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Investment Watch

4th Quarter, 2002

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"BAH HUMBUG"

While watching Charles Dickens' A Christmas Carol over this holiday season, a quotation from another of his timeless works eerily captured my own viewpoint about the past year-

"It was the best of times,
it was the worst of times,
…
it was the spring of hope,
it was the winter of despair,
…the period was so far like the present."

As Dickens asserts, the best and worst of times exist simultaneously throughout history. *True in 1775 and still true in 2003!* Also, it seems that the disparity between the best and worst is wider today than any time before. If you think I'm crazy because you can't remember ***anything*** good during the past year, give me a little time to explain! But first let's review what we all know were …

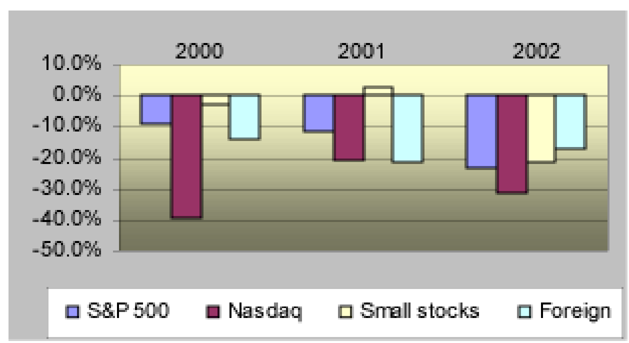
"the worst of times"

During most of the past year, it was easy to identify with Scrooge's vision that everything in the world was dreadful.

Geopolitical risks in our world appear to be worse than they have been in a long time. Al Qaeda's doctrine of international terrorism, the "axis of evil", and a potential war with Iraq were and will continue to be immeasurable threats that will dampen any recovery. It doesn't say a lot for world stability when Saddam Hussein makes 2002 People Magazine's Top 25 Most Intriguing People List.

At home, the accounting scandals of Enron, WorldCom, and Global Crossings, along with corporate malfeasance made us distrust not only the corporate executives, but also those charged with protecting our investments who sacrificed their independent judgment. They crippled investor confidence.

Is the stock market the worst of the worst? It's now a matter of the historical record. We have just ended the third consecutive losing year—with the latest one being the worst yet! This downturn will go down in the books as the third "worst of times" for stocks posting a cumulative loss of –39%.



What a way to start a new century! As shown in the graph, the carnage was widespread, not only in all of the U.S. markets, but the foreign markets as well. No wonder we feel like Scrooge. We only have 61¢ of each dollar invested left to count. Bah Humbug!

Although we may feel the economy should be categorized with the "worst of times"; as we discussed last quarter, the economy has not been bad. According to the Bureau of Economic Analysis, the economy grew by over

"BAH HUMBUG"
(cont'd)

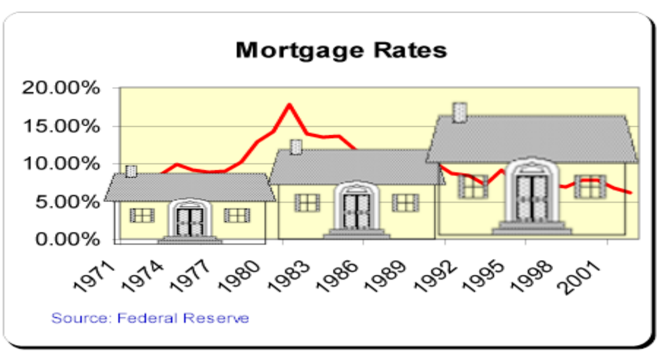
3% during the past year. This is the <u>same</u> average level of growth as the dynamic 90's! Yes, the stock market and the economy are **out of sync.** On one hand, unknown events could push us into the dreaded **double dip recession**, but on the other hand, the steady pulse of the economy may continue, which leads us to...

"the best of times"

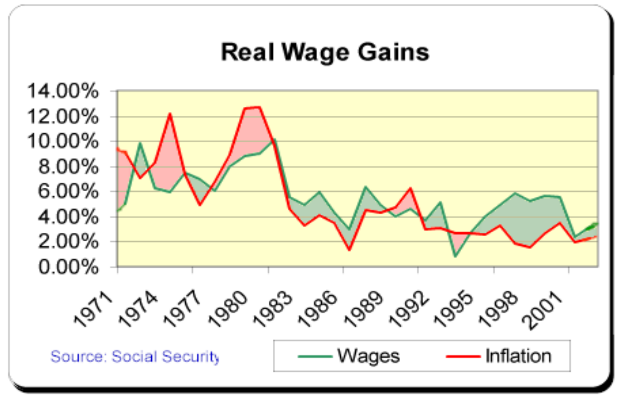
The most important aspect of our financial security is **future earning potential**. Greenspan has been saying that the dramatic increases in productivity gains have generated substantial household wealth. I've done the math and I'm here to say that he's right! We are (on average) **financially much better off today** than we realize.

Before you say "*Bah humbug*" and dismiss my reasoning as nonsense, let me explain. Remember the Ghost of Christmas Future worked miracles on Scrooge!

Even though our investments in the stock market have taken a beating, for the average worker, the largest part of our portfolio is our home. Home values have increased. Additionally, our costs to maintain this investment have decreased due to mortgage rates falling to a 40-year low. This has allowed many Americans to either refinance to lower their



payments or get more house for the money, increasing the value of their real estate investment and, therefore, their portfolio.
Low inflation, which fueled the fall in mortgage rates, also contributed to real wage gains not seen since the 1960's. Besides low inflation, Greenspan attributes these wage gains to a dramatic increase in productivity. Although the unemployment rate is at an eight year high, historically the current 6% rate is considered nearly full employment. Therefore, almost all Americans are working and in real dollar terms have more spendable income. This is hard to believe, but I'm an actuary not an Arthur Andersen accountant, so trust these numbers!



As shown in the graph, the average wages reported to the Social Security Administration outpaced inflation by about 2% for the years 1995-2002. The green shaded areas are net real wage gains and the red shaded areas are periods when inflation exceeds the average increase in wages.

For us older folks, looking back to the 70's during the Carter era, we knew the pain of high inflation and low wage growth. Remember the *Misery Index*? Today, low inflation and the increase in productivity over the last eight years have resulted in a significant increase in future earning potential with average real wage gains of 18%.

Are we just spending more and enjoying it less? I don't think so. Glance again at the graph on the left. It illustrates that the average new homes are getting larger and larger. The **American Dream** of a house and a two car garage is a reality for more of us today than any time in the past.

So even though these are ***"the worst of times"***, they are also ***"the best of times"***.

Keith Kowalczyk