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## Wondering About Small Caps

*by Walter S. Frank, Chief Investment Officer*

We don't usually spend a great deal of time trying to figure out which particular investing style is going to lead the performance league in the months ahead. Our pat answer to that issue whenever it comes up is that we let the fund selection system perform that function. In normal times (are there such things anymore?) that answer fills the bill.

But when it comes to putting together our portfolios, the pat answer is a bit of a cop-out. If you take a look at our portfolios you will see they have, and have had for some time, a decided small-cap value tilt. (This has been a very good thing until quite recently.)

We were led to small-cap value by the selection system. Once we were led there, though, it was our judgement that small caps were the way to go. This determined how much weight to give the group in selecting funds for the portfolios.

In other words, choosing funds for the portfolios is not a simple mechanical act. We're always mindful of diversification needs. We're also mindful of different managerial styles. Are the operating styles of two managers, whose funds operate in the same sector of the market, sufficiently different so that the two funds are not clones of each other?

Along these lines in looking at the results of the selection system we cannot help but wonder whether the hey-day of the small cap funds, and value in particular, is coming to an end. Having been discovered after years of neglect during the bubble, and enjoying a great run during a bear market, has all the gain been squeezed out of small-cap value? After listening to some managers in the sector, we don't think so, but we're far from pounding the table on the issue.

### *The price of success*

Just before the market's May/July swoon small caps were coming along swimmingly. We even wrote an article then concluding that the small cap boom had more to go. But

as the group sank in the market selloff, we were reminded of the views of two practitioners which take on added significance today. One view was aired by the mid-cap and small-cap value team of the Artisan family of funds. The managers flat out stated that they could not find anything to buy in their universe. This was disturbing. Here were first-rate pros saying the sectors were completely picked over. The bargains were gone.

The other view came from William Nygren of Oakmark fame. It goes without saying that anything Nygren says we take seriously. He is good, and equally important, thoughtful. During a conference call Nygren made the point that in terms of valuation there is no longer any discrepancy between small-cap and large-cap stocks. During the bubble small caps, especially value, were neglected and undervalued. But the small-cap value run corrected that. On a valuation basis the sectors are on a par, in his opinion. He is happy to fish in large-cap waters.

### *Revisiting small caps*

As if these views were not enough, the market collapse from May to July, in sweeping all before it, was particularly hard on small caps of all stripes. Many of the standout performers of the year, such as Wasatch Small Cap Value or Royce Opportunity, fell with a thump into the sell range. Obviously some of the selling was pure profit-taking. Small-caps were one of the few places where profits existed to be taken. But then we wondered...is more going on than that?

The first thing we did was go back and talk to the Artisan managers—to be exact, James Kieffer, co-portfolio manager of the Artisan Mid Cap Value and Small Cap Value Funds. This time, after the fall, the story is different. Not completely different, but different.

What has happened, says Kieffer, "is that we have more names to look at that are of interest." The small-cap debacle of the last two months has not only brought more stocks back into the small-cap range, it has also broadened the list of names to encompass more industry sectors.

Stocks are cheaper than they were. OK, we all know that. That is true for every portfolio. Ah, but what is important is that while they have become cheaper for everyone, the economic environment in the small-cap value sector has not worsened. While those stocks have come down, their outlook has not. Relative to the outlook, stocks really are cheaper.

As Kieffer put it, "When we talked to companies in the spring, we weren't given any encouraging signals. That hasn't changed. But now there is less negative news coming from the companies we talk to."

*(continued on page 2)*

### Market Trends

	Trailing 12-Mo Trend	Forward 6-Mo Estimate
Economy	Higher	Higher
Interest Rates	Lower	Flat/Lower
Dollar	Lower	Flat/Lower
Inflation	Flat	Flat
Dow	Lower	Higher
NASDAQ	Lower	Higher
Europe	Lower	Higher
Japan (Nikkei)	Lower	Higher
Hong Kong (Hang Seng)	Lower	Higher

(continued from page 1)

All in all, Kieffer can now see good double-digit returns coming from his portfolios, "if things play out." However, he is careful to say that he is not talking about high teens compounded returns given the current environment. He didn't say so, but an easy inference from what he did say is that the recovery would have to grip before he would talk about decent compounded returns.

After Kieffer, we were able to go back to Oakmark again to get their current view. This time it was not Nygren's views but those of James Benson who runs the Oakmark Small Cap Fund. As an Oakmark fund, Small Cap is also a value fund.

Benson is more upbeat than the positive, but cautious, Kieffer. Benson pointed out, "Earlier I had trouble putting cash to work. In July, everything went on sale." He said that it looks to be the best time to invest since early 2000. (Consider what small-cap value has done since then.) Good buys, he said, are available at 10 times next year's earnings. As he put it, "I am excited in terms of valuation. The ability to find values is easy again."

