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THIRD QUARTER 2001 COMMENTARY OCTOBER 2001

FREEDOM

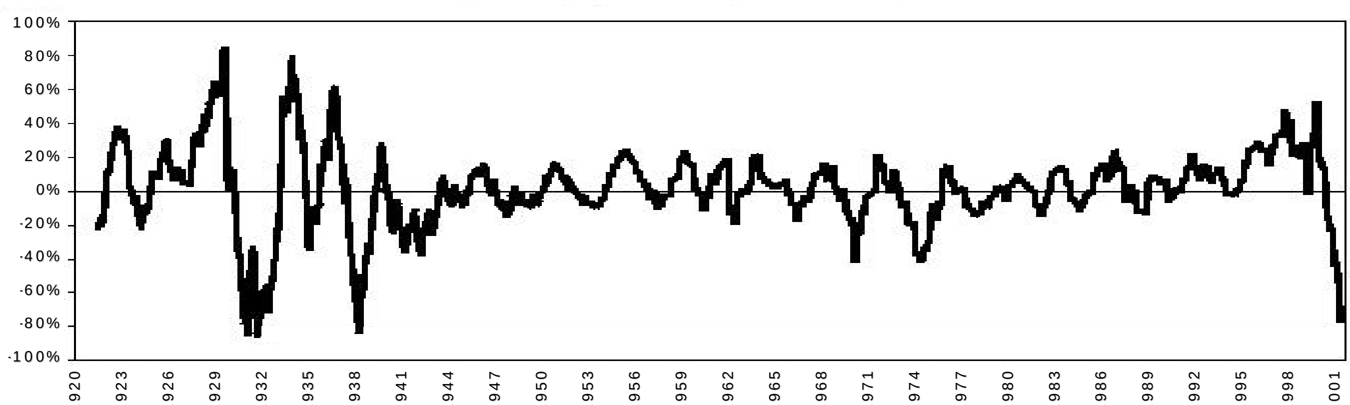
September. On the 17th of that month in 1862, 23,000 Americans were killed or wounded near a little town in Maryland on the banks of the Potomac River called Antietam. It was the bloodiest day in American history. Two weeks earlier, Robert E. Lee defeated the Union Army for the second time at Manassas, Virginia, opening the way for the Confederacy to bring the war to Union soil for the first time. Antietam was the lowest point in the war to save the union, arguably the lowest point in American history.

September. In ways that previous generations remember vividly the day President Kennedy was killed or Pearl Harbor was bombed, the images of the burning, and then collapsing, World Trade towers will be indelibly etched in the minds of our generation. In the week that followed, the country closed. We did not spend, we did not travel, we did not invest. When the markets reopened, stocks lost almost 12% of their value, more than $1 trillion. As Graph 1 illustrates, since the peak in March 2000, stocks have lost $7.6 trillion, a drop of such magnitude rivaling the 1930s.

The terrorist attacks gave a final shove to an economy already slipping into a recession. Industrial production fell in September for the 12th consecutive month, the longest string of monthly declines since we wound down the war effort in 1945. Excess capacity abounds, as factory utilization now stands at 75.5%, the lowest since 1983. Corporate profits are being punished, as shown in Graph 2. This year will see the biggest drop in profits since the 1930s.

The good news about recessions is that they generally don't last very long. Over the past forty years, there have been six recessions lasting on average about 11 months with a real decline in GDP of 2.4%. So, can we expect to come out of the recession

