CORE Comments
ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

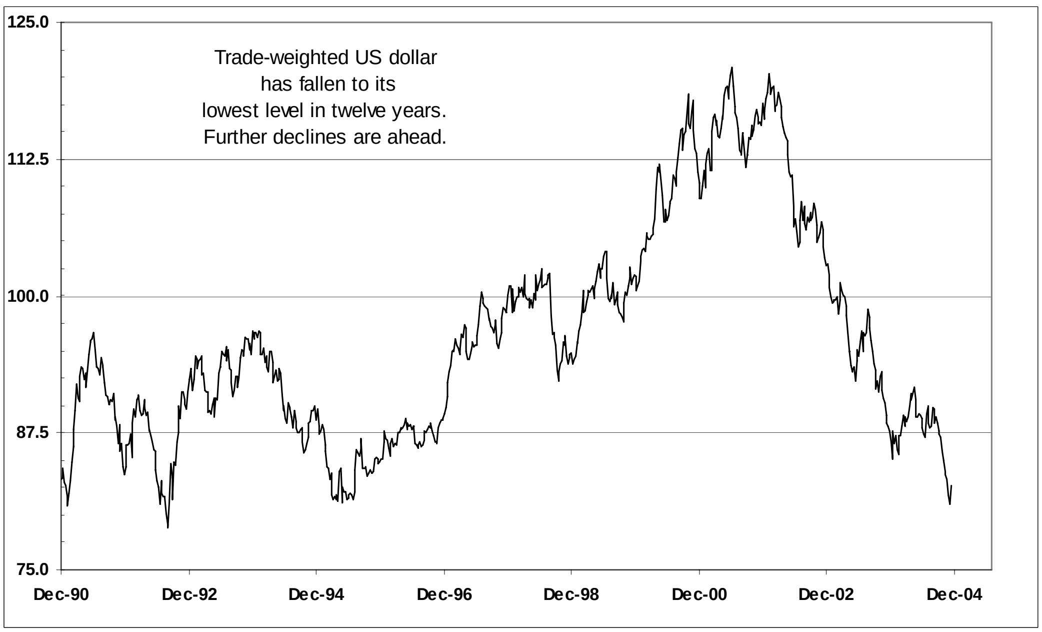
December 11, 2004

# Strong Portfolio Gains as the Year's End Approaches

*Healthy portfolio gains continue.*
*Declines in the value of the dollar are not over.*

This year is ending with fine gains in your portfolios. The last three months have been very productive for most of the assets in which we invest. The accelerating decline in the value of the dollar has dramatically increased the value of our foreign bond investments. The stock market, which was weak until the latter part of August, has come alive and contributed to our gains. Our investments in REITs and utilities stocks have been unusually strong. The result is gains in most portfolios of more than 5 percent since the end of September and of 12 percent or more since the beginning of the year.

**Sharp declines in the dollar.** Because we have had large investments in assets that gain in value as the dollar falls, the recent rapid decline in the dollar has been a boon to our portfolios. I wrote last month on the day after the presidential election that, because of fiscal policies favored by the Bush administration, the dollar was very likely to decline further.




Since election day, the value of the dollar (on a trade-weighted basis) has fallen by 3 percent; the euro has appreciated by somewhat more. It appears now that the dollar is likely to be markedly lower in a year or two years than it is today. Considered purely as an investment matter, the strong probability of dollar depreciation is a good thing: we can continue to invest in assets that appreciate in value as the dollar declines and we can expect to earn good returns from those investments.

***By:***

***John N. Mayberry***

**Financial imbalances and risk to investors.** However, from a broader perspective, the likelihood that the dollar will continue its decline is unwelcome. As I have written before, the enormous imbalance between what America spends and what it saves is at the heart of the dollar's problem. America exports far less than it imports from abroad, so much so that our current account deficit is about $600 billion, or 6% of America's GDP. Because America's net saving, by government, individuals, and businesses, is extremely low, foreign savings fund America's deficit. At present levels, the United States absorbs three quarters of the world's savings and investment. As the dollar declines in value, those dollar-denominated savings lose their value, making further foreign investment less attractive.

*America's current account deficit, already enormous will increase further. Financial imbalances may lead to financial crisis and recession.*

America's current account deficit is almost certain to grow for the foreseeable future. The Bush Administration's plans for further tax cuts, for more borrowing by the Federal Government, and for changes to Social Security will widen the deficit. There is little likelihood that our exports will increase by more than our imports grow; hence the trade deficit will widen further. To continue to attract the needed foreign investment to fund the huge and growing deficits, a combination of higher US interest rates and a lower exchange rate for the dollar will be necessary. Higher interest rates in the US and higher costs for imported goods may well cause spending to slow, increasing the risk of economic recession. A number of thoughtful observers believe that these enormous financial imbalances present the risk--in future years--of a serious and destabilizing financial crisis.

Such a crisis is not at hand now: China and Japan have important interests in continuing to buy US securities with the dollar surpluses they accumulate. For now, US deficits are being funded without causing severe financial strains to the system. However, as these financial imbalances grow, investors must be vigilant to watch for systemic strains and must consider defensive action to protect investment portfolios.

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**Investments for now and investments for a financial crisis.** I conclude that we can still make investments of the types that have served us well: We can emphasize the relatively inexpensive investments, like foreign bonds, physical commodities and undervalued sectors of the stock market. I continue to see value in energy-related stocks and I am considering investments in pharmaceuticals as Merck, Pfizer and Lilly have fallen to attractive levels. As certain investment assets we own become more expensive--REITs and utility stocks are two examples--we can cut those positions or restrain new investments in those areas. So, for now, while financial imbalances do not seem unduly to strain the systems, we can still expect to earn reasonable returns from our highly diversified portfolios.

In future years, as financial imbalances worsen and the dollar's decline accelerates, it may be necessary to cut investments in stocks and other economically sensitive assets and to concentrate investments in foreign bonds and non-dollar money market securities. As I analyze the situation now, foreign currency money funds are likely to be safe and to offer a good way to preserve the value of your investment capital in a crisis. I will be alert to warning signals and prepared to act.

* * * *

**An expression of gratitude.** It is an enormous privilege to be entrusted with your investment capital and to be given the opportunity to work with you. I am very grateful every day to have this wonderful job, with its stimulating intellectual challenges and the rich and satisfying personal relationships with you.

I thank each of you sincerely and wish you the best for the holidays and the new year.