One interesting point Benson made, which may explain some of the mid-August rally, is that prices and interest rates have come down enough to make leveraged buy-outs work again in the small-cap sector. He is seeing them occurring.

The two portfolio managers are not the only small-cap managers who have commented that values are reasonable once again. Others have said the same thing and remain bullish about their sector.

#### **Growth or value?**

When this year began, if pressed, we would have predicted that small-cap growth would head our performance table for 2002. We had two supports for that view. First, we all now "know" that small-caps lead the way as the economy recovers from recession. This is now an accepted and proven piece of market knowledge. Counting all the recessions over the last 50 years, but not including the 2001 recession, small caps, on average, have returned 15% more (38% vs. 23%) than large caps over the first recovery year.

Second, we expected an increasingly sturdy recovery this year. As the recovery picked up steam, we saw the growth stocks profit outlook getting better and better as the year went on. Putting the two together produced our optimistic view of small-cap growth. Add in that after its great run, we thought small-cap value would lag as investors moved to the cheaper and faster-growing growth stocks.

For a while (through May) it looked as if small-cap growth, while not leading by any means, was at least showing up among the top 20 funds on our domestic list. Then came the selling which hit growth even harder than value.

The biggest blow to growth came from the economy. The economy looked solid through June but then hit a few speed bumps. Growth during the summer so far has looked fairly anemic. At the very least we are not seeing the momentum that should be developing now if small-cap growth funds are to shine.

The small-cap growth fund renaissance which we expected has been delayed. We don't think the delay will be too long, but we cannot be certain. When the recovery finally gets in gear, and we expect it will before the year is out, we should see attention finally focus on small-cap growth. Profit growth there could be robust once activity strengthens

For now small-cap value is apparently still the preferable way to go. As to whether the portfolios will retain their small-cap tilt, the portfolio managers in that sector seem to have answered that one for us. The value managers expect to see good gains ahead, at least over the immediate over the intermediate-term. We also expect the group to continue its relative outperformance for some few months ahead if not longer. \$

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## Rate Cut Ahead

The strong market rally of the past few weeks has been most welcome, but in some ways it came totally out of left field. Here was a case where the economic news has been discouraging but the market has advanced. The disconnect continues, this time in the opposite direction. While the rally has some foundation (it is not merely a bounce by a severely oversold market off the July lows), it needs stronger economic news, in our opinion, if it is not ultimately to run off into the sand.

As we wrote in the last issue, the economic question facing the markets now was whether the disappointing July numbers—employment, production, new orders, etc.—were just a one-time aberration or the beginning of a new slower trend for the economy. What few August numbers we now have, jobless claims and retail sales reports, are not encouraging. Things aren't getting worse, but neither are they getting better. We're still stuck in the July slump.

Growth forecasts for this year are coming down, as you would suspect. Along with growth, Wall Street has also been cutting profit forecasts for the S&P 500. Analysts' estimates of profits are also coming down, although the analysts are still looking for good gains over this last half of the year compared with last year.

At its meeting on August 13, the Fed responded to all this by shifting its bias from neutral to weakness, as far as its view of the outlook was concerned. We did not expect more from the Fed because we thought it would wait for the August numbers before it decided to act (or not).

If the August numbers continue soggy, and the evidence we have is that they will, then we expect another rate cut at the Fed's late September meeting. We don't see the Fed sitting on its hands at this stage without doing its best to jump-start the economy.

Some of the bears have likened our current condition to that of the Japanese economy after the bubble burst. We think the analogy is a gross oversimplification. But one lesson from the Japanese experience, says a recent paper written by Fed staffers, is that the monetary authorities should act forcefully at times like these. We expect they will.

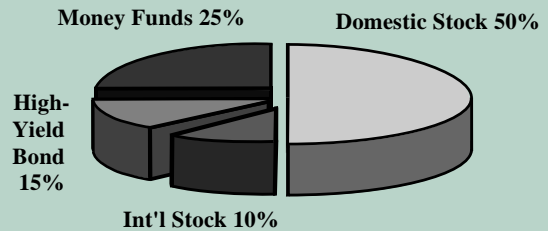
### Japan funds

Some of you may notice that the Japan funds have risen high on our international fund list but are still carried as holds. The reason for that is that judgment, as well as position on the list, enters into our buy/sell recommendations. This is especially true with international funds, where currency fluctuations often enter into a fund's performance. Accordingly we are maintaining a hold for the Japan Funds now.

