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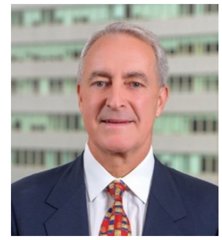

Thoughts for Investors

Albert C. Boris, III
Managing Director, Investments

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"I've made most of my money in bear markets. I just didn't realize it at the time."

– Shelby C. Davis

Shelby Davis, considered one of the best stock pickers you never heard of, learned that "opportunity knocks when problems are discovered, not when they are solved."

In this newsletter I would like to address three topics:

1. Why stocks go up and outperform bonds;
2. Why a bear market is the best time to find opportunity; and
3. How to get the courage to invest during these times.

WHY STOCKS GO UP AND OUTPERFORM BONDS

Most investors inherently know that stocks outperform bonds. But why? Why do stocks go up? In his 1925 review of Edgar Lawrence Smith's book Common Stocks as Long Term Investments, John Maynard Keynes wrote that Smith had come up with the answer. "Well managed industrial companies do not, as a rule, distribute to the shareholders the whole of their earned profits. In good years, if not in all years, they retain a part of their profits and put them back in the business. Thus, there is an element of compound interest operating in favor of a sound industrial investment." In other words, compounding of retained earnings over time makes the company more valuable and therefore makes the stock go up. Walmart started with 1 store and now there are tens of thousands. Contrast this with a $10,000 10-year bond or CD. Ten years later, after the interest is paid, it is still worth only $10K. Bond holders are lenders, stockholders are owners.

WHY A BEAR MARKET IS THE BEST TIME TO FIND OPPORTUNITY

"After the great market decline of 1929 to 1932 all common stocks were widely regarded as speculative by nature. A leading authority stated flatly that only bonds could be bought for investment."

– Benjamin Graham

This was the widespread belief seventy years ago and the same belief is widespread today! Currently there is a record $2.4 TRILLION in money market funds earning less than one percent on average! Most people cannot meet even modest goals earning one percent. Furthermore, if adjusted for inflation, low as it is, the returns on money market funds are actually negative. Only the perceived future risk of stocks can explain why investors would accept the low returns of money market. Is this concern justified? What is its cost?

Jeremy Siegel, in his book Stocks for The Long Run states that stocks "unquestionably are riskier than bonds or bills in the short run." He also states that:

"In every five-year period since 1802, however, the worst performance in stocks at -11% per year has been only slightly worse than the worst performance in bonds or bills."

He goes on to say that over periods of 17 years or more, stocks, in contrast to bonds or bills, have never had a negative real holding period return yield. In fact, he further points out that the last 30-year period in which bonds beat stocks, ended in

1861, at the onset of the Civil War. Since then, investors have been forced to pay a steep premium for the perceived "lack of risk" of bonds. With the threat of a war with Iraq, the premium paid for bonds has increased yet again. Pessimism about stocks is so high that stocks as a percentage of total 401(k) assets hit an all-time low of 57.2% by September 30th, 2002.

"Pessimism is the most common cause of low prices. We want to do business in such an environment, not because we like pessimism but because we like the prices it produces. It is optimism that is the enemy of the rational buyer."

- Warren Buffett

"Bull markets are born on pessimism, grow on skepticism, mature on optimism, and die on euphoria. The time of maximum pessimism is the best time to buy.."

- John Templeton

So during a bear market, while bond investors pay a premium for safety, pessimism allows stock investors to evaluate stocks for purchase at the most opportunistic prices.

THE COURAGE TO INVEST

$10,000 invested in the S&P 500 between 1925 and 2001 grew to a whopping $22,790,000 versus

$159,000 if invested in US Treasuries. Remember Siegel's comment earlier, that in every five-year period since 1802 the worst performance in stocks was only slightly worse than the worse performance in bonds or bills. The only catch is that you had to buy and hold stocks continuously. If you missed the best 38 months (approximately 3 years) during that time period your return would have been reduced to $179,000. Missing the best 38 months out of 76 years is a lot easier than you think because the best 38 months usually followed closely behind the worst months. It's the worst

months that cause investors to give up in panic or disgust. Yet there is a technique that all investors can use to prevent this from happening. It's called "dollar cost averaging."

Even Buffett, Templeton, Graham, and Davis depended on this technique. Remember Davis' quote at the beginning of this newsletter. Dollar cost averaging is simply the process of investing like amounts consistently over time. Unfortunately, most investors short-circuit the process.

To paraphrase Templeton, the typical investor buys little at the bottom because they are pessimistic. This is of course when they should be investing the most. As the market starts rising they invest a little more, though with a great deal of skepticism. As soon as the market "recovers" or they believe its "safe to go back in the water" they are optimistic about committing money to the market. Finally, at what turns out to be the peak of the market, every stock looks promising, investors are committing large amounts of money to the market, even borrowing money to do so, and euphoria is rampant. Inevitably, the cycle is completed when the market falls and investors retreat by stopping investing or even withdrawing their money from the stock market entirely.

An example of how performance is negatively affected by not following the dollar cost averaging plan can be seen with some 401(k) investors. The media and publications such as Morningstar are reporting that through October 2002 the compound annual return for the S&P 500 index for the last five years was basically flat (actually +0.73%). No so with the performance for a S&P 500 index fund investor who over the last five years has contributed the maximum amount to their 401(k). S&P 500 index fund investors contributed a total of $61,500 and the value of their account through the same time period is now $52,014 or 15% lower. How can this be true? Simply because the

Morningstar returns assume a one-time contribution 5 years ago, whereas in reality a 401(k) investor putting their money in a S&P 500 index fund starting in 1997, contributed $9,500 plus $10,000 in 1998 and 1999, $10,500 in 2000 and 2001, and finally $11,000 in 2002 for a total of $61,500. As the market was rising toward euphoria, more and more money was being contributed. With the negative returns of the last three years affecting a larger and larger portfolio, the positive returns on the earlier, smaller portfolio were wiped out. Consequently, the compound annual return for the S&P 500 index for the five years through 2002 is not flat but down 5.1%.

Investors are lamenting that not having made money in the last five years it will be impossible to do so with the current economic scenario in the next five years.

CONCLUSION

Pessimism can be used constructively by all investors. History has shown us that the consistent investing strategy of dollar cost averaging can help investors minimize the debilitating effects of emotional investing.

Consistent investing can give you the courage to invest and stay invested to catch those best performing months when they inevitably and unexpectedly occur. And they will occur. For in the words of J. P. Morgan,

"Any man who is a bear on the future of this country will go broke."

AUDI PARTEM ALTERAM

Hear the Other Side

The Boris-Kaplan Group // 1735 Market Street, Suite 1400 // Philadelphia, PA 19103 // T 215.563.2300
www.alexbrown.com/boriskaplan

If you would like to discuss the topic of this newsletter, or our team's approach to investing, please feel free to contact us by email at al.boris@alexbrown.com.

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