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CORE Comments
ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

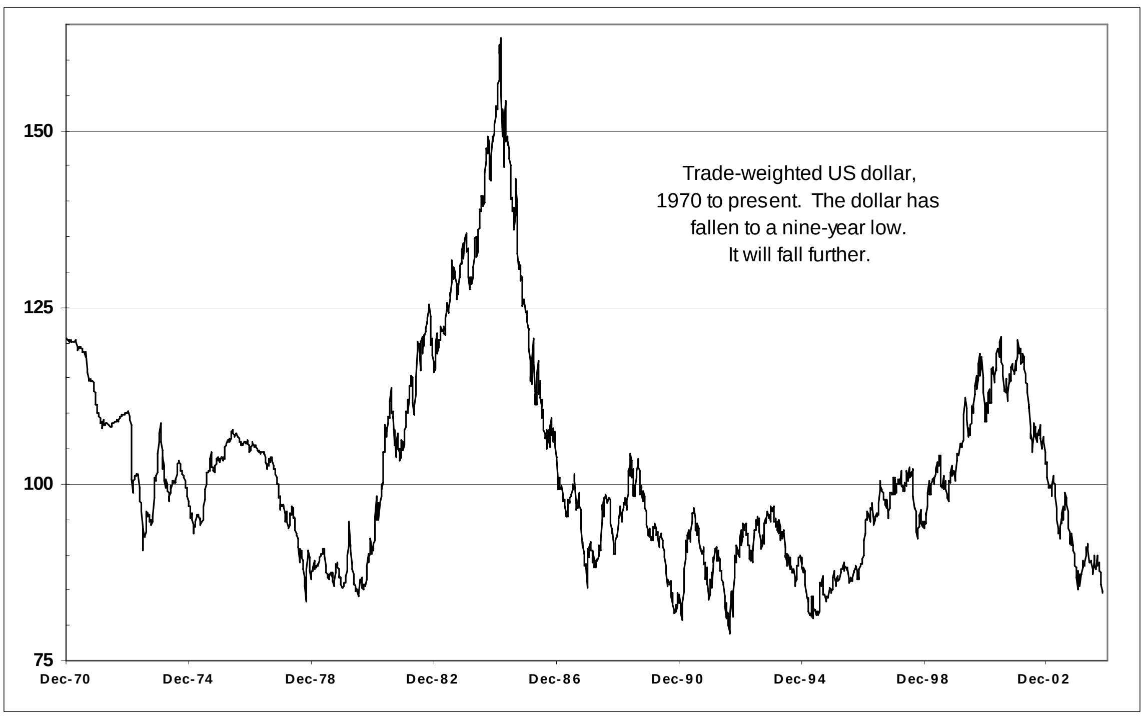
November 4, 2004

# Investments in the Second Bush Administration

*October was a strong month for our investments. In Bush's second term, some investments are likely to perform very well.*

The election has been decided, much more quickly than expected. I write to consider the investment consequences that flow from Bush's re-election.

**The dollar's value will decline further.** The fiscal policy of the first Bush administration was remarkable. The combination of enormous tax cuts and big increases in spending by the federal government had the predictable effect: a large and growing federal budget deficit. Tax revenues are about $100 billion dollars less in this fiscal year than in Bush's first; spending is about $400 billion more. The deficit contributes significantly to America's weakening current account balance with the rest of the world. Unless fiscal policy changes dramatically in a second Bush administration, it seems likely that America's budget and current account deficits will grow.




To fund America's current account deficit, now running at the rate of just less than $600 billion per year, the United States must attract about $2 billion of foreign capital each business day. In the long run, this may only be accomplished if the dollar's value declines sufficiently to induce foreign investors to buy US assets and US securities. Since early in 2002, as the US deficit began to grow rapidly, the value of the dollar has lost 30% of its value as measured against a basket of major foreign currencies. It is <u>very</u> likely to fall further during the second Bush administration. Hence, as an investment matter, we can expect that our investments in foreign bonds, which are denominated in euros, yen, British pounds, and other currencies, will continue to appreciate in value. These have been successful investments for us since we first made them in 2002; it appears likely that they will be good investments in the period ahead.

***By:***

***John N. Mayberry***

*Along with the falling dollar, interest rates will rise. Energy-related investments look favorable.*

**Inflation and demand for oil and other commodities.** Oil prices have risen dramatically during the first Bush administration, especially in the last year. Increasing demand for oil and other industrial and agricultural commodities has driven up their prices. The factors are many: the enormous growth of China's economy and oil-friendly policies by the Bush administration are two. It is a reasonable assumption that, with usual market-based cyclical swings, demand will remain strong and prices will rise further. Our so-far successful investments in physical commodities and energy-related stocks still look promising. Higher prices for these assets are more likely with Bush's win.

**Interest rates, inflation and bonds.** Higher interest rates on US bonds look likely. Inflation, should it increase, will lower bond prices and raise yields. Indeed, interest rates will need to rise in order to make US bonds attractive to foreign investors. So far, inflation has remained rather low and bonds have continued to trade at high prices and low yields. The Fed's policy and general economic weakness in the United States have contributed to low inflation and low interest rates. Although we cannot be certain when rates will rise, we should keep US bond positions rather small.

**The stock market.** Bush's policies generally favored the stock market in his first term. The substantial cut in taxes on dividends is one example. Probably stock market-friendly policies will be a feature of the second term, as well. The administration has made plain its desire to cut or eliminate taxes on income from investments. Large cuts in corporate taxes in the first term may well be followed by even more. Considered simply from the point of view of likely government policy, the re-election of Bush must be considered a plus for US stocks.

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Core's investments in stocks for clients has been rather small for a time. Despite favorable policies from the administration, the financial imbalances that arise from our large and growing deficits pose a threat to stocks. And, because most sectors of the stock market already trade at high prices in relation to corporate profits, it seems risky to me to add significantly to your present investments in stocks.

**Real estate investments.** REITs have been very strong again. Second-term policies affecting commercial real estate will probably be neutral or somewhat favorable. The very strong performance of REITs in the last two years almost certainly has to do, in part, with their being seen as a substitute investment for low-yielding bonds. Because of this, REITs are now highly correlated with interest rate movements. This suggests that REITs are vulnerable as interest rates rise.

**Review of October performance.** Market action in the last several weeks may have been forecasting Bush's victory. The dollar was quite weak, commodities rose in price, and stocks and REITs were strong. Your portfolios earned good returns in October; most accounts gained two percent or more. The most conservatively invested accounts rose by about one percent. The "non-traditional" investments we make for you, including in foreign bonds, REITs, and commodities, have been very favorable this year, when the US stock and US bond markets have struggled. The broad range of investments reduces risk to your capital.

We will continue to balance Core portfolios with these investments and to favor those assets, like foreign bonds, that offer better values and more promise in Bush's second administration.

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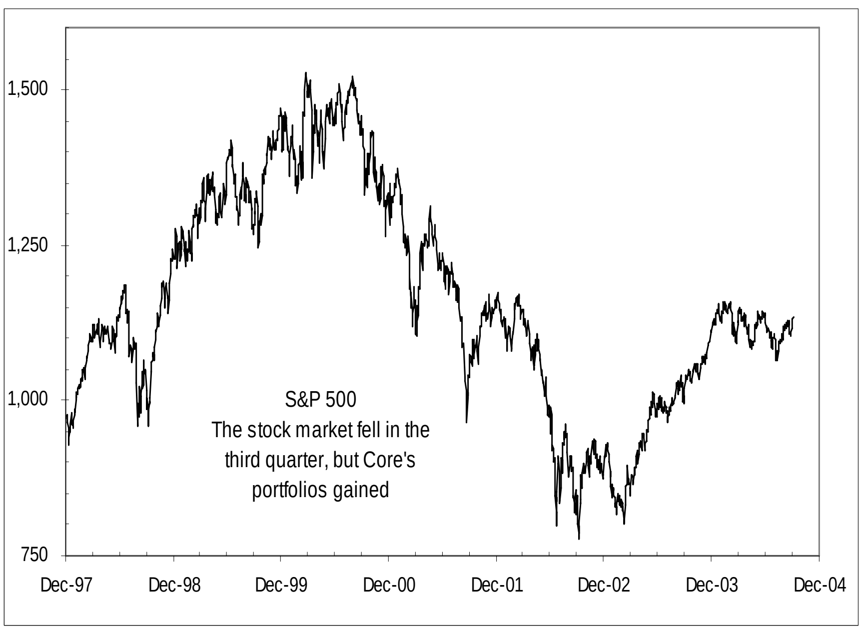
CORE Comments
ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

October 6, 2004

## Core's Portfolios Gain . . .
## . . . While the Stock Market Falls

*Although stocks were weak in the last three months, other assets in which we invest gained in value.*

The third quarter of 2004 was a poor one for the stock market. The S&P 500 fell by 2.3%; the Dow by 3.4%, and the Nasdaq by 7.4%. Happily, the other investments in Core's portfolios rose over the period, and client accounts gained, generally from 2% to 5%. Core's strong investments were in REITs (commercial real estate and timberlands), foreign bonds, and physical commodities (including crude oil). These "alternative" investments that Core has been making for you for several years are contributing to your portfolio as intended: They are providing positive returns and they are lowering overall portfolio risk, by diversifying away from the traditional stock and bond investments. Without these investments, your portfolios would, most likely, have shown a small loss in the period; instead, your portfolios earned a healthy return. Let us review the different investments in turn.