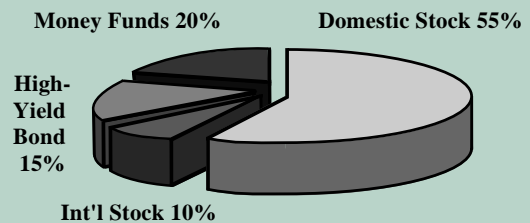
### Portfolio changes

The Hotline of Tuesday August 13 recommended the sale of Royce Opportunity in the *MONEYLETTER* Venturesome and Conservative Portfolios, and also the sale of Royce Low Priced Stock in the *MONEYLETTER* Moderate Portfolio. The same Hotline said that Ariel Fund (not to be confused with Ariel Appreciation Fund) would replace the Royce funds in all three portfolios. Details will appear in the next issue. \$

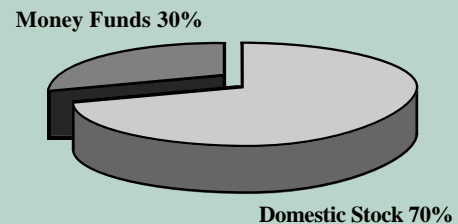
### CONSERVATIVE



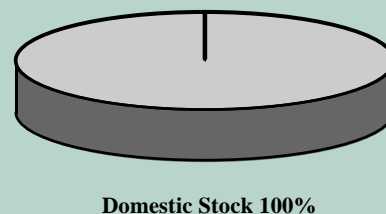
### MODERATE



### VENTURESOME



### SIGNAL



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## Domestic Stock Funds

RANK	8/16 2002	1Mo Ago	6Mo Ago	Ticker Symbol	FUND NAME (Max. Load)	Fund Type	Conservative Moderate Venturesome			TOTAL RETURN			PRICE	RISK		NTF/ wtf
							B	B	B	1 mo.	6 mo.	12 mo.	PER SHARE	Std. Dev.	Beta	
1	4	5	<b>YACKX</b>	<b>Yacktman Fund</b>	MC	B	B	B	6.4%	3.9%	12.7%	\$11.74	18.2	0.55	FSW	
2	20	19	VUSVX	Vontobel U.S. Value (2%r<90d)	LCVal	B	B	B	7.5	-0.1	3.9	20.45	22.0	0.44	Fsw	
3	3	36	EEQFX	Eclipse Small Cap Value	SCVal	B	B	B	0.3	3.2	4.2	12.58	18.6	0.75	FSW	
4	18	15	CFIMX	Clipper Fund	LCVal	B	B	B	5.7	-1.1	5.3	83.47	15.7	0.30	sw	
5	19	27	<b>ARGFX</b>	<b>Ariel Fund</b>	SCVal	B	B	B	4.5	-2.0	3.4	37.01	18.9	0.40	FSW	
6	1	14	AVALX	Aegis Value Fund	SCVal	B	B	B	-1.3	-1.3	7.2	12.99	18.2	0.31	fw	
7	21	13	<b>NBGNX</b>	<b>Neuberger Berman Genesis (closed)</b>	SC	B	B	B	5.6	-3.1	0.7	19.87	19.6	0.62	FSW	
8	5	7	<b>FLPSX</b>	<b>Fidelity L P Stock (closed,3%&amp;1.5%r&lt;90)</b>	SCVal	B	B	B	-0.2	-2.3	5.5	26.99	16.6	0.57	fsw	
9	9	23	PRWCX	T. Rowe Price Cap Appreciation	LCVal	B	B	B	2.1	-2.1	0.5	14.62	10.7	0.24	fsw	
10	10	20	RYTRX	Royce Total Return (1%r<180d)	SCVal	B	B	B	1.0	-2.5	0.1	8.44	13.6	0.41	FSW	
11	68	34	OAKLX	Oakmark Select (closed) (2%r<90d)	MCVal	H	H	H	7.6	-4.6	-6.9	25.38	26.2	0.83	FSW	
12	2	54	LLSCX	Longleaf Partners Smallcap (closed)	SCVal	B	B	B	-2.0	-1.1	-4.1	22.03	17.0	0.45	fsw	
13	11	4	PRSVX	T. Rowe Price S-C Value (closed,1%r<1yr)	SCVal	B	B	B	-1.6	-3.8	1.9	22.26	16.4	0.44	fsw	
14	6	48	<b>FFTYX</b>	<b>Fidelity Fifty+ (.75%r&lt;30d)</b>	LC	B	B	B	-0.2	-2.6	-4.2	16.13	28.2	0.87	FSW	
15	14	64	RSPFX	RS Partners	SC	*	B	B	-0.5	-2.7	-4.1	17.08	-	0.59	FSW	
