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

NEWSLETTER

October 2002

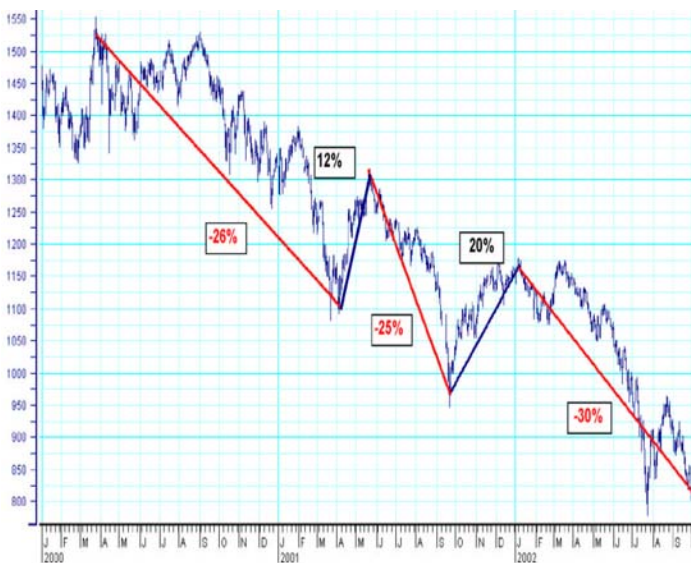
THE BEAR MARKET

And Its Prognosis

During the last two and a half years, the stock market experienced its worst bear market in a half century.

It's lasted longer than the 1973-75 market decline that was plagued with oil rationing, spiraling inflation, war in the Middle East, and the bankruptcy of New York City. The magnitude of this decline is also extraordinary. From the early 2000 peak to quarter-end, the Standard & Poor's Index is down 46.6%, the Dow 35.2%, and the NASDAQ imploded 76.8%!

CHART I
STANDARD & POOR'S 500 INDEX



The decline in the Standard & Poor's Index took place in three waves, with each down leg ranging between 25% and 30%, separated by rebounds of 12% and then 20%. The first drop was concentrated in the technology sector. The second was more broad-based as the economy fell into recession and culminated with the attack on September 11th. The third, and most recent, responded to a number of disappointments: revelations of accounting irregularities and corporate fraud, fears that the economy would

decelerate into a "double dip" recession, and a potential war with Iraq.

Looking ahead, the outlook for the stock market can be segmented into three areas of concern: the economy, valuation, and investor sentiment.

The Economy The economy declined during the first three quarters of 2001. Since then, there has been an uneven recovery. Growth accelerated to a high of 5% during this year's first quarter as production increased to re-stock depleted inventories. With that accomplished, growth moderated to 1.3% in the second quarter. The recovery is fragile, and a "double dip" (flat to declining economic conditions over the next several quarters) would not be unusual. Industrial production continues to recover but consumer spending is decelerating in spite of low interest rates. For the balance of this year, economic growth is likely to be modest, in the 1.0% - 2.0% range. Next year, however, growth should accelerate and average between 2.0% - 3.0%.

In this environment, corporate profits can expand but not nearly as robust as in prior recoveries when the rebound in the economy was more vigorous. Aside from changes in accounting definitions, Standard & Poor's profits are essentially unchanged this year but are expected to increase 7% - 10% in 2003. Thus, Standard & Poor's earnings may not recover to 2000 levels until 2004.

On this basis, the economic environment is only mildly supportive of higher stock prices.

Valuation The excess valuation that developed during the latter part of the 1990's has been reversed by virtue of the bear market. The price-earnings ratio for the Standard & Poor's Index, which exceeded 30 in 1999 and 2000, is now below 17 times projected earnings for this year, and below 16 times next year's. This level was normal for much of the decade of the 1990's. If adjustment is made for interest rates that are 25% - 50% lower than for much of the past

decade, stocks now appear undervalued. Thus valuation analysis suggests that the stock market has dropped to a level that presents a unique buying opportunity.

Investor Sentiment Investor sentiment is very poor. Accounting fraud and deceptive practices on the part of corporate management have shaken investor confidence. Companies that were once considered “core” portfolio holdings have collapsed in value and seriously impacted the financial well being of many investors. Those who were over-exposed to the technology and communications sectors have suffered far greater and may require many years to recover.

The trend in stock prices is also quite negative with a succession of short-term rallies failing to surpass their prior highs and successive sell-offs reaching new lows. With a 17% third quarter decline in the Standard & Poor’s Index, investor confidence of an early rebound has been shaken and the withdrawal of funds from mutual funds has been at an unprecedented pace.

Moreover, the prospect of war with Iraq has exacerbated investor apprehension further. Investors tend to sell stocks in advance of military action to reduce their risk. This was quite evident prior to Pearl Harbor, the Korean War, and between Iraq’s invasion of Kuwait and the initiation of Desert Storm.

However, stocks also have a tendency to rebound, and sometimes quite sharply, after such events. One year after the start of the Korean War, the Standard & Poor’s Index advanced 11% and rose more than 30% after the start of Desert Storm. Thus, Iraq’s impact on the market could be quite significant; yet, short-lived.

INVESTMENT STRATEGY

The last nine months have been particularly difficult. A year-to-date decline of 28% for the Standard & Poor’s Index far exceeds the 9% and 12% declines in 2000 and 2001. This persistent and accelerating decline reflects negative investor sentiment as investors contend with a fragile economic recovery.

It is in environments as this that investors develop an aversion to holding stock and become obsessed with near-term negatives while ignoring longer-term opportunities that become available with low valuations. This is characteristic of market troughs. While more time may be required before a rebound can take place, stocks are now at a level from which a substantial recovery is possible.

The strategy of this Firm has been to build cash reserves throughout the year as a hedge against declining stock prices. The cash raised was not, for the most part, deployed into bonds and real estate related investments. The risk in bonds is increasing as the prospect of war and an economic recovery could lead to higher yields (lower bond prices) in the future. Nor does real estate appear to be the answer. Inflated real estate values have also increased the risk in that sector. Over committing funds to those areas could be short sighted and disappointing in the years to come. Thus, the optimal strategy appears to be to “harbor” cash reserves and exercise patience for the time to reinvest in the stock market.

This process of reinvesting cash reserves should start gradually during the fourth quarter, in anticipation of improving economic conditions next year as well as subsiding concerns on accounting issues and management credibility. The pace of reinvesting should be adjusted to, and be a function of, 1) the degree to which evidence develops that the economic rebound is on track and not lapsing into a double-dip, and 2) either a subsiding of Iraqi tensions or progress on the military front.

Modest economic growth projected for next year will not create a “rising tide” in which all companies benefit. Instead, it will be an environment that discriminates between the stronger sectors that will be able to grow profits while others may not yet fare as well. Therefore, stock selection should focus on those sectors that are able to experience above-average growth. These include the financial, healthcare, industrial, and some retail sectors.

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

MARKET INDEX	12/31/01	9/30/02	Return
Standard & Poor’s 500	1,148	815	-28.2%
Dow Jones Average	10,022	7,701	-23.2%
NASDAQ	1,951	1,172	-39.9%
EAFE Index	1,155	920	-20.3%
3 Mth U.S. Treasury Bill	1.7%	1.5%	1.2%
10-Yr U.S. Treasury Bond	5.0%	3.6%	15.3%
10-Yr AAA. Tax-Exempt Bond	4.4%	3.3%	12.6%

*Estimate

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