

## Quarterly Review and Outlook—October 2002

**DENVER  
INVESTMENT  
ADVISORS LLC**

**T**he summer of our discontent is how the third quarter of 2002 may be remembered by investors the world over. Equity returns were in a word, ugly. The S&P 500 was down 17.3%, matching the decline in the Dow Jones Industrials average of 17.4%. Not to be outdone, the Nasdaq Composite dropped 19.9%, while the small-cap Russell 2000 Index shed 21.4%. Looking abroad, things were even worse. The Dow Jones Euro Stoxx Index lost 29% of its value. U.S. stocks beat 19 of the 30 global markets, reminding us that despite headlines of corporate and accounting malfeasance, U.S. accounting is still relatively transparent compared to other developed nations.



We are well into our third year of a bear market that has shown stronger teeth than were imagined. Only in the Depression of 1929-32 did the S&P 500 endure four consecutive years of losses. We saw in the third quarter the 13th worst returns since 1924, and the worst quarter since the fourth quarter of 1987. How does this current bear market stack up against previous ones? The bear market of 1973-74 was 651 days long and tumbled 48.2%. As of October 9, we are approaching on 930 days and a 49.1% decline that has taken the S&P 500 from 1527.5 to 776.8.

Data on the economic front has done little to allay investor's fears. It would seem that growth has slowed, and falling equity prices have taken their toll on both consumers and businesses. Since the fall in stocks began in the spring of 2000, household ownership of equities has been cut nearly in half.

It is apparent that both the U.S. and global economies need a shot in the arm, and it may likely originate here in the United States. Additional monetary or fiscal stimulus are not out of the question, as the government is willing to use all of its available tools to ensure that the policy mix is right for the economy. Today's situation is unlike the 1929-32 bear market which was made worse by Fed tightening and other significant policy mistakes. Also, it appears that the general economy is performing better than general commentary, which is being colored by the plunge in the stock market. Profits, employment, and capital expenditures by business

## ***Strategy Statement Summary***

and government are all improving. Additionally, inflation and interest rates remain low and consumers continue to refinance mortgages reducing their payments and adding to their discretionary dollars.

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Another useful comparison might be the economic recovery that started in 1991. If the news about today's economy looks sluggish, one needs only to look back at the news of Q4 1991 (the third quarter of the economic recovery) to feel downright depressed. Bad news abounded about corporate profits, employment prospects, international growth, debt ratings, and the financial health of the country, not to mention the Gulf War. In hindsight, all the bad news was priced into the equity markets and then some. Just when it seemed like we were headed off the edge of the cliff, markets did a "U-turn" and proceeded to surprise investors on the upside with the S&P 500 gaining 26.3% that year.

With a background like that, it is understandably easy to fall into a malaise about the capital markets. However, looking at past bear markets reminds us once again that these unfavorable market conditions do indeed come to an end. What past bear markets do tell us is that when the turn does come, it tends to come quickly and decisively. It often leaves many investors sitting on the sidelines watching in disbelief as the losses are erased at a respectable clip. Returns in the first year after a bear market are typically well above average. 1933 saw the market climb 54%. In 1942 investors were comforted with a 20% gain and in 1975 the market surged 37.2%.

What typically follows a quarter as bad as the last one is a topic that we recently examined. Since World War II the market has never failed to be higher one, two, three, four, or eight quarters after a 15% or greater decline. The market has tended to reverse course with a vengeance after an extremely poor showing. Unless we are entering a period of sustained deflation and continued uncertainty around the world, patient investors will ultimately be rewarded with a market that turns when it is least expected.

A look at the fifteen worst quarters shows that unless the U.S. economy is headed into a prolonged deflationary period, history points to the fact that equity returns will most likely bounce back from the third quarter's results. Added to the mix is the fact that retail investors are cashing out of their equity mutual funds in record amounts (and purchasing bond funds at an equally astonishing rate). In the past, this type of action by the retail investor has been an important inflection point. The recent stampede away from equities and into bonds is occurring at a time that, in retrospect, could prove to be a bad time for selling stocks and buying bonds.

### Worst Quarters For S&P 500

#### Subsequent Performance

<u>Date</u>	<u>Rank</u>	<u>%Change</u>	<u>1Q</u>	<u>2Q</u>	<u>3Q</u>	<u>4Q</u>	<u>8Q</u>
12/31/29	3	-22.88	17.20	-4.62	-13.33	-28.48	-62.14
06/30/30	11	-18.62	-9.14	-25.02	-18.43	-27.52	-78.35
12/31/30	14	-17.48	8.80	-3.32	-36.70	-47.07	-55.08
09/30/31	2	-34.52	-16.37	-24.72	-54.38	-16.79	1.24
12/31/31	16	-16.37	-9.98	-45.44	-0.49	-15.15	24.38
06/30/32	1	-39.4	82.39	55.53	32.05	146.28	121.44
03/31/33	17	-15.09	86.50	68.03	72.65	83.76	44.79
12/31/37	5	-23.33	-19.43	9.57	16.02	25.21	18.39
03/31/38	8	-19.43	36.00	44.00	55.41	29.18	44.12
03/31/39	15	-16.88	-1.09	18.58	13.75	11.57	-9.29
06/30/40	12	-18.53	6.81	6.01	-0.20	-1.30	-16.83
09/30/46	10	-18.83	2.27	1.40	1.67	1.00	3.54
06/30/62	7	-21.28	2.78	15.25	21.59	26.70	49.21
06/30/70	9	-18.87	15.80	26.72	37.94	37.10	47.33
09/30/74	4	-26.12	7.90	31.19	49.81	32.00	65.63
12/31/87	6	-23.23	4.78	10.69	10.05	12.40	43.03
09/30/02	13	-17.63	?	?	?	?	?
<b>Total*</b>							
<b>Mean</b>		<b>-22.30</b>	<b>13.45</b>	<b>11.49</b>	<b>11.71</b>	<b>16.81</b>	<b>15.09</b>
<b>Median</b>		<b>-19.15</b>	<b>5.80</b>	<b>10.13</b>	<b>11.90</b>	<b>11.99</b>	<b>21.39</b>
<b>Standard deviation</b>		<b>6.84</b>	<b>30.84</b>	<b>29.86</b>	<b>33.60</b>	<b>46.96</b>	<b>51.79</b>
<b>Post WW II*</b>							
<b>Mean</b>		<b>-21.67</b>	<b>6.71</b>	<b>17.05</b>	<b>24.21</b>	<b>21.84</b>	<b>41.75</b>
<b>Median</b>		<b>-21.28</b>	<b>4.78</b>	<b>15.25</b>	<b>21.59</b>	<b>26.70</b>	<b>47.33</b>
<b>Standard deviation</b>		<b>3.09</b>	<b>5.54</b>	<b>12.06</b>	<b>19.74</b>	<b>14.86</b>	<b>23.01</b>