16	26	29	TWEIX	American Century Equity Income	MCVal	B	B	B	2.9	-5.2	-3.7	6.65	15.1	0.44	FSW	
17	7	3	BERWX	Berwyn Fund (1%r<180d)	SCVal	B	B	B	-1.9	-3.8	0.2	19.36	18.7	0.41	fsw	
18	38	81	FCNTX	Fidelity Contrafund (3%)	LCGro	(B)	(B)	(B)	4.1	-4.8	-7.3	40.27	20.1	0.84	fsw	
19	16	39	RYPRX	Royce Premier (1%r<180d)	SC	B	B	B	1.7	-4.7	-4.1	9.75	18.7	0.62	fs	
20	30	37	BGRFX	Baron Growth	SCGro	B	B	B	2.6	-5.0	-5.0	28.34	25.4	1.06	FSW	
21	52	2	CAAPX	Ariel Appreciation	MCVal	H	H	H	3.3	-7.7	-2.8	34.81	18.0	0.50	FSW	
22	75	46	OAKMX	Oakmark Fund	MCVal	H	H	H	5.8	-6.6	-9.5	32.19	20.6	0.59	FSW	
23	13	41	PRNEX	T. Rowe Price New Era	LC	B	B	B	0.7	-4.1	-8.2	21.23	26.7	0.72	fsw	
24	41	56	BVALX	Babson Value	LCVal	(B)	(B)	(B)	3.4	-6.0	-9.8	39.79	20.6	0.70	FSW	
25	25	6	TRMCX	T.Rowe Price Mid Cap Value	MCVal	B	B	B	0.2	-7.9	-1.2	15.39	15.9	0.60	fsw	
26	23	227	NBFSX	Neuberger Berman Fasciano Inv	SCGro	B	B	B	0.6	-7.3	-4.4	31.32	15.7	0.67	FSW	
27	53	85	LMASX	Legg Mason Special Investment Trust	MC	H	H	H	0.9	-5.5	-9.9	28.74	30.6	1.18	w	
28	55	58	STDIX	Strong Discovery+	MCGro	H	H	H	2.6	-7.4	-8.8	14.75	25.1	0.83	FSW	
29	31	31	<b>FDVLX</b>	<b>Fidelity Value</b>	MCVal	H	H	H	0.2	-6.6	-7.5	47.91	22.8	0.64	FSW	
30	59	25	TWVLX	American Century Value	MCVal	H	H	H	2.8	-8.9	-7.8	6.25	20.4	0.59	FSW	
31	46	42	HOVLX	Homestead Value	MCVal	H	H	H	1.7	-7.8	-9.0	22.95	18.1	0.59		
32	93	88	FDFFX	Fidelity Independence (ret.only)	LCGro	H	H	H	5.8	-10.2	-9.3	14.20	42.4	1.24	Fsw	
33	54	-	SMCDX	Strong Mid Cap Disciplined	MCVal	H	H	H	1.7	-9.4	-5.6	15.46	23.4	0.92	FSW	
34	50	106	DNLDX	Dreyfus New Leaders	MCGro	H	H	H	2.4	-7.3	-12.3	36.19	25.2	0.92	FSW	
35	28	33	<b>BSCFX</b>	<b>Baron Small Cap</b>	SCGro	(H)	(H)	(H)	-1.5	-8.1	-4.8	14.17	28.0	1.07	FSW	
36	47	60	BARAX	Baron Asset	MCGro	H	H	H	1.3	-7.4	-10.8	39.56	28.1	1.22	FSW	
37	22	11	OAKSX	Oakmark Small Cap (2%r<90d)	SCVal	B	B	B	-0.3	-8.8	-5.1	16.17	18.1	0.54	FSW	
38	29	89	MUTHX	Mutual Shares (1%) CIZ	MCVal	(B)	(B)	(B)	1.3	-6.9	-12.3	17.51	16.6	0.62	sw	
39	15	30	LLPFX	Longleaf Partners	MCVal	B	B	B	-2.0	-6.4	-9.3	22.60	20.1	0.58	fsw	
40	114	70	DGAGX	Dreyfus Appreciation	LC	H	H	H	6.6	-10.2	-13.0	33.81	17.6	0.80	FSW	
41	34	16	LSSCX	Loomis Sayles Small Cap Value	SC	H	H	H	-0.4	-8.7	-6.6	18.82	19.4	0.69	sW	
42	66	-	CRIMX	CRM Mid Cap Value Ins	MCVal	H	H	H	1.6	-11.6	-3.0	16.11	-	-		