**Commodity investments.** Recall that in January of this year, we made an investment in a mutual fund of the Pimco group, Pimco Commodity Real Return fund. This fund provides investment in a basket of physical commodities, including grains, metals, petroleum products, industrial and precious metals, and other agricultural products. (There is no leverage in this investment. Thus, if you hold $20,000 of this fund, you own, indirectly, $20,000 of these commodities.) The investment reason for this investment is two-fold: First, it benefits from growing world-wide demand for oil and industrial commodities, especially from China. Second, it benefits from the long-term decline in the value of the US dollar, because these commodities are priced in dollars. As you know, there has been an enormous increase in the price of crude oil this year, from about $30 per barrel to $50 now. This investment has been quite strong in the last month, but I think it likely that commodity prices will be higher a year from now than they are today. Hence, I think we will earn more from this investment.

***By:***

***John N. Mayberry***

**Foreign bonds.** The US dollar fell continuously through 2002 and 2003. This year it has bounced up and down in value against major foreign currencies but with essentially no change all year. Our investment in foreign bonds denominated in currencies other than the dollar gained about 4% in the third quarter, but is little changed on the year as a whole. Because of the huge deficit the United States has with the rest of the world, it is very likely that the dollar will decline in value in the coming years. As the dollar's value declines, the value of our investment in foreign bonds rises.


**Real Estate.** Since 2002, we have invested in commercial real estate (as opposed to owner-occupied houses) and in timberlands via Real Estate Investment Trusts ("REITs"). These have been very good investments, earning an annual dividend around 6%, and increasing in value by another 10% or more. In the recent three months, these investments gained around 5%. It is unrealistic to expect REITs to perform as well in the next two years as they have in the last two years, because the price of the REITs has risen faster than the value of the underlying real estate. However, in my judgment, we should hold these investments and expect at least to earn the still-healthy dividend.

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**The Stock Market.** Indecisive trading has characterized the stock market all year. There has been no sustained rise or fall in prices, reflecting the uncertain valuations for the market. Although growth in corporate profits has been very strong, prospects for growth in the next year are less attractive. The market appears still to be somewhat overvalued, although sectors of it, notably oil and energy-related stocks still have good prospects. I plan to continue my cautious approach to investing in stocks.

**US bonds.** The bond market has been very interesting in recent months. Oil prices have risen sharply. The Fed has been raising short-term rates from historically low levels. Economic growth, while not unrestrained, has been steady. Many--myself included--have thought that these conditions would cause bond prices to fall this year and yields to rise. Confounding us, the bond market recently rallied and yields on the benchmark ten-year treasury bond fell below 4% again. This may reflect the view that economic growth will be rather weak in the next six months. It may also reflect buying of US treasuries by foreigners. The Japanese and Chinese central banks have been big buyers of US bonds for the last year and more. These countries have huge trade surpluses with the United States and their buying of treasuries "recycles" their dollars and keeps their own currencies from appreciating too much against the dollar. Additional large scale buying may be coming from OPEC countries, which are earning enormous sums on their sales of oil to the US and Europe. If these are the factors in the strength in US bonds, they also explain the relative stability of the US dollar this year: although the United States has a $500 billion deficit with the rest of the world, the dollar can hold its value if foreign banks and companies keep buying US dollar assets.

**A new face at Core.** Robert DeBaldo, a recent law school graduate with securities industry experience, has joined Core. Rob works with me on a wide range of investment and client matters.


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CORE Comments
ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

July 28, 2004

## Quiet Markets

*Volatility in stock and bond markets is very low.*

*Sleepy markets are drifting lower.*

Apart from an intense wave of selling in the six weeks from April 1, US stock and bond markets have had an unusually calm year. As July ends, the stock market is drifting lower. The S&P 500 has declined by about 3 percent since the end of 2003. The bond market is roughly unchanged on the year. Recent economic reports, suggesting slower growth, are a drag on the market. Job growth and retail sales have been weaker than thought, upsetting a widespread belief that economic growth would remain strong all year.

On June 30, the Federal Reserve Board began its widely-anticipated increase in the fed funds rates and it is likely that rate hikes will continue perhaps for a year or two. Because of the somewhat weak economic reports, long-term interest rates have fallen recently, but probably those rates will rise over the next year, as well.

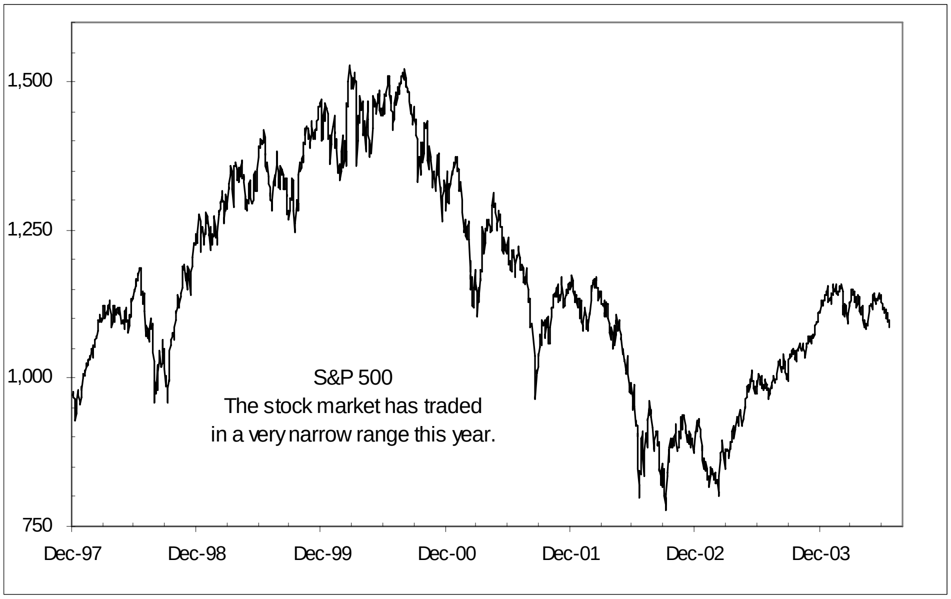

**The US dollar and foreign bonds.** Beginning in January, the dollar had a four-month rally that extended to mid-May. This appears to have been a brief interruption in the dollar's long-term bear market, now in its third year. At this writing, foreign currencies have resumed their gains against the dollar and it remains quite likely that the dollar will lose value over the next twelve months. The nearby chart shows the changes in value of the dollar since the early nineties.