Graph 1
18 month Change in US Equity Market Capitalization as % of GDP



Source: Bridgewater Associates

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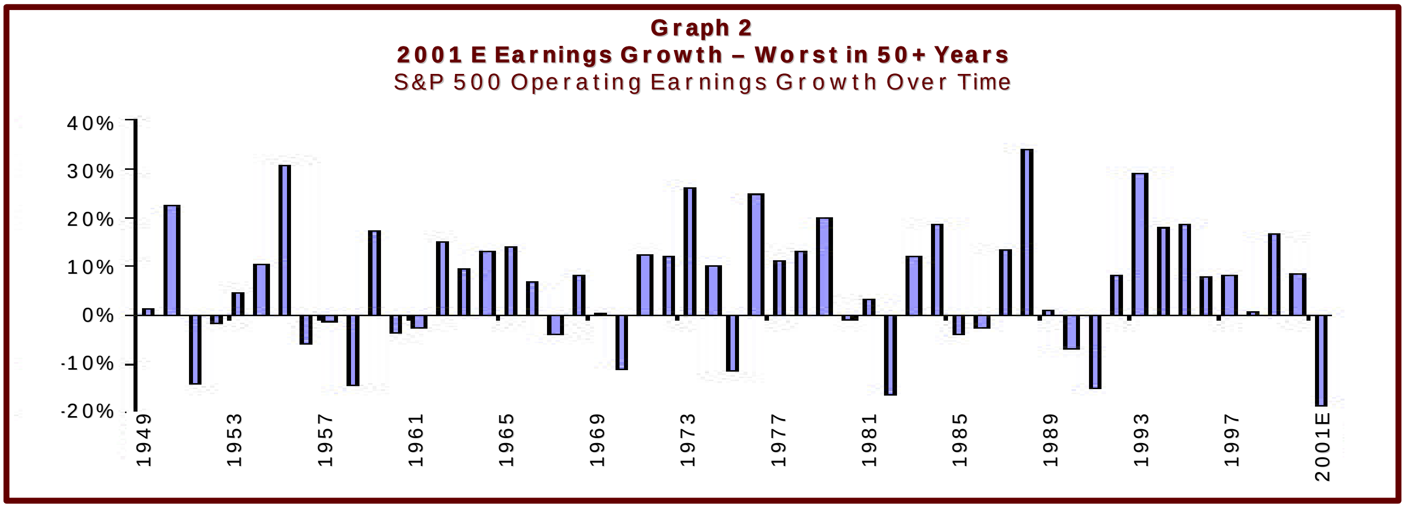
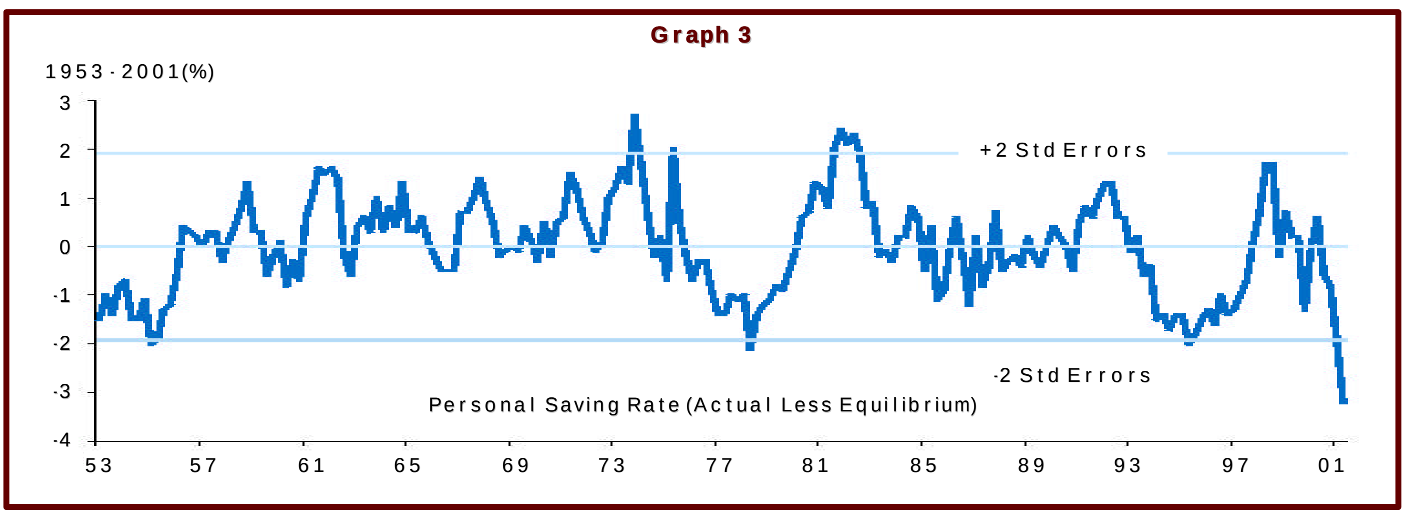