43	69	-	CRMMX	CRM Mid Cap Value Inv	MCVal	H	H	H	1.5	-11.7	-3.1	16.03	-	-	FSW	
44	45	38	DODGX	Dodge & Cox Stock	LCVal	H	H	H	1.0	-8.7	-9.8	90.14	19.8	0.64	sw	
45	27	91	BEGRX	Mutual Beacon (1%) CIZ	MCVal	H	H	H	0.7	-7.4	-12.9	11.81	15.9	0.58	sw	
46	64	95	MFOCX	Marsico Focus	LCGro	S	S	S	0.1	-8.4	-9.5	12.42	31.5	1.12	FSW	
47	62	44	<b>VIMSX</b>	<b>Vanguard Mid-Cap Index+</b>	MC	H	H	H	2.2	-9.6	-9.6	10.45	26.2	1.02	fsw	
48	101	146	NICSX	Nicholas Fund	LC	S	S	S	5.9	-10.1	-14.6	46.06	18.4	0.90	w	
49	42	21	BEMVX	Berger Mid Cap Value	MCVal	H	H	H	0.5	-9.7	-7.3	15.11	23.3	0.80	FSW	
50	39	65	SAOPX	Salomon Brothers Opportunity	LCVal	H	H	H	1.0	-8.7	-11.2	41.71	16.5	0.58	sw	
51	65	47	PESPX	Dreyfus Mid Cap Index	MCGro	H	H	H	2.1	-9.8	-10.1	18.69	25.8	1.02	FSW	
52	80	144	SLASX	Selected American Shares	LCVal	H	H	H	3.2	-8.8	-14.5	26.65	20.5	0.92	sW	
53	58	43	MERDX	Meridian Fund	SCGro	H	H	H	0.8	-10.2	-7.9	25.11	21.4	0.77	fsw	
54	32	75	MQIFX	Mutual Qualified (1%) CIZ	MCVal	H	H	H	0.3	-7.7	-13.2	14.75	16.9	0.61	sw	
55	12	-	TASCX	Third Avenue Small-Cap Value	SCVal	(H)	(H)	(H)	-4.3	-7.0	-8.5	14.10	17.5	0.58	FSW	
56	94	90	VWNFX	Vanguard Windsor II	LCVal	H	H	H	3.6	-8.9	-15.7	22.32	18.5	0.65	fsw	
57	48	12	<b>FDSCX</b>	<b>Fidelity Small Cap Ind. (1.5%r&lt;90d)</b>	SC	H	H	H	-0.1	-11.6	-3.8	14.29	22.8	0.83	fsw	
58	51	80	TWEBX	Tweedy, Browne American Value	MCVal	H	H	H	0.1	-8.2	-13.2	21.06	15.2	0.51	fsw	
59	91	118	NCTWX	Nicholas II	MCVal	S	S	S	4.7	-11.7	-12.7	16.65	21.3	1.00	w	
60	36	17	BPSCX	Boston Ptnrs Smlcap Val (closed,1%r<1yr)	SCVal	H	H	H	-4.0	-8.4	-8.4	15.58	-	0.52	FSW	
61	60	49	BOGLX	Bogle Small Cap Growth (closed)	SCGro	S	S	S	0.2	-10.1	-10.8	17.92	-	-		
62	86	139	PFVLX	Preferred Value	LCVal	H	H	H	2.0	-8.7	-17.1	16.08	19.5	0.79	w	
63	78	45	PRFDX	T. Rowe Price Equity-Income	LCVal	H	H	H	1.9	-10.5	-12.7	20.76	16.7	0.53	fsw	
64	35	160	VCV SX	Vanguard Convertible Securities	Convrt	H	H	H	-0.3	-9.2	-12.7	10.13	20.4	0.69	fsw	
65	43	115	SRFBX	Liberty-SteinRoe Balanced	G&I	H	H	H	0.7	-9.8	-13.4	21.50	12.3	0.61	FSW	
66	117	79	FGRIX	Fidelity Growth & Income (3%)	G&I	S	S	S	4.7	-11.6	-14.9	32.19	16.7	0.80	fsw	
67	89	51	VEIPX	Vanguard Equity-Income	LCVal	H	H	H	2.7	-11.0	-13.5	19.70	16.0	0.55	fsw	
68	37	28	<b>VISVX</b>	<b>Vanguard Small-Cap Value Index</b>	SCVal	H	H	H	-2.6	-10.0	-9.1	9.02	-	0.70	fsw	