Recent reports of flows of capital into and out of the United States suggest that the dollar will probably fall a fair amount further in the next one to three years. Recall that the United States has huge deficit in trade with the rest of the world, and requires an enormous flow of foreign capital into US assets to balance this deficit. In the last year, the trade deficit has been $572 billion, more than 5% of America's GDP. In May, the net inflow of foreign capital to US assets was $56 billion, sharply lower than earlier levels. Foreign investors withdrew $13.4 billion from US equity investments in May, continuing a recent trend of disinvestment. The slow down in the flows of foreign capital into US assets suggests that the US dollar will have to fall significantly in value in order to finance our very large deficit with the rest of the world.


***By:***

***John N. Mayberry***

As you know, we have held large investments in foreign bonds for you over the last two years. The bonds are denominated in foreign currencies and their values rise as the dollar falls. During the dollar's four-month rally early this year, the value of our foreign bond investments fell, but this investment is gaining again with the dollar's renewed decline. My expectation is that the dollar will fall to its levels of the early 1990s or even lower over the next twelve to twenty four months. This continues to be a low-risk, productive investment for you.




**Foreign investment and US stocks.** The US stock market has traded in an unusually narrow range this year; in recent weeks it has fallen slightly and stands slightly in the red since the year began. Strong growth in corporate profits, a reasonably robust economy, and the promise by the Fed that interest rates will rise slowly from the historically low levels that now prevail have all encouraged stock investors. Against these positives is the realization that stock prices are high and that any number of factors could drag prices down. Risk of terrorism, concerns about the outcome of our presidential election, and the unwillingness of foreign investors to keep buying US securities all weigh upon stock prices and threaten to kick them lower. Just as the US bond market has been sustained by enormous Japanese purchases of US Treasury securities, of which I wrote a few months ago, so the US stock market needs capital from foreign investors to maintain its strength. That flow of capital is uncertain, at least until the dollar falls to more attractive levels.

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**The presidential election and the markets.** I write as the Democratic convention unfolds. How might the November election affect the markets? Is commonplace to assert that the markets prefer Republicans, but the reality is that markets have done well and poorly over time without respect to the party affiliation of the president. The Democrats are busy this week reminding all who will listen how well the economy and the markets did while Clinton was president.

This election presents a novel risk to the financial markets, one that few foresaw before 2000: that is, the risk of a disputed result to the election. Although half of the voters were unhappy with the outcome in 2000, there was widespread acceptance of the legitimacy of Bush as president. If this year's election is very close and if there are one or more instances of Florida-like results, I fear that a very large number of people will not accept the legitimacy of the result. Should that occur, confidence in the durability and vitality of democracy in the United States will suffer. That outcome would likely have a very serious and damaging effect on financial markets. No small part of America's economic and financial success has arisen from the essential fairness and strength of our democratic and constitutional institutions. A disputed win by one's candidate might be a far worse outcome than a clear victory by the candidate one opposes. Let us hope for a fair election with a settled and widely accepted outcome.


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CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

June 22, 2004

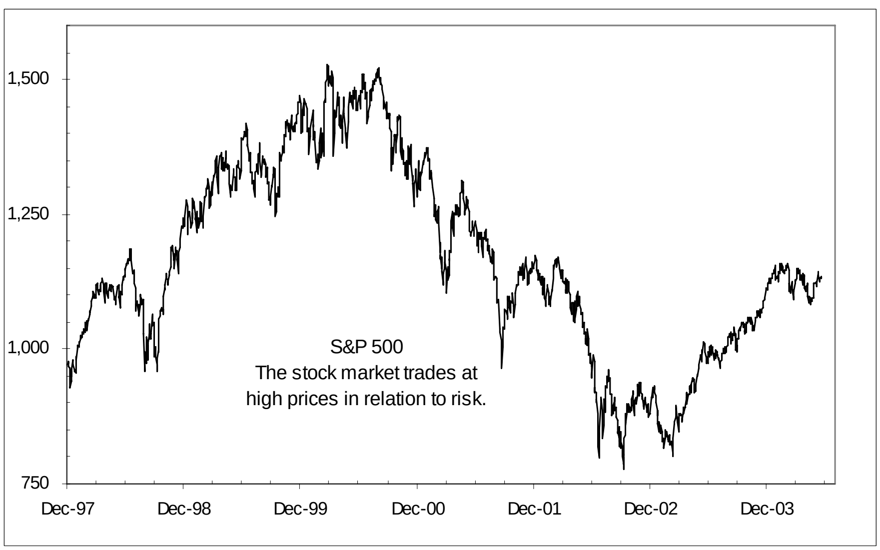
## Dharma Combat

*Notes from an investment committee meeting.*

*How much risk premium do we need?*

Last Thursday, I spent five hours at the quarterly Asset Allocation meeting for an investment group on whose investment committee I sit. The firm is several retired women partners from Goldman Sachs and the head of an Italian family with industrial interests in Europe, Brazil, and the US.

In the quarterly Asset Allocation meeting, the group tries to hammer out a consensus about how the investment capital is to be allocated among the different investible asset classes. This decision is, of course, the most important one that Core makes for you and your investment capital, so I welcome opportunities to serve on investment committees like this.




The practice with this group is for members, before the meeting, to fill out a worksheet that seeks a description of best case, worst case, and most likely case for factors that govern investment returns over the next year. The form also asks members to put forward their notions of "unexpected surprises" that will benefit or harm investments. At the meeting, the group engages in what its chair describes as "dharma combat", as the members argue and justify their individual ideas in the course of an attempt to reach a consensus view.

**By:**

***John N. Mayberry***

At Thursday's discussion, the conversation distilled itself to this essential question: How much "risk premium" do we require to invest in risky assets (like stocks) when terrorists seek to disrupt our economic and political systems at their cores? In the parlance of investment folks, "risk premium" refers to the amount of extra return required to compensate for risk. If risk is high, one should demand a higher risk premium for investment in risky assets. That means, of course, that one should only buy stocks (or other risky assets) at low prices when there are significant risks to financial, political and economic systems.

But this, of course, begs this question: Is external risk high in June 2004?

*How high is external risk? Although unknowable, this is the question we must attempt to answer.*

*In my view, risk is high enough to warrant a cautious strategy to keep investments in risky assets low.*

Al Qaeda is seeking to drive foreign oil service workers from Saudi Arabia and to disrupt Saudi oil production. Those operating in Iraq target--among other things--its oil production and distribution facilities in these days before the transfer of "sovereignty" on June 30. Last year's attacks in Iraq on the UN mission and the Spanish headquarters were part of the effort to dissuade other members of the world community from participation in reconstruction of Iraq's political systems and infrastructure. Of course, the March 11th bombing in Madrid was another in this same series of attacks. It is not far fetched to imagine that Al Qaeda seeks another blow, like that of September 11th, on the political, financial, or economic structure of Britain or the United States. The run up to the American presidential election is, one would imagine, a propitious time, from Al Qaeda's perspective, to launch another attack.

It is, of course, impossible to know how high the risk is that there will be a really disruptive terrorist attack. It is worth remembering that the September 11th attacks did not cause long-term damage to financial systems or the economies as a whole. Certain places, especially New York City, and certain industries, travel-related mostly, suffered long-term damage. But, devastating as those attacks were, they did not bring down the financial and banking systems, nor did they cause long-term system-wide economic problems. It is easy for all of us to imagine worse attacks--dirty nukes rendering Manhattan uninhabitable are a particular nightmare of mine. But, how likely is it that there will be such a "successful" attack?

