



EARL M. FOSTER ASSOCIATES

I N V E S T M E N T M A N A G E M E N T

NEWSLETTER

July 2002

PATIENCE AND DISCIPLINE

The Standard & Poor's 500 Index closed June 30th with its largest quarterly decline since this bear market began! From its high in March 2000, the Index fell 37% over the next 16 months to a September 2001 low. Its subsequent rebound into January 2002 now seems like a distant memory. Since then, the Index dropped 16% and retraced almost all of its recovery since the attack on the World Trade Center.

Some retracing of prior gains is normal, but the magnitude of the decline since the beginning of the year is exceptional and a product of several factors. First, economic growth moderated from what was expected six months ago. Growth in final sales for the second half of this year is now projected at 2.7% (annual rate) versus 3.5% six months ago. As a result, corporate earnings growth will not be as robust as originally expected.

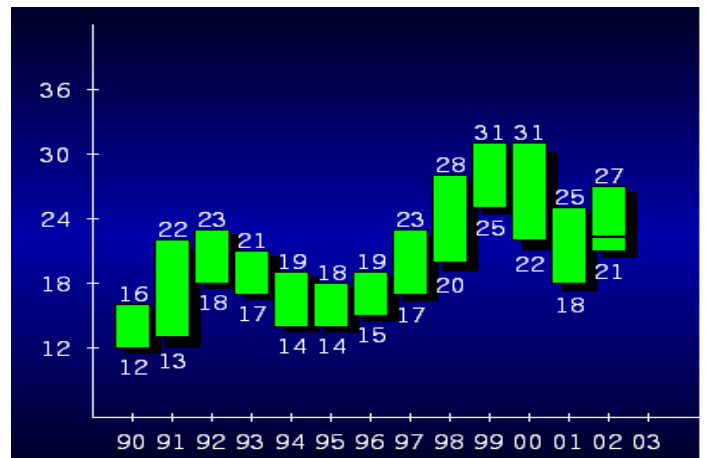
CHART I
S&P 500 Index



Second, valuations are still high. Before the 2000-01 bear market began, price-earnings ratios were extraordinarily high, rising to over 30 times current earnings for the Standard & Poor's Index. The "bear market" contracted that ratio down to about 22, but the multiple still appears "rich" compared to the 12-23 range that existed in the 1990's prior to the "bubble" period.

CHART II
S&P 500 Price-Earnings Ratios

Third, Middle East turmoil and the threat of terrorism



continue to erode investor sentiment. An escalation in the Middle East hostilities or a significant act of terrorism could shake an already fragile investor and lead to further downward revisions in the economic outlook.

Fourth, and by no means least, credibility of corporate management and their accounting disclosures following the Enron, Global Crossing, Tyco, and WorldCom scandals along with disclosures of improper financial dealings amongst a wide range of companies has cast a pall over the investment environment. As the Securities and Exchange Commission continues to investigate, increased scrutiny from investors and analysts will cause this cloud of skepticism to persist.

PROSPECT FOR MARKET REBOUND

In spite of the above, the underpinnings of a stock market recovery are already in place: namely, low interest rates and rising corporate earnings.

There is an inverse relationship between bond yields and price-earnings ratios for stocks. During the double-digit

interest rate environment of the early 1980s, price-earnings ratios were in single digits as stock prices competed against attractive bond yields. Conversely, low interest rates, such as we had over the last few years, led to exceptionally high price-earnings ratios.

If today's price-earnings ratios are adjusted for low interest rates, stocks, at their recent lows, appear more reasonably valued than the unadjusted numbers suggest. This is particularly so if the aberrations in the technology sector were removed from the Standard & Poor's Index. A proprietary model used in our analysis indicates that if interest rates remain low, stocks have limited downside risk of only 5% to 10%. By way of contrast, however, they also have a corresponding recovery potential in excess of 20%.

In spite of downward revisions in corporate earnings for this year and next, earnings are rising. Profits are expected to grow about 10% this year and next. Although most of this year's increase is related to changes in the accounting definition of profits, next year's earnings increase is "real".

INVESTMENT STRATEGY

Over the last quarter, our investment strategy focused on protecting portfolio values with stock positions in the more defensive financial, healthcare, and utility sectors, investments in preferred stocks, and/or generally reducing exposure to the stock market with increasing cash reserves. This cushioned against a good part of the sharp second quarter market decline.

Shifting into the second half of the year, a recovery from recent stock market declines is expected. However, a typical rebound such as occurred in 1998, 1991, and 1987 is unlikely. Moreover, a return to the peak of two years ago could require three or more years. Instead, international turmoil, terrorism, and lingering accounting credibility issues will lead to a more modest, slower, and erratic rebound. Nevertheless, it should be a rebound where stocks generate higher returns than cash reserves and bonds.

On this basis, an increase in common stock investment should be undertaken during the second half of the year to position the portfolio for 2003. By then, earnings should be stronger, and accounting disclosures less dramatic.

However, stock selection will be especially important, and close attention should be paid to valuation. While price-earnings ratios declined by nearly a third from their lofty 1999-2000 peaks, many sectors of the stock market are still burdened with excessive valuations. In particular, some growth stocks (those with high forecasted growth rates)

may have price-earnings ratios that are not justified by their earnings performance.

Therefore stock selection should focus on two dimensions. First and foremost is value. Low interest rates do justify higher price-earnings ratios than existed in the 1970s or 1980s. But, higher price-earnings ratios, if they are to be sustained, must be supported by "real" earnings growth. That is, earnings growth realized in the past as well as projected. Many companies in the technology sector, as well as some large capitalization companies that are unable to maintain their former growth rates, are vulnerable to further correction in their valuations and are likely to underperform during the market rebound.

Second, industry diversification should reflect growth rates in the underlying economic sectors. Household savings rates plummeted during the last decade, as consumer spending was encouraged with rising home and stock market values. Now, savings rates are rising but are still well below normal as households engage in a process of restoring a better balance between their incomes and spending. This phenomenon will restrain growth in the consumer sector, and an under-weight in this sector may be appropriate. By way of contrast, industrial production was in a major decline over the last two years as businesses reduced inventories. That process is now reversing, and the industrial sector of the economy should lead the recovery in business conditions. As such, sector diversification should overweight industrials, particularly manufacturing companies that cater to capital investment and services.

TABLE I
Market Performance Comparison
(Including Interest and Dividend Income)*

MARKET INDEX	6/30/02	QTD Return	YTD Return
Standard & Poor's 500	990	-13.4%	-13.2%
Dow Jones Average	9,243	-10.7%	-6.9%
NASDAQ	1,465	-20.6%	-24.9%
EAFE Index	1,123	-2.8%	-2.8%
3 Mth U.S. Treasury Bill	1.7%	0.4%	0.9%
10-Yr U.S. Treasury Bond	4.8%	5.6%	4.2%
10-Yr AAA. Tax-Exempt Bond	4.0%	5.1%	5.3%

*Estimate