*Bold funds* are currently held in *MONEYLETTER* model portfolios.

*Advice:* B=Buy, H=Hold, S=Sell, (B), (H), (S)= advice new this issue, \*=not for this portfolio. +=Appropriate for Signal Investors.

*Std. Dev.:* monthly standard deviation based on two-year returns.

*Beta:* fund's correlation to the market (S&P 500 = 1.0). A fund with a beta greater than 1.0 is more volatile than the S&P 500.

*NTF/wtf:* NO TRANSACTION FEE/with transaction fee (F/f) for Fidelity, (S/s) for Schwab and (W/w) for TD Waterhouse.

# FUND SCORECARD & RECOMMENDATIONS

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## Domestic Stock Funds (cont.)

RANK	8/16 2002	1 Mo Ago	6 Mo Ago	Ticker Symbol	FUND NAME (Max. Load)	Fund Type	Conservative	Moderate	Venturesome	TOTAL RETURN			PRICE PER SHARE	RISK		NTF/wtf
										1 mo.	6 mo.	12 mo.		Std. Dev.	Beta	
69	77	-	BPMCX	Boston Partners Mid Cap Value	MCVal	S	S	S	1.3	-12.2	-9.5	9.69	18.3	0.76	FSW	
70	8	111	IZZYX	ICM/Isabelle Small Cap Value	SCVal	(H)	(H)	(H)	-10.3	-5.1	-10.2	10.88	26.5	0.67	FSW	
71	17	24	PENNIX	Royce Penn Mutual+ (1%r<180d)	SCVal	(H)	(H)	(H)	-4.1	-9.9	-7.3	6.71	16.7	0.51	fsw	
72	100	92	LSGIX	Loomis Sayles Value	LCVal	S	S	S	2.6	-10.4	-16.4	12.70	17.5	0.72	fsW	
73	70	96	MGRIX	Marsico Growth & Income	G&I	S	S	S	-0.6	-10.5	-11.8	12.62	29.7	1.08	FSW	
74	119	108	FDEQX	Fidelity Disciplined Equity	LC	S	S	S	3.5	-11.9	-15.2	19.09	19.7	0.94	Fsw	
75	110	59	PRDGX	T. Rowe Price Dividend Growth	LCVal	S	S	S	3.4	-12.2	-14.4	17.69	14.0	0.57	fsw	
76	99	53	HAVLX	Harbor Value	LCVal	S	S	S	3.4	-11.8	-15.8	12.28	20.0	0.76	sw	
77	63	35	OTCFX	T. Rowe Price Small Cap Stock Fund+	SC	S	S	S	-0.4	-12.2	-9.6	21.83	22.0	0.73	fsw	
78	125	174	TWHIX	American Century Heritage	MCGro	S	S	S	3.5	-10.8	-19.2	9.46	32.1	0.98	FSW	
79	83	97	KAUFEX	Federated Kaufmann Fund+ (0.2%)	MCGro	S	S	S	1.4	-11.5	-14.5	3.63	33.5	0.86	FSW	
80	82	87	SSHFX	Sound Shore	MCVal	S	S	S	2.1	-11.3	-16.2	26.30	18.4	0.60	sW	
81	96	149	SCDUX	Scudder Large Co Value	LCVal	*	S	S	1.6	-10.4	-18.0	19.49	18.2	0.70	FSW	
82	88	61	FEQIX	Fidelity Equity-Income	LCVal	S	S	S	1.9	-11.3	-16.2	41.71	18.4	0.74	Fsw	
83	33	26	HRTVX	Heartland Value (1%r<90d)	SCVal	(S)	(S)	(S)	-4.4	-11.0	-8.0	32.63	22.5	0.63	FsW	
84	108	180	TWCVX	American Century Vista	MCGro	*	S	S	3.7	-12.1	-18.1	9.66	52.3	1.17	FSW	
85	79	107	VEXMX	Vanguard Extended Market Index	MC	S	S	S	1.0	-12.0	-14.9	19.38	31.4	1.17	fsw	
86	122	98	BIGRX	American Century Income & Growth	G&I	S	S	S	3.4	-12.6	-17.4	22.93	20.0	0.99	FSW	
87	85	74	FEQTX	Fidelity Equity-Income II	G&I	S	S	S	1.5	-12.2	-15.5	17.83	17.2	0.74	Fsw	
88	133	137	BEQGX	American Century Equity Growth	LCVal	S	S	S	3.7	-12.3	-18.5	16.01	20.8	1.03	FSW	
89	57	-	CRMSX	CRM Small Cap Value Inv	SCVal	(S)	(S)	(S)	-2.1	-11.8	-11.4	18.04	-	-	FSW	
90	141	110	TWCUX	American Century Ultra+	LCGro	S	S	S	4.5	-13.3	-17.9	22.93	28.7	1.28	FSW	
91	84	112	MPSCX	MSI Small Cap Value (closed)	SCVal	S	S	S	0.8	-11.7	-16.7	15.12	25.5	0.77	fsw	
92	74	69	GABAX	Gabelli Asset	MC	S	S	S	0.8	-11.7	-16.8	28.25	17.2	0.76	FSW	
93	138	114	VQNPX	Vanguard Growth & Income	G&I	S	S	S	4.1	-13.4	-18.0	23.40	20.9	1.02	fsw	
94	95	-	CGMFX	CGM Focus	SCVal	*	S	S	-2.4	-17.3	0.5	19.52	55.1	0.02	fsw	
115	49	10	WMCVX	Wasatch Small Cap Value (closed,2%r<60d)	SCVal	(S)	(S)	(S)	-6.2	-12.4	-11.5	3.62	27.5	0.71	FSW	
132	81	62	NAESX	Vanguard SmallCap Index+	SC	H	H	H	-2.6	-14.5	-16.3	16.30	26.7	0.87	fsw	
135	40	52	RYPNX	Royce Opportunity+ (1%r<180d)	SCVal	(S)	(S)	(S)	-6.6	-13.3	-14.3	7.69	27.3	0.77	fsw	
137	120	50	VWNDX	Vanguard Windsor	LCVal	H	H	H	1.1	-16.0	-19.4	12.45	23.3	0.86	fsw	
148	44	18	RYLPX	Royce Low Priced Stock (1%r<180d)	SCVal	(S)	(S)	(S)	-5.5	-16.2	-11.9	9.73	24.8	0.69	FSW	
211	183	156	VHCOX	Vanguard Cap Opp (\$25,000&1%r<5yr)	MCGro	H	H	H	-1.4	-23.7	-30.3	17.10	38.1	1.06	fsw	

