despite the sharp stock price declines since 2000, corporate profits have similarly collapsed in the worst decline since the 1929-32 introduction to the Great Depression. As this is written, the S&P 500 is still selling at over 34 times its most recent twelve-month earnings. Never before the late 1990’s had the S&P 500 sold at a multiple above the mid-twenties, and those higher numbers came only at market peaks from which significant market declines began. In other words, the market is selling today still far above the valuations reached only at history’s bull market peaks. The declines that followed typically brought price-to-earnings ratios down to single digits before a new bull market would begin.

While rallies, sometimes even significant, lengthy ones, can begin from any level, no bull market in U.S. history has ever begun anywhere close to current valuations. It is likely that the ultimate bottom of this decline will be at far lower levels, very probably a few years from now. Even if fundamental conditions continue to improve--and that is far from certain--today's market prices still make no sense. They resemble our example's \$500 a pound, and this is hardly prime filet mignon yet.

At this year's client conference, I applauded the work of Professors Ruben C. Trevino and Fiona Robertson of Seattle University. Their article in the February 2002 issue of the Journal of Financial Planning demonstrated for the periods from 1929 to 1997 a very clear reverse correlation between price-to-earnings level at the time of a stock market investment and the subsequent long-term performance of the investment. Purchases at low price-to-earnings (PE) levels led to well above average subsequent long-term returns, while purchases at high PE levels produced far below average returns.

We expanded the Trevino-Robertson study, adding to the time period analyzed, and confirmed their findings over time periods ranging from three to fifteen years. The regression equation derived from the observation of 76 years of data would indicate the expected average return for common stocks over the next ten years from the end of the June quarter to be a negative return per year. It makes the point that, rallies notwithstanding, this is not a level at which to simply buy and hold common stocks.

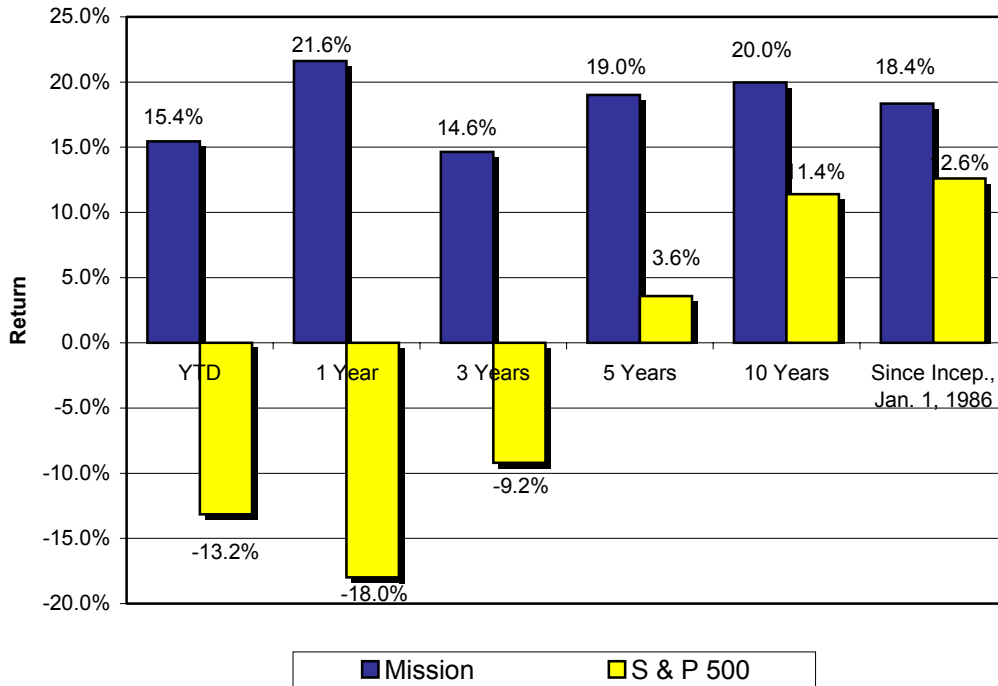
* * *

The investment consulting industry, like the vast majority of both institutional and individual investors, has grown up in a bull market environment. Not having seen the consequences of even one historically normal bear market, they have developed investment program designs built to succeed in the 1980's and 1990's. The basic construct is to set an asset allocation and periodically rebalance to it. Unfortunately, if common stocks perform far below average over the next decade, the consultants' advice will prove counterproductive. Over the next several years we expect that a great many institutional investment programs will move away from a fixed asset allocation approach to one alternately overweighting asset categories that have a probability of outperforming others based on historical valuation criteria. We expect that large numbers of individual investors will tire of the high costs of similarly structured brokerage wrap fee programs in an era of low returns.

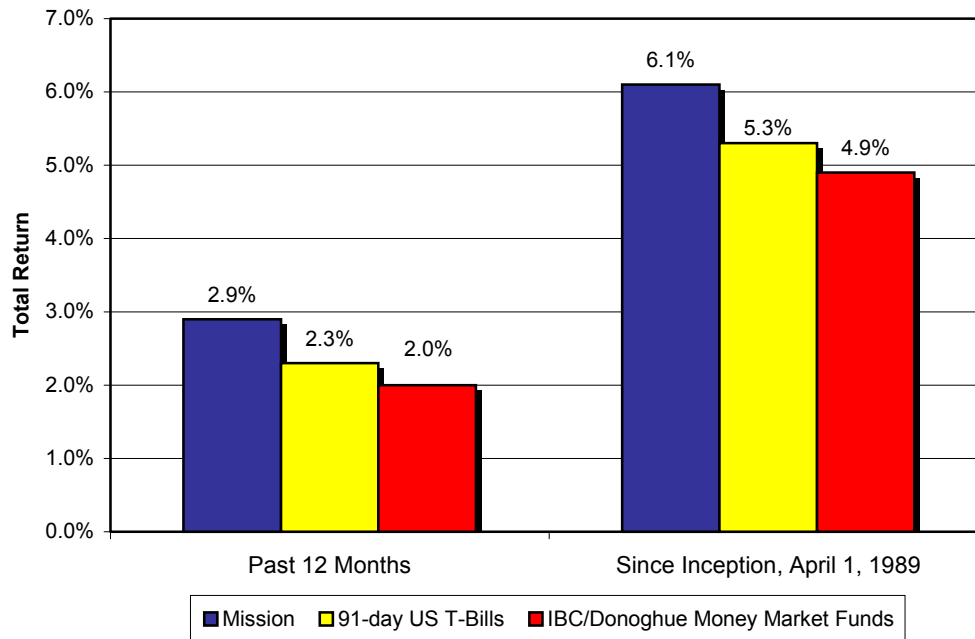
We are very pleased to have saved our clients' assets from the declines of the past two years. We anticipate downwardly biased markets will continue to be a problem over the next few years. As prices of equities decline, we expect to find more opportunities to add reasonably valued stocks that have the potential for growth when the economy expands. We will remain disciplined, however, and patient, waiting for significant equity expansion until more attractive valuations appear.

Thomas J. Feeney
Managing Director and Chief Investment Officer

**Mission Equity
Performance Results
Through June 30, 2002**



**Mission Cash Management
Performance Results
Through June 30, 2002**



Past Performance May Not Be Predictive Of Future Performance
(Performance Gross of Fees)