Source: Morgan Stanley Research, S&P

sometime mid-next year? After all, this downturn is wringing out the excesses of our most recent boom. Inventories are unwinding, capital spending has been slashed, energy prices have plummeted, consumer sentiment is in despair and massive fiscal and monetary stimuli are in place or on the way. This last point is noteworthy. Another $100 billion of fiscal stimulus, on top of the $40 billion in tax rebates we saw this summer is likely next year. That represents a fiscal package of about 1½% of GDP, the biggest fiscal stimulus in over 25 years. The Federal Reserve has brought overnight rates down to 2.5% from 6.5% at the beginning of this year, and another 50 basis point reduction is expected by the end of the year. We'd have to go back more than forty years to find lower rates.

If this were a typical cyclical downturn, all this is a recipe for a sharp rebound next year. But this is probably not a typical cyclical downturn. There is a secular component to this recession, and there are four reasons to suggest that the coming recovery may be less vigorous than might otherwise be expected.

The first issue is the structural imbalances we've built up in the economy. We have huge trade and capital account deficits financed, by definition, by foreigners. Should that support waver, look for the dollar to crack. We've discussed before the record level of capital (especially, IT) spending in the last half of the 1990s that needs to be cut (it is, but there's more to come). Our personal balance sheets are also in need of repair. Household debt burden has risen more than 20% faster than income



Source: Federal Reserve Board.

over the past six years. No surprise that the personal savings rate has almost fallen faster than we can record it (Graph 3).

The second secular concern is trade. Steven Roach of Morgan Stanley estimates that the drop in the growth rate of world trade this year, to around zero, will be the biggest single annual decline on record. Trade accounts for about a quarter of the US economy, double the percentage from a decade ago, responsible for an extra 0.5%-1.0% p.a. boost to our economy. Stagnant trade will mute the coming recovery.

A related concern is globalization. On the upside of the virtuous circle, globalization benefited everyone. Production of goods was moved to the place of comparative advantage, freeing resources for more productive use. Low value-added services aided less developed countries as rising demand led to more investment and faster growth in these economies. Developed countries were then able to redirect resources to higher value-added services, and productivity improved through better inventory management, itself enabled by advances in transportation, logistics and software. All of this was the result of *and* made possible by the rise of globalization, and the standard of living was thus raised for everyone. But the downside of the vicious circle is that a downturn in the leading economies affects every economy. We are now in the first global, synchronous recession since the oil shock of the early 1970s. Not one country in the world is growing faster this year than it was in the previous year. So, what country or region will lead the world out of recession?

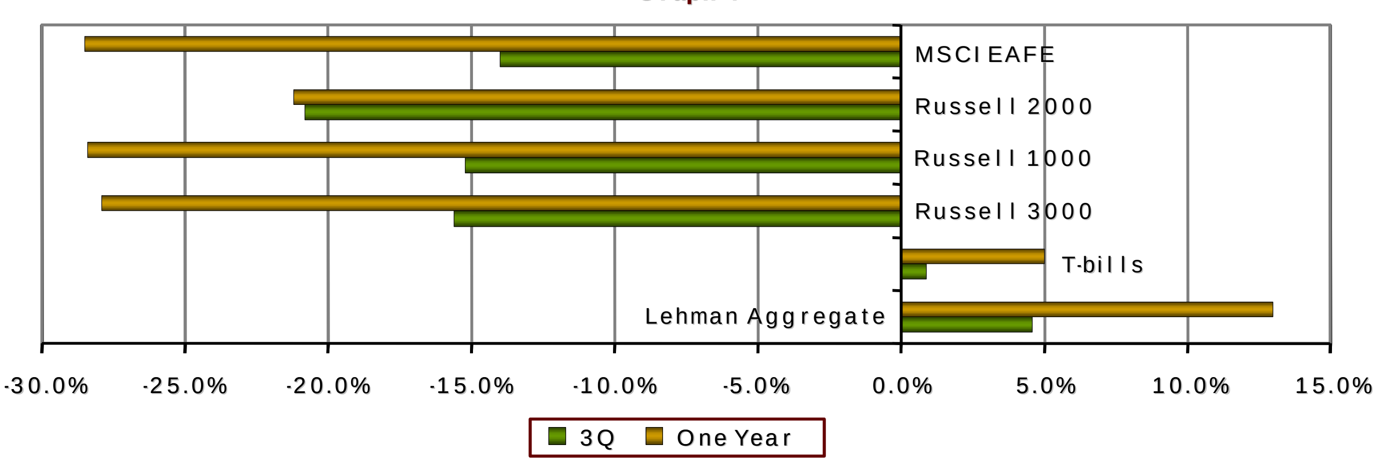
The final structural concern we'll note is that the cost of doing business jumped measurably after 11 September. We are all paying more now for insurance (assuming we can still get it), for security, for inventory. At the micro (personal) level, we'll adjust. So it takes an extra hour to travel, we'll get used to it. So we'll stock an extra few days of supply, just in case (instead of just in time). But multiply those hours, those stocks, that money by the millions, and the macroeconomic effect could be large. We will probably recover from this recession sometime next year, but a resumption of the robust growth of the late 1990s seems unlikely.