\*Excludes 09/30/02

Note: All returns are price only

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when least expected to do so...*

What is the market looking for at this point? We see a number of potential catalysts that include the following:

- Tangible proof of solid economic growth
- Some resolution of the Iraq situation either through conflict or diplomacy
- Oil below \$25 per barrel
- Tax cuts aimed at investors, especially those eliminating the double taxation of dividends
- Further Fed easing
- Better-than-expected earnings growth

While this "wish list" is by no means exhaustive, it represents areas to watch for improvement.

### **Conclusion**

With these in mind, our asset allocation recommendation remains 65% equity, 35% bonds. As we previously stated, "The recent decline in stock prices has reduced our effective exposure, and we are not in a hurry to push the ratio back up." The same could be said this quarter as we watch for signs of improvement, all the while keeping in mind that the markets usually turn when least expected to do so.

### **Brief Review of Economic Scenarios—**

#### **A Description of the Possible Economic Outcomes Used in Our Asset Allocation Model**

**Weak Recovery**—In this scenario, global over-capacity, especially in technology and telecom, limits the amount of capital spending companies are willing to budget. A somewhat extended consumer, having become relatively leveraged during boom times, finally retrenches as the home mortgage refinance cycle comes to an end. Limited consumer spending and capital expenditures by companies puts a cap on employment growth. Stock returns are average and bond returns are below average.

**Failed Recovery**—Further declines in capital spending are due to a fiscal paralysis that feeds on itself. Corporate governance issues and accounting scandals continue to be uncovered. Final demand fails to grow, causing increasing unemployment as companies cut back on costs. Consumers are reticent to spend due to stagnant wage growth and an uncertain job market. Savings rates increase, and consumers use available discretionary cash to deleverage their balance sheets. Stock returns are slightly negative and are eclipsed by robust bond returns.

**Strong Recovery**—Capital spending increases as corporate profits turn up. The perceived excess capacity in technology and telecom turn out to be transient as the business cycle turns upward. A synchronized

global recovery fuels increasing final demand for goods and services. Under-capacity in the old economy shows up in new spending on fixed plant and equipment which turns into a replacement cycle further increasing demand. Wage increases and a robust job market spur consumers to continue to spend. Stock returns progressively get better as the recovery continues. Bond returns are poor.

**External Shock**—Here we acknowledge that there are risks to the financial markets that are not related to the business cycle and interest rates. Possible events include additional terrorist threats to the U.S., escalation of instability in the Middle East and interruption in world oil supplies. Stock returns are below average over the three-year period while bond returns are average.

## Capital Market Impact

The following table summarizes the capital market impacts under these scenarios:

### THREE-YEAR IMPACT

Scenario	Earnings	Interest Rates	Price/Earnings Ratios	Stock Return	Bond Return	Cash Equivalent Return
Weak Recovery	Up Modestly	Up Modestly	Flat	Average	Below Average	Average
Strong Recovery	Up Strongly	Up Significantly	Up Slightly	Above Average	Poor	Above Average
Failed Recovery	Flat	Down Notably	Down Modestly	Poor	Above Average	Average
External Shock	Down Moderately	Down Somewhat	Down Significantly	Poor	Average	Average

Scenario	Current Quarter Probabilities	Previous Quarter Probabilities
Weak Recovery	50%	50%
Strong Recovery	40%	40%
Failed Recovery	5%	5%
External Shock	5%	5%

## Notes on Quantitative Work

### CAPITAL MARKET AND ECONOMIC INDICATORS

Indicator	September 30, 2002	June 28, 2002
S&P 500	\$815.28	\$989.82
P/E Based on Latest 12 Months' Operating Earnings	17.6x	22.1x
Dividend Yield	1.9%	1.6%
Long Treasury Bond Yield to Maturity	5.0%	5.5%
90-Day Treasury Bill Yield	1.7%	1.9%

Based on the foregoing probabilities for our scenarios, the following expected returns for the four asset classes we monitor are used to arrive at recommended asset mixes:

<b>Asset Class</b>	<b>Current Quarter Expected Return Through Third Quarter 2005</b>	<b>Previous Quarter Expected Return Through Second Quarter 2005</b>
Stocks	12.4%	11.1%
Long Bonds	0.6%	3.1%
Intermediate Bonds	1.3%	2.4%
T-Bills	3.1%	3.9%

Based on these expectations and our typical account objectives, our current recommended asset mix is 65% stocks, 35% bonds and 0% cash equivalents.

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