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During our "dharma combat", we also considered the risk presented to the financial systems by financial derivatives, swap contracts and the like. This might be called "friendly fire", to continue our wartime metaphors, because derivative instruments have been created by our side and for beneficent, risk-management purposes. However, some people, like Warren Buffett of Berkshire Hathaway, with the deepest understanding and biggest economic stake in them, regard them as serious threats to the financial system. Alan Greenspan directly contradicts Mr. Buffett's view. Everyone around the table last Thursday remembered, as you probably do, the extraordinary financial market losses of August, September and October 1998, during the Asian currency crisis, Russia's repudiation of its debt, and the collapse of the huge hedge fund, Long Term Capital Management.

In the end, the committee decided on a lower than normal allocation to stocks and a higher level of less risky assets, including cash and commodities. This accords with my view and reflects the investments I have made over the couple of years. In these days, while stock prices are high and the risk premium accorded to them is quite low, a strategy of avoiding excess risk is best, particularly for those investors whose need for capital preservation outweighs their need to stretch for investment gain.

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CORE Comments
ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

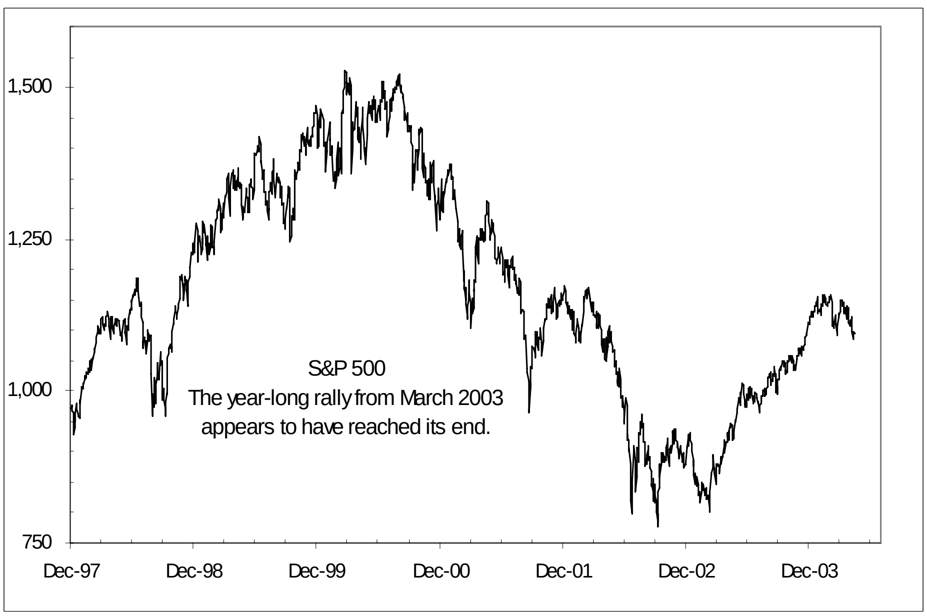
May 18, 2004

# A Point of Inflection

*The Fed's reflationary policies are about to be reversed. Anticipation of these changes has caused abrupt reversals in many investment markets in the last several weeks.*

Although overshadowed by awful developments in Iraq, financial markets presented a very difficult period since the end of March. Successive reports of very strong growth in employment at the beginning of April and of May provided a point of inflection for investors. All at once the markets reacted to the realization that the Fed's extended regime of impossibly low short-term interest rates is coming to an end. This caused a collapse in bond prices while bond yields soared by nearly a full percent.

By the time of the first jobs report on April 2, stocks had already ended their powerful, uninterrupted advance and begun to falter. By the time the May 7 report, stocks were in full-fledged rout. REITs, which enjoyed exceptional gains for more than a year, fell sharply from early April. Evidence of powerful economic growth in the United States--sufficient even to rouse employers to start hiring--caused foreign currency traders to buy dollars. In short, many of your investment positions fell in the last six weeks and several markets reached levels of selling typically seen only during large-scale financial panics. The stock market's decline was, by some measures, more intense in early May than in the aftermath of September 11 and in the period of the Asian currency crisis and Russian default of August and September 1998.




**By:**

***John N. Mayberry***

**The underlying theme: Inflation.** Despite sudden reversals in the assets in which we invest, the principal force shaping investments remains the return of inflation. Several of our investments benefit from inflation, some quite directly. For well over a year, the Federal Reserve Board has encouraged inflation. It made very plain its belief that deflation--falling prices--was a far greater risk to the economy and far more difficult to remedy than inflation. Hence, since the end of 2002, the Fed has pursued inflationary policies. The Fed's policies, the stimulus from tax cuts, and growing demand from China, are causing the prices of goods and services to rise--as we all see in our day-to-day activities.

*Inflation is rising. The range of assets in which we have made investments should benefit from inflation, the reversals of the last several weeks notwithstanding.*

Our direct investment in a commodity fund will, of course, benefit from continued commodity inflation, including increases in oil prices. For some clients, we have investment in oil- and energy-related stocks. Our utilities investments offer a high and growing rate of dividends, offsetting inflationary pressures. Our US bond investments are concentrated in the so-called "TIPS", (treasury inflation-protected securities). With these bonds, the principal repayment amount increases each year at the rate of increase in consumer prices. Our REIT investments, which declined sharply in recent weeks along with everything else, have inflation protection built in: in inflationary environments, real assets climb in price. The underlying real estate holdings within REITs gain with inflation.

Our foreign bond investments declined as the dollar strengthened. Apparently, capital is flowing back into dollar assets now because US economic growth, around 5%, is generally higher than in other major economies. My expectation is that the dollar will resume its decline in coming months. Our trade deficit widened again last month, an ominous sign for this country that must now borrow from foreign investors more than $2 billion each business day. In coming months, it is likely that the huge imbalance in capital flows will once again cause the dollar to weaken. The adjacent chart shows the modest recent rally in the context of the larger bear market, now in its third year.


**Are we at a turning point?** The Fed's policy of ultra-low interest rates drove investors into risky assets. Will the adjustment to the upcoming period of rising short-term interest rates reveal vulnerabilities in the financial system of which we had been unaware? Will the deteriorating security position Iraq give rise to events that disrupt investor confidence or financial systems? To pose these questions is to acknowledge that we live in risky times. We intend to keep your investments in riskier assets low while volatility and political risk are both quite high.

**A note about Post Properties.** About a year ago, we made an investment in Post Properties for many clients, an investment we still hold. Post Properties is a REIT that owns high-quality apartments, mostly in the southeastern states. In recent weeks, its founder and former chairman has been waging a rather acrimonious dispute with the company's current management. Both parties are filling our mailboxes with denunciations of the other. Do not be concerned. When we made this investment, this feud was in progress; it remains unresolved. We shareholders of Post Properties are likely ultimately to reap the benefits of this squabble. A third party may step in to acquire Post at higher prices, because at present these shares trade well below the intrinsic value of the assets of this REIT. As the feud goes on, we collect a large dividend while we await a resolution and higher prices.