Predictably, the equity markets have suffered. And there was nowhere to run, nowhere to hide, at least among stocks (Graph 4). Every sector of the S&P 500 Index has lost ground this year, led by technology's 45% plunge. Technology started the year as the largest sector in the index at 21.4%, but now with 14.3%, trails financials (18.3%) and healthcare (15.6%).

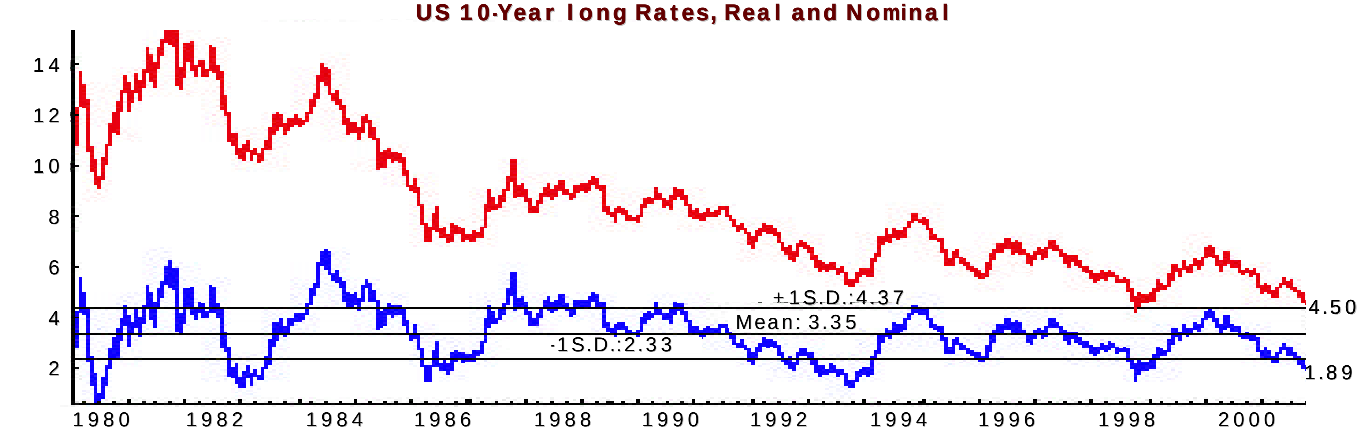
This bear market is global. Since its peak in March 2000, the MSCI All-Country World Index is off 37%. 1973-74 was a little worse, with a 43% decline in that 18-month period. But this is about as bad a market as anyone alive can remember. *[Actually, my wife's Grandpa John remembers the 1929 crash. He bought New York Telephone back then and it held up well, and he's been buying the Bells now, about the only sector that has done well this year. We're trying to hire him on at Angeles].*

Rising risk premia and falling inflation expectations, monetary easing and world recession have all helped to push bond yields to levels not seen since the early 1960s. An important question is

