

4th quarter of 2002

For three consecutive years the stock market declined.

Accounting scandals, jobless economic recovery, uneven corporate profitability, continuing worries about terrorist attacks at home and abroad, and geopolitical risks related to Iraq and North Korea are the factors behind the worst three year performance since the 1929-1932 period. Over the last three-year period, S&P 500 Index declined by 37.59% and NASDAQ Index by 67.16%. Stocks in almost all industries or sectors experienced major declines over the last three years.

As a portfolio manager and your investment advisor, I have been very disappointed with the market. I was anticipating a market correction in 1997 and was very skeptical about the hypes associated with the Internet madness. However, the following events all happened about the same time and were beyond my imagination; 1) the first global recession since 1973-1974, 2) burst of the Internet bubble and collapse of the telecommunication industry, 3) 9-11 and the collapse of the airline industry, 4) geopolitical crises one after another, 5) unprecedented accounting scandals and massive bankruptcies, 6) worries about Japan-style global deflations, 7) collapse of investor confidence in the stock market, and 8) extreme risk aversion of business executives. The cumulative impact of these events resulted in the worst stock market in over 70 years.

On the other hand, the most difficult stock market since 1929-1932 has prompted me to reexamine all my ideas about investment strategies and develop new methodologies for analyzing the stock market and individual companies. The following are some intensive studies and research I have done over the last few years:

- The Proper Valuation of Stocks Relative to Treasury Bonds.
- New Asset Class such as Convertible Bonds.
- T-ratio for Evaluating Stocks.

Let me elaborate a little more on the results and conclusions on these issues:

The Proper Valuation of Stocks Relative to Treasury Bonds:

Stocks and treasury bonds are competitors for investors' money. If the potential returns from bonds are higher than stocks, bonds are then undervalued and stocks overvalued. Sooner or later, investors will sell stocks and buy bonds. The returns from bonds are represented by their yield to maturity and potential returns from stocks are represented by earnings yield (earnings per share divided by price per share). As of yesterday, 30-year Treasury bond has a yield of about 5.0% while the earnings yield of S&P 500 is about 5.88%. If the earnings of corporations and interest rates do not change over the next twelve months, the stocks are undervalued relative to Treasury bonds by about 18%. The best independent and professional economic analysis service website www.economy.com estimates that the stocks are undervalued by about 37% based on the assumption that corporate earnings will increase by about 9% and interest rates will go up by about 1 percentage point over the next twelve months.

The most significant application of the knowledge whether stocks are overvalued or undervalued is to help determine which asset class (stocks versus bonds) are the best investments in the future. It also helps timing the purchase or sale of stocks.

New Asset Class such as Convertible Bonds:

I have been actively searching for investment classes that offer decent long-term returns while having far less volatility than stocks. The asset class I like is called "convertible bonds". Convertible bonds are issued by U.S. corporations and they pay fixed interest every six months until maturity. They are often priced at discounts relative to the principal so that there is potential for capital gains. When the stock of

the company, which is the issuer of the bond, stays low or even declines, the bond is protected by the income stream and return of the principal. If the stock price goes up enough, the bond can be converted into stocks according to a fixed ratio. In general, the convertible bonds pay about 7% interest now. The convertibles have about 70% of upward potential of stocks while having only 35% of downward potential of stocks. The worst case for convertible bonds only happens when the company goes bankrupt. Otherwise, they do well when either stocks or bonds do well.

Convertible bonds are particularly good for conservative investors and for retirement accounts of other investors.

I began to buy convertible bonds for my clients at the end of 2001. As of December 31, 2002, all these convertible bonds had an annual return of 5.15%.

T-Ratio for Evaluating Stocks

There are simply no methods to predict perfectly the returns of individual stocks because it is one of the fundamental laws in nature that we remember the past but cannot predict the future. That is the reason why diversification is the foundation for any successful long-term investment strategy. However, it is still important to estimate whether a particular stock is overvalued or undervalued, relative to other stocks and to bonds. I have devised a methodology that can assist me in answering the question whether a stock is properly valued. The methodology takes into consideration of the P/E ratio of a stock under consideration, the median P/E ratio of S&P 500 Index, the volatility of the stock (represented by beta), expected earnings growth ratio of S&P 500, and expected and historical growth rate of earnings of the company. All those numbers are put to a formula that results in a number called T-Ratio. The T-ratio has intuitive meanings and can be used to evaluate relative valuations of stocks. Although a vigorous back testing of the model has just started, the preliminary evaluation of the model over the last two years demonstrated its usefulness.