Dow Jones  
NASDAQ  
S&P 500

3.7% -11.3% -15.4%  
-1.0 -24.6 -29.5  
3.1 -15.9 -21.4

indexes do not  
include dividends

## International Stock Funds

1	1	-	MACSX	Matthews Asia Growth&Income (2%r<90d)	Pacific	B	B	B	-1.4%	5.6%	19.4%	\$10.64	14.4	-	FSW
2	7	59	MJFOX	Matthews Japan Fund (2%r<90d)	Japan	*	H	H	-4.4	15.0	-15.4	9.80	-	-	FSW
3	10	55	FJPNX	Fidelity Japan (3%&1.5%r<90d)	Japan	*	H	H	-5.2	10.5	-18.8	9.18	34.8	-	Fsw
4	23	50	VNEPX	Vontobel International Equity (2%r<90d)	Int'l	(B)	(B)	(B)	0.6	3.3	-11.3	12.51	21.1	-	FsW
5	6	54	SJPNX	Japan Fund (Scudder) (2%r<180d)	Japan	*	H	H	-5.5	7.3	-17.8	6.77	31.4	-	FSW
6	13	49	VPACX	Vanguard Pacific Stock Index	Pacific	*	B	B	-4.2	5.3	-14.8	6.62	24.7	-	fsw
7	17	58	PRJPX	T. Rowe Price Japan	Japan	*	H	H	-4.3	6.8	-19.4	5.95	28.6	-	s
8	11	23	FPBFX	Fidelity Pacific Basin (3%&1.5%r<90d)	Pacific	*	B	B	-4.8	1.2	-6.7	13.98	30.0	-	Fsw
9	16	19	BJBIX	Julius Baer Intl. Equity A	Int'l	B	B	B	-3.1	-1.3	-4.8	20.23	28.8	-	FS
10	4	11	OAKEX	Oakmark Intl Small Cap (closed,2%r<90d)	Int'l	B	B	B	-8.4	-2.1	3.1	11.43	25.6	-	FSW
11	2	4	FSEAX	Fidelity SE Asia (3%&1.5%r<90d)	Pacific	*	B	B	-7.7	-5.2	8.4	11.15	38.5	-	fsw
12	21	22	FIGRX	Fidelity International G & I	Int'l	H	H	H	-2.9	-2.5	-8.1	17.91	22.0	-	Fsw
13	9	-	DRFMX	Dreyfus Emerging Market (1%r)	intl	*	B	B	-7.0	-5.3	4.7	11.38	21.8	-	FSW
14	3	5	PRASX	T. Rowe Price New Asia	Pacific	*	B	B	-7.8	-6.2	7.2	6.26	33.6	-	fsw
15	18	30	PFIFX	Preferred International	Int'l	B	B	B	-4.0	-1.5	-11.0	11.15	17.4	-	w
16	28	21	USIFX	USAA International	Int'l	H	H	H	0.8	-5.0	-10.6	15.60	18.1	-	fw
17	22	20	FDIVX	Fidelity Diversified Inter'l (1%r<30d)	Int'l	H	H	H	-2.9	-3.7	-8.4	17.93	20.4	-	Fsw
18	8	12	SCOPX	Scudder Pacific Opport (2%r<1yr)	Pacific	*	H	H	-6.7	-6.6	4.3	8.80	33.5	-	FSW
19	20	-	FIVFX	Fidelity Aggressive Intl. (1%r<30d)	intl	H	H	H	-5.0	-6.1	-3.3	11.32	25.6	-	Fsw
20	5	10	MAPTX	Matthews Pacific Tiger (2%r<90d)	Pacific	*	(H)	(H)	-10.0	-5.8	3.1	8.55	47.1	-	FSW
21	27	16	HAINX	Harbor International	Int'l	H	H	H	-2.3	-6.1	-8.4	27.94	17.8	-	sw
22	25	1	OAKGX	Oakmark Global (2%r<90d)	Global	H	H	H	-4.9	-7.5	-1.6	12.36	-	-	FSW
23	12	2	FEMKX	Fidelity Emerg Mkts (3%&1.5%r<90d)	Int'l	*	(H)	(H)	-7.0	-8.6	2.6	7.59	32.9	-	fsw
24	24	36	CMISX	Columbia International Stock	Int'l	H	H	H	-2.7	-5.0	-14.4	11.00	22.2	-	fsw
25	34	40	SWINX	Schwab International Index (1.5%r<180d)	Int'l	H	H	H	-0.1	-6.1	-16.1	11.27	18.0	-	S
26	31	-	GIGRX	Gabelli Intl. Growth	intl	S	S	S	-1.4	-5.9	-15.9	12.53	21.0	-	FSW
27	35	46	SCINX	Scudder International (2%r<180d)	Int'l	S	S	S	-0.5	-5.7	-18.9	33.15	21.4	-	FSW
28	39	14	TBGVX	Tweedy, Browne Global Value	Global	H	H	H	-2.2	-8.1	-11.2	17.10	14.6	-	fsw
29	26	47	ICHKX	Investec China & Hong Kong	Pacific	*	H	H	-6.0	-6.9	-11.6	10.78	39.2	-	FSW
30	50	35	TWGGX	American Century Global Growth	Global	S	S	S	-1.8	-8.3	-15.1	5.56	-	-	FSW
31	40	45	TWIEX	American Century Intl Growth	Int'l	S	S	S	-1.6	-7.7	-18.0	6.94	27.7	-	FSW
32	36	28	VWIGX	Vanguard International Growth	Int'l	H	H	H	-1.1	-9.1	-15.5	13.15	17.6	-	fsw
33	57	24	USAWX	USAA World Growth	Int'l	S	S	S	2.6	-11.0	-16.3	12.51	20.0	-	f
34	45	37	VEURX	Vanguard European Stock Index	Europe	S	S	S	0.3	-9.7	-17.1	17.45	17.3	-	fsw
42	14	3	VEIEX	Vanguard Emerg Mkts Stk Index (0.5%r)	Int'l	*	H	H	-8.4	-11.9	-3.0	7.83	32.3	-	fsw