Graph 4



Graph 5
US 10-Year long Rates, Real and Nominal



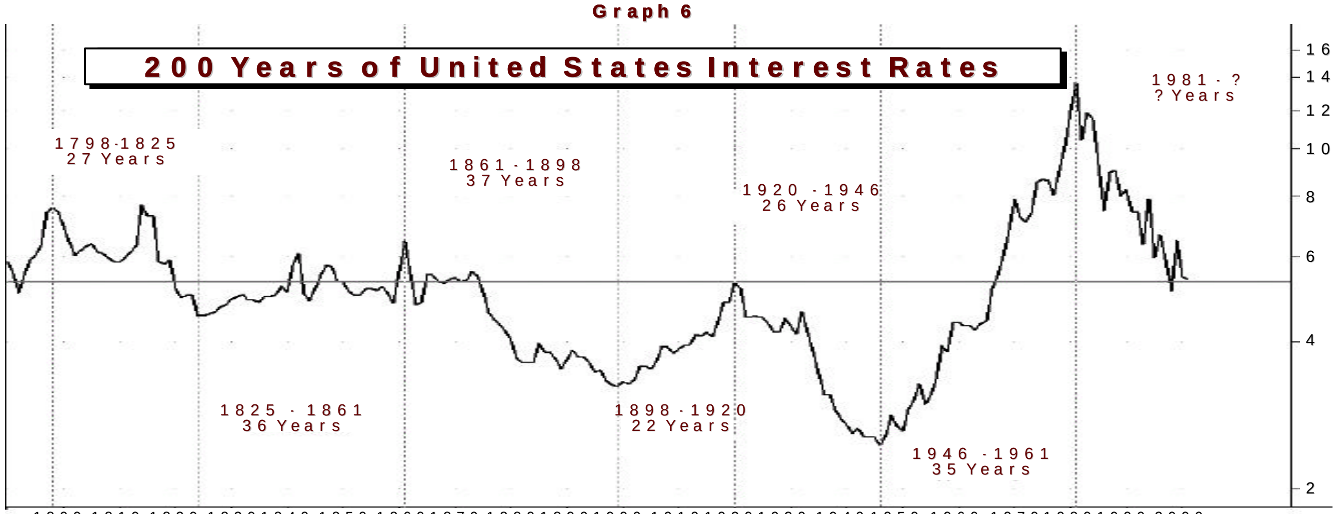
Source: Datastream, Morgan Stanley Investment Management, DRI

whether yields have bottomed or if rates can continue to decline further. This matters as much to the equity markets as it does to the bond market. The answer, as you might expect, depends on your inflation view.

Graph 5 looks at nominal and real (inflation-adjusted) yields on the ten-year Treasury note over the past 20 years. Note that real yields are today more than one standard deviation below the average over this period, but this embeds the most recent 12-month inflation rate of 2.6%. The market currently believes (implied in the TIPS curve) that the ten-year inflation rate is likely to be 1.5%, which translates to a real yield much closer to the 20-year average. So if you believe the low inflation estimates, real yields are not especially low even as nominal yields are.

Before you decide on the direction of bond yields, consider Graph 6, nominal interest rates over the past 200 years. A couple of thoughts come to mind look-

Graph 6



Data Used in Chart

- Foreign loan made to U.S. government: 1790, 1792, 1794.
- Average foreign loans made to U.S. government: 1791.
- Federal government bonds: 1798-1820, 1860-1.
- Federal government average new issue: 1841.
- Federal government average market yield: 1842-8.
- New England municipals: 1821-5, 1827, 1829-30, 1832-40, 1849-50, 1865-1884.
- Highest grade corporates (RR): 1826-4, 1885-98.
- 30- year prime corporates: 1899-1976.
- 30-year treasury bond yield: 1977-present.
- Interpolated: 1793, 1795-7, 1822, 1826, 1828, 1831.

Note: 1821 – U.S. debt insignificant. 1833 – No federal debt at all.

