ROOF ADVISORY GROUP, INC.™
INVESTMENT ADVISORY & FINANCIAL PLANNING SERVICES

INVESTMENT UPDATE

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Economic Conditions & Market Outlook

We have noted many times before that investment markets have always been driven by a combination of economic and psychological forces. During the past nine months, the interplay between these factors has created a head-spinning array of market conditions, leaving many investors dazed and confused. The most visible influence during the later part of this period has been the Iraqi confrontation.

As tensions related to the impending conflict with Iraq continued to grow in the months prior to war, market analysts placed more and more emphasis on the stagnating psychological effect this uncertainty was having on both the U.S. economy and stock market. Though it became clear there would not be any meaningful improvement in either while the country was engaged in war, some observers mistakenly assumed this international turmoil was the primary impediment to U.S. economic health and prosperity.

Consequently, a number of Wall Street prognosticators suggested there would be a stock market surge, similar to post-Desert Storm 1991, if Saddam and his regime were disposed of with relative speed and efficiency. To the chagrin of these pundits, there has not been a significant and sustainable post-war bounce in the market despite the swift and decisive military victory.

This is really not a surprise for two different reasons. First, any parallel drawn between the present market and the conditions in 1991 is a stretch. For example, the S & P 500 price/earnings (P/E) ratio currently hovers around 30 versus a level of 15.5 in 1991. Not only were stocks more attractively priced at that time, they were also returning more via dividends; with the S & P 500 yielding an average of 3.75% versus the current rate of 1.91%±. Likewise, despite the market downturn of the past several years, the percentage of average U.S. family net worth invested in stocks is almost twice the percentage it was twelve years ago. For these and other reasons, the market circumstances then and now are entirely different, providing no historic justification for a rush into equities just because the fighting has ended.

Second, and more importantly, resolving the military conflict in Iraq has not clarified the fundamental uncertainty currently facing the U.S. markets. War or no war, the underlying U.S. economy remains soft with an unpredictable path ahead for the remainder of 2003.

As an illustration, consumer spending typically accounts for the majority of U.S. economic activity but it has been the sole sustaining force of the U.S. economy for the past several years, with corporate spending being downright miserly as businesses reduced excess capacity. Most economists don't expect a dramatic pick-up in corporate spending until at least the third quarter of 2003, leaving the U.S. consumer once again carrying the ball. Whether this is enough to sustain the current rate of modest economic growth is an unanswered question.

While John and Jane Q. Public's spending is influenced by many factors, perhaps none is more important than consumer confidence. Has the resolution of war tensions helped the consumer's sense of optimism? Certainly. But this positive has been offset by other negatives, such as increasing unemployment that recently reached a twelve-month high. A major contributor to consumer spending has also been cash flow from home refinancings, but this can't continue indefinitely. Interest rates will only go so low and the 'equity' needed for home equity loans will eventually be leveraged out.

On the corporate side, some spending may have been delayed due to geopolitical uncertainties however, we are not a proponent of theory that there will be a surge of post-war corporate spending due to pent-up demand. Unlike consumers, most companies don't spend because they want to. They spend because they suspect their spending will ultimately result in either increased growth or profits. Given the contraction many firms have recently gone through, we don't suspect a dramatic loosening of corporate purse strings until there are consistent indicators of demand for their goods and services.

From a market perspective, recent quarterly reports of corporate earnings are providing some upbeat positive surprises that should be viewed in context. Companies have painfully learned the consequences of not meeting earnings projections and have lowered the bar accordingly. Likewise, much of the earnings improvement has come as a result of expense reduction, such as the layoffs mentioned previously. A better positive indicator will be when top-end demand, i.e. sales and spending, shows consistent improvement on a quarterly basis.

Our Stance

In the meantime, we suggest a patient posture that focuses on fundamentals and casts a suspicious eye toward any Wall Street exhortations that the train may be leaving the station. For example, eBay shares recently were trading at 80 times 2003's projected earnings, a P/E ratio that must have even the most reformed daytrader pining for the good ole'days. Despite a Wall Street Journal estimate that 38% of the entire U.S. adult population would have to be active eBay users to justify such lofty projections, 12 of the 15 brokerage firm analysts tracking eBay in First Call recommended it as a 'buy' or better. Hmmmmm, will they ever learn?

Does this mean we have a dour attitude toward all equities? Absolutely not. The relative risk versus potential return of selective equities looks quite favorable when compared to fixed income alternatives. We continue to add high quality equity holdings as appropriate. Specifically, stocks of companies in credible businesses with solid management, consistent earnings, and low relative debt can be potentially be attractive. Additionally, we prefer a P/E ratio of 15 or below, a dividend yield exceeding 2%, and price appreciation potential of 10%.

Roof Advisory Group's disciplined approach focuses on strategies designed to add value to client portfolios while controlling downside risk. These strategies include clearly defined investment policy ranges based on each client's personal investment objectives/risk tolerance, ongoing evaluation of relative portfolio return, and strictly monitoring portfolio adherence to benchmark parameters.

Each client situation is unique, but outlined below are a few of the general tactics currently being applied:

- For the majority of our clientele, we are at the 'minimum' equity allocation as defined by their investment policy. We have been at the low end of most clients' equity allocation since yearend 2000, with brief dip *below* minimum from March to September 2001. This low-end stock exposure has helped preserve portfolio value in the dramatically declining market of the past several years. We currently are capitalizing on attractive equity buying opportunities when presented and will shift from our 'minimum' position as overall economic conditions show *sustainable* improvement and market fundamentals solidify. This shift could possibly begin within the next three to six months but, as always, will be incremental and disciplined.

- Diversification has been, and always will be, a priority in our management approach. Equities are diversified based on industry group and business sector. This has prevented clientele from being overexposed in the areas most impacted by the bear market's decline, i.e. technology and telecom. Likewise, fixed income assets are diversified by issuer, industry and, in the case of municipal bonds, geographic region.

- From an equity 'style' perspective, we continue to weight a portfolio's balance toward *value* while maintaining some *growth* exposure. As outlined previously, individual stocks of companies with strong bottom-line fundamentals, attractive valuations, and consistent dividend yields have been used in appropriately sized equity portfolios. These are often blended with managed funds that are complementary to the portfolio's objectives and enhance diversification.

- Individual bonds are used for larger fixed income portfolios to control risk. Short to mid term maturity investment-grade bonds are emphasized, though reduced yields have pushed some bond maturities slightly longer. The maximum average maturity for a laddered fixed income portfolio remains around 7-9 years. Overall bond quality is not sacrificed for yield. A client's tax bracket/account type determines whether taxable or tax-free bonds are more advantageous.

- At present, our bias towards larger cap stocks with strong balance sheets remains intact. Mid/small cap equity exposure is currently minimized within policy standards. Any specific international equity exposure has been, and will continue to remain, incidental.

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