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CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

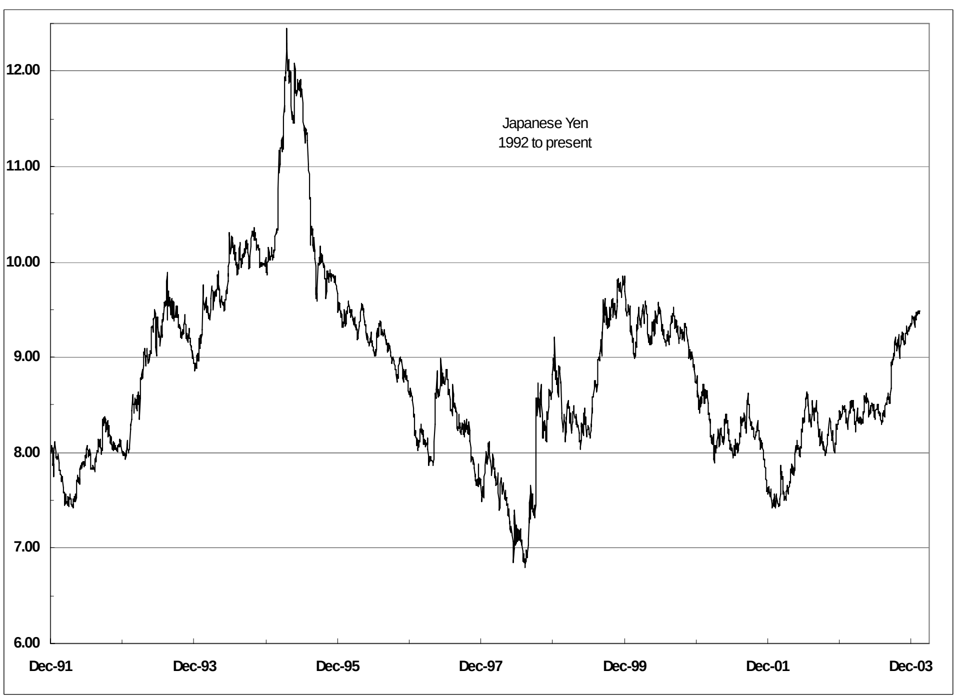
February 18, 2004

# Financial Imbalance.
# Will Things Teeter and Fall?

*The world has an unusually large number of precarious financial situations. This letter considers Japan's policy of printing yen to buy dollars to invest in US treasury bonds. On a staggering scale.*

Since the beginning of January, investment market trends from the latter part of 2003 have persisted. Stocks are higher; the dollar is weaker. REITs keep gaining; bonds are just about unchanged. However, the apparent stability in financial markets masks conditions of increasing imbalance and growing risk. In this letter, I discuss one feature in this complex web, namely the extraordinary, and probably ultimately destabilizing, monetary actions by Japanese fiscal and monetary authorities.

As you will remember, Japan's economy has been very weak for more than a decade. The collapse of Japan's stock market and real estate bubbles of the late 1980s has caused fifteen years--so far--of very weak economic activity and prolonged periods of deflation. Recall the oft-repeated anecdote that, in 1989, the value of grounds and buildings of the Imperial Palace in Tokyo was greater than the value of all the real estate in California. After these bubbles burst in Japan, years of various policies designed to stimulate demand and to restore Japan's busted banks failed to create strong, sustained growth. Quite recently, Japan's stock market languished at levels about 75 percent below its 1989 peak, and its economy struggled to avoid deflationary contraction.




Adding to Japan's problems has been the weakening US dollar. Japan's economy depends in large part on exports. To make its exports affordable, Japan favors a relatively cheap yen. Japan has chosen an audacious and breathtaking solution to these problems and conducted the most aggressive experiment in monetary policy ever. Japan has, it seems, two goals in mind: to sustain economic growth in the United States and to keep the yen from rising rapidly against the dollar.

**By:**

***John N. Mayberry***

Since January 2003, the Japanese Central Bank has employed its printing press to create 27 trillion yen. With these yen, the Japanese purchased dollars and invested about $250 billion in US treasury securities, thereby financing about one half the US federal budget deficit. The enormous purchases of US treasuries have kept interest rates on US long-term bonds artificially low. These low interest rates have stimulated economic expansion in the United States and globally.

*Japan's purchases of US treasury bonds keep the yen from rising in value too quickly. Additionally, Japanese purchases keep US interest rates low and stimulate economic growth in the US.*

In the short term, all this has been in Japan's interest and America's. Low interest rates in America have kept the boom in house prices intact and consumer spending in the US relatively high, even while employment conditions have been so poor. Economic strength in the US has stimulated demand across East Asia--in China, Korea, Taiwan, as well as in Japan. Export demand has kept Japan's otherwise sickly economy afloat and warded off further deflation. Because the currency intervention has kept the yen relatively cheap against the dollar, the US has been able to buy Japan's exports in quantity.

*The problem is that such aggressive monetary actions, in which our Federal Reserve also engages, are inherently destabilizing. They increase the risk of financial crisis.*

But, is this sustainable? Can the Japanese simply "print" yen--27 trillion yen per year--and create money out of thin air? The central banks of the major economies can create money for a time without causing ill effects. But throughout history, episodes like this have always given way to financial crises, as the imbalances of artificially created money finally overwhelm the short-term good effects. At the very least, such increases in liquidity--that is, in the supply of money--increase the risk of inflation.

*Core is investing very cautiously and across a broad range of assets in order to lessen the risk in your portfolios.*

**Minimizing investment risk in our era of financial strains.** I have written over the last few years of other areas of financial stress: reborn speculative excess in the US stock market, America's huge and growing federal budget deficit and its deficit in trade with the rest of the world, to name a few. Our investment strategy is to limit investment in the riskier assets, which now include the very highly priced US stock and bond markets, and to deploy your capital in a range of safer investments, including non-dollar bonds, REITs, absolute-return hedge funds and physical commodities. As financial imbalances strain the investment markets, our range of assets will protect your capital and allow it to grow.

## Comings and Goings

**Some news from Core.** We have taken a new office in Sausalito, California into which we will move shortly. Our old phone numbers will continue for a time; our new main number is (415) 332-2000. Our address is 108 Caledonia Street in Sausalito, and our new mailing address is P.O. Box 1629, Sausalito, CA 94966. Our (800) 451-2240 remains, as do our internet and email addresses. We will post directions to the office on www.coreasset.com and look forward to welcoming you to our new office.

Janet McKinley, who has been with Core for five years, is leaving to join another firm, and we wish her the very best professional experience. Janet has been a delight to work with and I know many clients have enjoyed her, as well.

We are very happy to welcome Juliette Ambatzidis to Core. Juliette is a native of Tiburon, who lived in Greece in the 'eighties and 'nineties. You will get to know Juliette as we work with you; I expect that you will be pleased, as I am, that she is with us. You may reach her by calling Core; her email address is Juliette@coreasset.com.