Source: Salomon Smith Barney

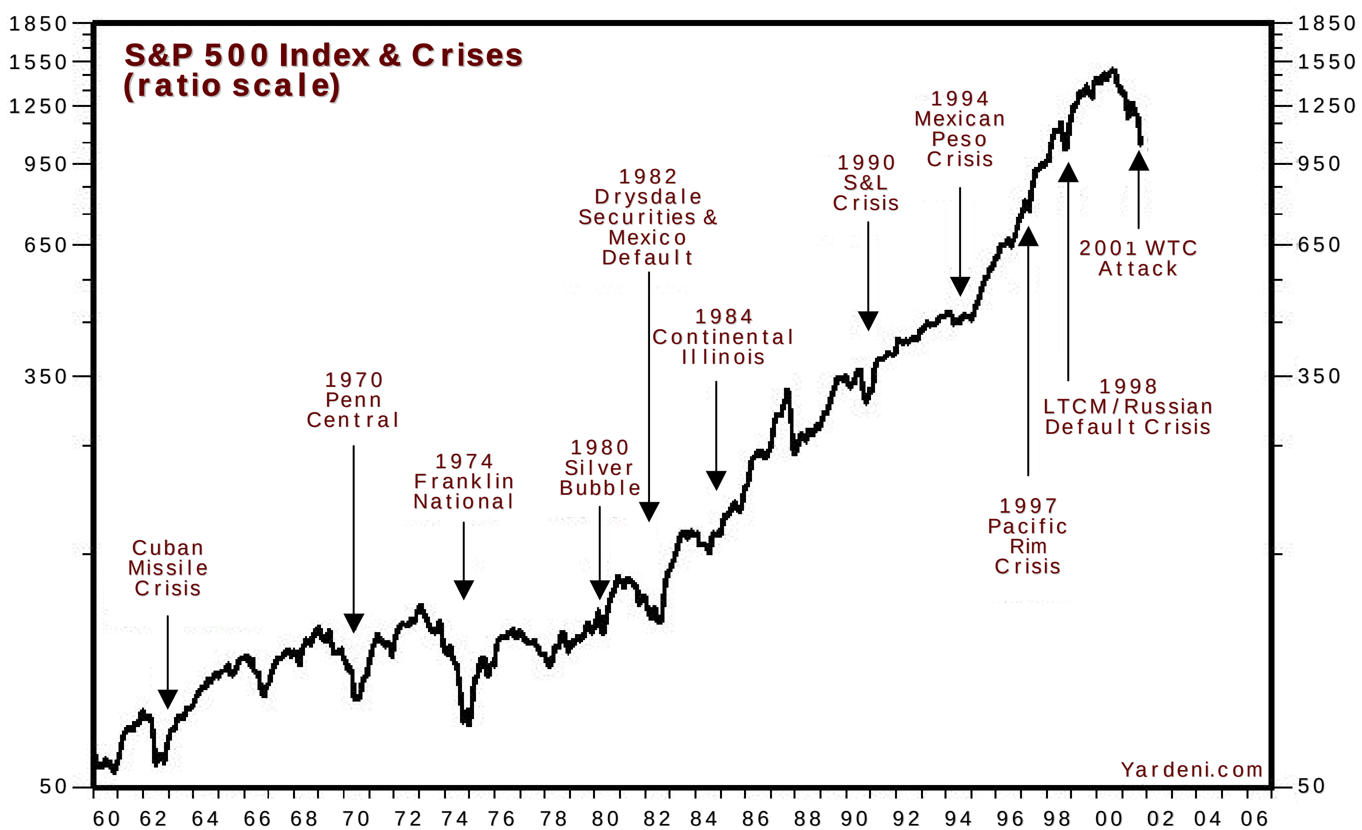
ing at this graph. One is the clear long-term cycles of interest rates, lasting, on average, about 30 years. Secondly, we are now right on the 200-year average of long-term rates, about 20 years into the current down cycle in yields.

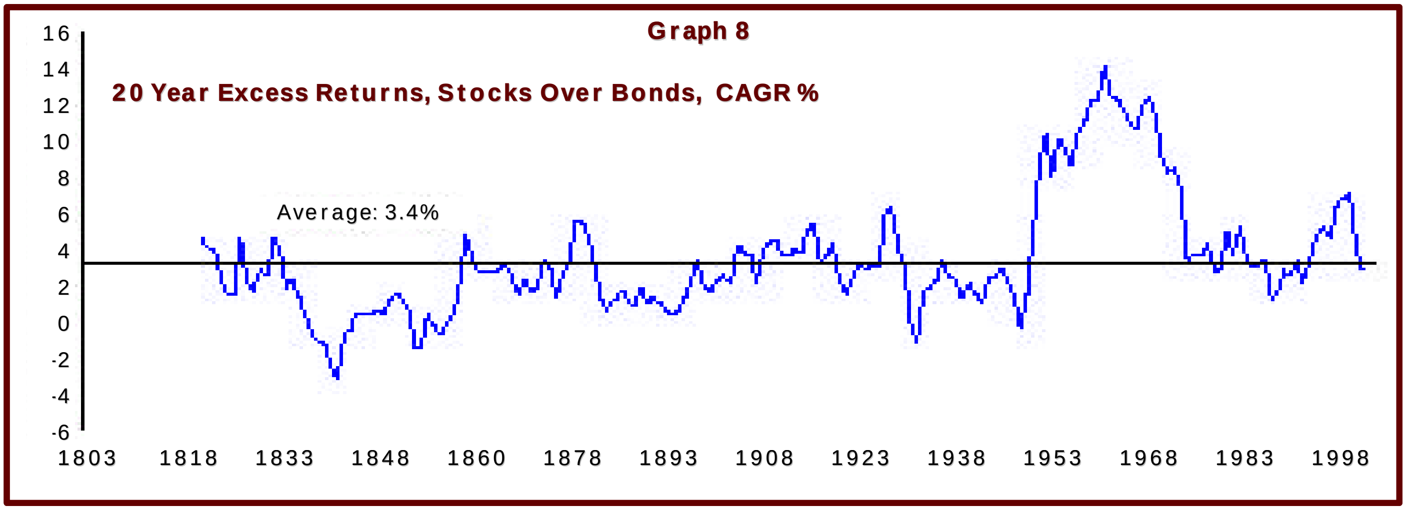
So where are rates headed? Well, there's a bit of a disconnect in the markets. The steep yield curve, the recovery on the equity markets from the 11 September attacks, the narrowing of credit spreads since then, all suggest a reasonably vigorous economic rebound and higher inflation. Yet all of the economic statistics are clearly negative with no improvement visible, and the implied inflation rate in the TIPS market has declined from 2.2% in April to 1.5% now, well below the trailing 12-month rate of 2.6%. There's an opportunity in all of this somewhere. Putting it all together, our view is that there is room in the coming months for a further decline in interest rates, and even if there is a pull back, the twenty-year secular trend of lower yields remains intact. The double-digit returns of the past year will be more difficult to attain going forward, but positive real returns from bonds still seems a good bet, especially if the recession is deeper or the recovery less vigorous than the market seems to think.

We've been pretty gloomy thus far, so let's add some more encouraging words. Our economy has faced numerous challenges over the years. Graph 7 highlights some of the crises over the past forty years, omitting the political tragedies of one presidential assassination, two impeachments and one resignation, numerous wars and some pretty egregious public policy mismanagement. Yet the stock market somehow managed to rise about 20-fold over this time. Since 1960, there have been nine major troughs (declines greater than 15%) in the market, and the average gain a year following the trough was 28%.

As institutional investors, we take an appropriate long-term perspective, and nothing in the current environment dissuades us from our belief that stocks are the best investment vehicle for the accretion of wealth. We admit to perhaps a higher level of uncertainty about the near-term direction of the markets, but we are sure as to the long-term outcome.

Graph 7





Source: Foundation for the Study of Cycles, NYSE

Graph 8 looks at the rolling 20-year periods over the past 200 years. We see that stocks have outperformed government bonds by an average of 3.4% annually. It's interesting to note that in the past 20-year period, stocks have outperformed bonds by about this rate despite the extraordinary absolute returns in this period. In other words, equity returns have been so good these past 20 years because bond returns have been so good over this period. But nothing now suggests that stock returns will trail bonds over the next 20-year period.

Steve Galbraith of Morgan Stanley has noted that the late 1990s was a great time to be an owner of equities but not a good time to be a buyer. This past year has been a very bad time to be an owner of stocks, and perhaps it's too early to say that it is now a good time to be a buyer, but that's our inclination. Given all that we've said about the economic data, all that we've documented about this bear market, we maintain our long-term commitment to equities.

In past letters, we've stressed the importance of portfolio diversification. Diversification offers the free lunch of higher returns and/or lower risk by owning a portfolio of securities whose returns are less than perfectly correlated. This is not a new concept, to be sure. Harry Markowitz wrote about it fifty years ago (and appropriately won a Nobel Prize for doing so). Every few years we review the concept with our clients in the context of asset allocation, so most are familiar with the benefits of diversification. A complementary topic, relevant to the prior discussion of the markets, but unfortunately less often discussed, is rebalancing. A disciplined rebalancing program not only ensures that portfolio risk does not drift too far from the intended target, but also turns the inherent volatility and correlation of asset prices into above average portfolio returns. Let's see how.