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# INVESTING IN 2004
## Some changes to your portfolios

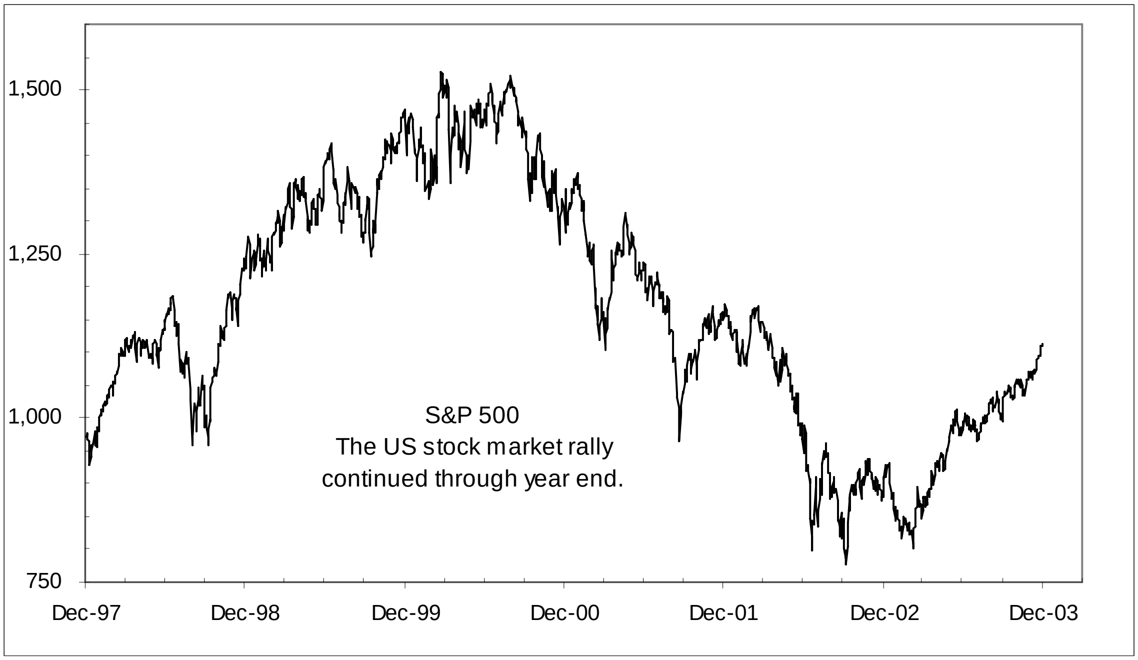
January 5, 2004

2003 was a very strong year for stocks, public real estate investments (REITs), and non-dollar bonds, three assets in which we invest for you. The US bond market had a year of very modest returns, after several good years. For the US dollar, it was a very poor year. Because we held investments for you in bonds denominated in foreign currencies and in non-US stock markets, both of which enjoyed gains, your portfolios benefited from the fall in the dollar. The various "absolute-return" hedge funds in which we invest via Core Equity Trust produced, in the aggregate, a higher level of return than expected in a year with such very low short-term interest rates.

Taken as a whole, 2003 was a good year for your investments, a welcome change from the very difficult years that preceded it. But where now? My sense is that the traditional asset classes in which most of us invest--US bonds and US stocks--are trading at high prices and are rather risky. By contrast, "non traditional" assets, including foreign bonds, REITs, and commodities, offer attractive returns with much less risk than in US stocks and bonds.

**A word of thanks.** Before launching my discussion of the different asset classes in which we invest, I wish to thank you for the privilege and opportunity to work with you. It is a great delight for me to perform the investment and financial planning work for you; I cherish the individual contacts I have with all of you. The intellectual aspects of investing are endlessly fascinating to me. The personal aspects of our conversations and meetings are an enormous pleasure. I thank you all for the opportunity to know you and to work with you on your investments.

**The US economy** expanded very rapidly in the second half of 2003, as the full effects of concerted fiscal and monetary stimulus were felt. The series of Bush administration tax cuts and the huge increase in federal spending joined with the Fed's policy of extremely low interest rates to produce a strong burst of growth. It is likely that the economy will continue to grow at a strong pace for the next several months at least. In the last few months, employment has increased, after a dreadful period of job losses since early in 2001. It is too early to judge whether jobs will be created fast enough to absorb new entrants to the labor market, but the direction is finally positive.




**US stocks and bonds.** The stock market has had a superb rally since March of last year. One (intended) effect of the Fed's policy of very low interest rate policy was to encourage investors to take more risk. (Money market rates below inflation discourage people from holding cash and drive them into riskier investments, like stocks.) But, as many have noted, last year's stock market rally was reminiscent of the stock market advances just before the stock market bubble burst: As a general matter, the stocks that gained the most last year were the most speculative ones, small, technology-oriented stocks with no earnings or with unpredictable earnings. The most stable companies, those with predictable and large earnings, were generally ignored. The result of the speculative tone to last year's stock market is that stock prices are now quite high when measured against the earnings that companies are likely to produce over the next year. One must conclude that stocks are quite expensive and, as a result, rather risky. (The chart above shows the S&P 500 from 1998 to the present. It shows the final run up in the decades-long bull market and the crushing bear market that began in 2000. As you can see, the S&P has recovered about half its bear market losses.)

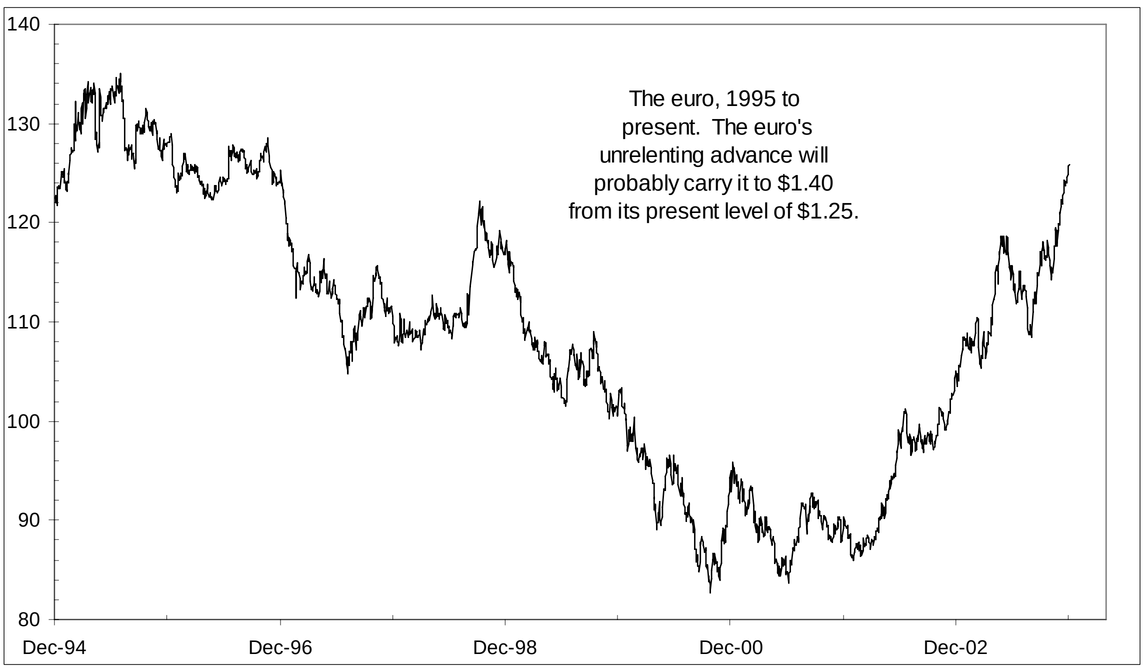
**Bear market or bull market?** The very power of the stock market since March raises the questions: Is the bear market that began in 2000 well truly over? Has the new bull market begun? If we could be confident that the stock markets lows were made in October 2002, we could invest more aggressively in stocks now. Of course, I do not know the answer to these questions, but I do have an opinion. My assessment is that we are in the midst of a powerful cyclical bull market within the context of a very broad bear market that began in 2000 and has only been interrupted by this counter-trend rally. My sense is that the tremendous bull market that extended from 1975 to 2000 (with some admittedly significant "cyclical" bear markets, like the 1987 market crash) is being followed by a bear market that has not yet ended. Stock prices, even at their October 2002 and March 2003 lows, never reached the low levels of valuation that happened at the end of previous, long-term and devastating bear markets. Caution is warranted, particularly now, when stock valuations have again become quite high.

**The US bond market,** for different reasons, is high priced and risky. Yields on US bonds, both corporate and government bonds, are quite low in relation to the strength in the economy and the likelihood that inflation will rise in the coming years. When the Fed was warning loudly in early 2003 about the risk of deflation (the condition of falling prices), the bond market rallied enormously and yields on government bonds fell to lows not seen for four decades. After its most recent meeting, the Fed's Open Market Committee stated that deflation is not a greater risk than inflation. Growth in the economy is finally beginning the process of causing inflation.

Interest rates on long-term bonds have risen from the four-decade lows that prevailed while the recovery was still uncertain and the Fed feared deflation, but they are still lower than they would be "normally" because the Fed continues to keep short-term interest rates at such low levels. In the course of 2004, the Fed will probably begin to raise the Federal funds rate, now 1%, back to "normal" levels, probably around 3%. As short-term interest rates rise, yields on long-term bonds will also rise. Holders of long-term bonds will see losses. To avoid these losses, we have sold all your long-term bonds during the last fifteen months and purchased inflation-adjusted bonds. I discussed inflation-adjusted bonds (called "TIPS", Treasury inflation-protected securities) in more detail in my general letter from late August 2003, which may be read on our web site, www.coreasset.com. Throughout 2004 and perhaps for longer, inflation and rising interest rates will cut into bond investments; inflation-adjusted bonds are the only bonds that provide a hedge against such losses.

**Real Estate Investment Trusts.** Publicly-traded commercial real estate funds (REITs) produced very high returns in 2003. Returns on REITs averaged about 25% during 2003, an amount far greater than the income generated by underlying commercial real estate properties. Because of this remarkable rally in REITs, they are less attractively priced now than a year or two ago. I doubt that REITs will generate such strong returns in 2004 as last year. For client accounts in which we hold individual REITs, we have focused on the sectors, like apartments, industrial properties, and timberlands, which appear to offer the best value. REITs are still supported by high dividends and are not wildly expensive, but we cannot expect them to provide the lush returns we earned in 2003.

**The dollar and foreign currencies.** The dollar declined significantly in 2003. On a trade-weighted basis, its value fell 15%. The euro alone appreciated by 20% in 2003 and has gained an astonishing 46% since January 2002. At the end of 2003 the euro was worth more than $1.25; in January 2002, the euro was worth only $0.86. The dollar's decline will almost certainly continue and the euro will probably rise above $1.40. The growing American deficit in trade in goods and services with the rest of the world weighs on the dollar. Moreover, both the Fed and the Bush administration are pleased with the dollar's decline. The Fed recognizes that as the dollar falls in value, the dollar cost of things rises. Inflation occurs and the risk of deflation goes away. The administration reckons that a weaker dollar makes US exports cheaper and helps to stimulate the economy. None of these forces is new; they will continue to drive down the value of the dollar and will drive up the cost of imported goods, like oil.




**Non-dollar bonds.** We will be selling our investment in the Federated International Bond fund and investing in the American Century International Bond fund in coming weeks. The Federated mutual fund group is one that has been implicated in the trading scandals of recent months. Apparently the abusive trading practices have not occurred in the fund in which we have an investment, but it undercuts my confidence in Federated funds group. As far as we know, the American Century fund group is untainted by the scandals. Its International Bond fund is a very good one; we held an investment in it in 2002 and early in 2003. For some clients, we have purchased a foreign currency money market fund. We may buy it for more clients in coming weeks. With this investment, we gain as the foreign currencies rise against the dollar, and we earn the somewhat higher interest rate available on non-dollar short-term investments.

**Commodities.** One feature of the dollar's decline in value is the increase in the dollar-denominated prices of various commodities, including oil products, precious and industrial metals, agricultural products, lumber, and the like. Additionally, as economies around the world recover, the demand for these commodities increases. Commodity prices rise and inflation in goods follows. In dollar terms, the broad-based commodity indices gained in 2003. For instance, The Economist All-items dollar index gained 16% last year. The same index fell by 4% in euro terms, a good illustration of the relation of currencies values and commodity prices. However, economic growth and demand for commodities will both be higher in 2004 than in 2003. Thus, commodity prices in dollar terms should rise again in 2004. (They will probably do so, to a lesser degree, in euro terms.)

Happily there is a mutual fund, managed by the superlative Pimco organization, that permits us to invest in a broad basket of commodities. The fund, called PIMCO Commodity Real Return Strategy, makes unleveraged investments in a basket of physical commodities and uses TIPS (inflation-adjusted Treasury bonds) as the collateral for these investments. This investment should produce a positive return for our portfolios and will provide further diversification. The correlation (relatedness of price movements) between stocks and commodities and between bonds and commodities is quite low, a further advantage to adding this fund to your portfolios.

As it happens, we have had some exposure to commodities for many clients for well over a year. We invested in Plum Creek Timber, a REIT that holds timberlands, some time ago. While the world economy remained very weak in 2002 and early 2003, this investment was unspectacular. Indeed, Plum Creek cut its dividend a year ago in response to poor conditions in timber markets. For the last ten months economies have strengthened, and Plum Creek has been a very strong investment. The value of its timberlands and the sales of its lumber are increasing. The Pimco fund is, of course, a much broader commodity investment than Plum Creek.

**Core Equity Trust and absolute-return strategies.** As of this writing, we do not have return information for December for all the funds in which Core Equity invests, but the full-year returns for 2003 will certainly be satisfactory, around 7% or 8%. This is quite good for a year when short-term interest rates have been around 1%. As I have written previously, absolute-return strategies as a group have a high correlation with short-term interest rates. When money market rates are 6%, for example, we might expect absolute-return investing to produce gains of 10% to 12%; when rates are at 1%, as in 2003, returns of 5% to 7% are normal.

Absolute-return strategies may be compared to fixed-income investments in that both produced stable returns. Given the poor prospects for bonds as economies recover and inflation grows, Core Equity will probably be an attractive source of stable, positive returns. We are making a new investment in a foreign-currency fund, from which I expect good returns. Additionally, as corporate takeovers and mergers increase in 2004, the merger arbitrage funds in which Core Equity invests will likely provide better results than achieved in 2002 and 2003, when merger activity was so depressed.

**In conclusion,** we can know little about how 2004 will unfold. The recent warnings about terrorism in the United States have reminded us--though we scarcely need the reminder--that the world is a tense place. Surprises--political, financial, and social--are a certainty and they will bring their weight to bear in the investment markets we ply. I know that the coming year will be fascinating; I will be alert and do my best to make useful decisions about your investment capital.

I strongly believe that the broad range of investments across stocks, bonds, REITs, non-dollar bonds, commodities, and absolute-return hedge funds give you a good chance of reasonable investment returns without taking much risk. Please call (800 451 2240) or email me (JNMayberry@coreasset.com) if you wish to discuss your investments. Best wishes for the new year.

John N. Mayberry