Using actual data from Merrill Lynch for the 12+ years from 31 December 1988 through 31 March 2001, we take eight portfolios (P1…P8) with the following broad asset allocation percentages:

	P1	P2	P3	P4	P5	P6	P7	P8
Stocks	100%	100%	80%	80%	65%	55%	40%	40%
Bonds	0%	0%	20%	15%	30%	30%	45%	40%
Cash	0%	0%	0%	5%	5%	15%	15%	20%

Let's further assign various sub-asset classes to these portfolios:

	P1	P2	P3	P4	P5	P6	P7	P8
S&P500	100%	15%	50%	15%	25%	25%	-	20%
S&P Gr.	-	25%	-	20%	15%	-	-	-
S&P Val.	-	-	-	-	-	15%	40%	20%
Mid Cap	-	25%	10%	20%	10%	10%	-	-
Sm. Cap	-	25%	10%	15%	10%	5%	-	-
Intl Eq	-	10%	10%	10%	5%	-	-	-
Int. Corp	-	-	20%	15%	-	-	15%	20%
Int. Mun	-	-	-	-	15%	15%	-	-
Int. Govt	-	-	-	-	-	-	30%	-
LT Corp	-	-	-	-	-	-	-	20%
LT Mun	-	-	-	-	15%	15%	-	-
3Tbill	-	-	-	5%	5%	15%	15%	20%

If we never rebalanced, here is the return and risk of these eight portfolios over those 12+ years:

	P1	P2	P3	P4	P5	P6	P7	P8
Return	14.1%	10.8%	10.5%	10.2%	9.9%	9.7%	9.5%	9.4%
Risk	14.1%	15.1%	12.0%	13.1%	11.7%	10.1%	7.7%	8.1%

But if we rebalanced back to targets every 31 December, here is what the return and risk would have been of each portfolio over that period:

	P1	P2	P3	P4	P5	P6	P7	P8
Return	14.1%	10.9%	10.5%	10.5%	10.2%	10.1%	9.8%	10.0%
Risk	14.1%	14.7%	11.2%	11.7%	9.9%	8.2%	6.1%	6.3%

Finally, here is the difference in risk and return, by portfolio, with rebalancing:

	P1	P2	P3	P4	P5	P6	P7	P8
Return	-	0.1%	-	0.3%	0.3%	0.4%	0.3%	0.6%
Risk	-	-0.4%	-0.8%	-1.4%	-1.8%	-1.9%	-1.5%	-1.8%

For every diversified portfolio, return was enhanced and risk was reduced by rebalancing. Of course, past performance is no guarantee of future results, this was just one period of time, and there are a number of methods to use in rebalancing, but we believe that every client should have and stick to a disciplined rebalancing program. If the relative performance of stocks and bonds this year has triggered a rebalancing into stocks, we encourage you to do so.

We started this letter by remembering the horrific events of two days in Septembers 139 years apart. The battle of Antietam was tragic for its horrendous loss of life, the most, by far, of any single day in American history. But it's important to remember too that Antietam was not only the first, but also the last battle fought on Union soil. Late in the day of 17 September 1862, General Lee retreated across the Potomac and back to the Shenandoah Valley, never to return. Five days later, an emboldened Abraham Lincoln issued the Proclamation of Emancipation declaring all slaves "shall be then, thenceforward, and forever free."

It was certainly not known at the time, but that calamitous day in September 1862 was both the most tragic day in American history and the turning point in the war to save the Union. Our future following the terrible events of 11 September is unknown to us. But we have a sense that it too marked both a nadir and a turning point for our country. Just as there were many tribulations and many lives lost in the battles that followed Antietam, we will face our own trials. We, too, will prevail.

Lincoln closed the Emancipation Proclamation with these words: "And upon this act, sincerely believed to be an act of justice…I invoke the considerate judgment of mankind, and the gracious favor of Almighty God." A thought for today too.

MICHAEL A. ROSEN
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OCTOBER 2001