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## FUND SCORECARD &amp; RECOMMENDATIONS

## Specialty Funds

RANK	8/16 2002	1 Mo Ago	6 Mo Ago	Ticker Symbol	FUND NAME (Max. Load)	Fund Type	Conservative	Moderate	Venturesome	TOTAL RETURN			PRICE	RISK		NTF/ wtf
										1 mo.	6 mo.	12 mo.	PER SHARE	Std. Dev.	Beta	
1	3	2	USAGX	USAA Precious Metals & Minerals	Gold	*	*	*	-7.0%	9.8%	53.1%	\$9.23	46.80	0.87	w	
2	2	3	BGEIX	Amer. Cent. Global Gold (1%r<60d)	Gold	*	*	*	-8.8	8.8	49.9	7.48	45.30	0.69	fsw	
3	4	7	SCGD	Scudder Gold	Gold	*	*	*	-8.5	13.6	37.2	9.34	36.70	0.74	FSW	
4	5	5	FGLDX	INVESCO Gold (3%)	Gold	*	*	*	-7.5	11.4	40.7	2.35	39.20	0.72	FSW	
5	6	4	FSAGX	Fidelity Sel Gold (3%&.75%r<30d)	Gold	*	*	*	-7.7	7.4	46.3	19.69	49.20	0.89	fsw	
6	1	1	USERX	U.S.Global Gold Shares (.25%r<30d)	Gold	*	*	*	-14.3	6.3	53.9	4.20	36.40	0.69	sw	
7	8	9	STMDX	Stratton Mthly Div REIT (1.5%r<120d)	RealEs	*	*	*	1.5	7.0	10.6	27.58	14.50	0.21	fsw	
8	9	12	FRESX	Fidelity Real Est Investment (.75%r<90d)	RealEs	*	*	*	0.5	5.2	5.0	19.15	15.10	0.21	Fsw	
9	14	30	RSCOX	RS Contrarian	Altern	*	*	*	3.3	6.0	-3.2	10.33	23.50	0.72	FSW	
10	13	8	CGMRX	CGM Realty	RealEs	*	*	*	1.4	2.1	9.1	14.47	15.80	0.26	fsw	
11	10	11	VGSI	Vanguard Special REIT Index (1%r<1yr)	RealEs	*	*	*	0.5	4.2	4.7	12.52	14.40	0.17	fsw	
12	7	6	VGPMX	Vanguard Precious Metals (closed,1%r<1yr)	Gold	*	*	*	-8.1	-1.9	30.7	9.95	43.10	0.87	fsw	
13	11	13	CSRSX	Cohen & Steers Realty Shares (1%r<180d)	RealEs	*	*	*	0.7	3.9	2.1	45.67	16.20	0.25	FSW	
14	12	10	VGEX	Vanguard Sp Energy (1%r<1yr)	Energy	*	*	*	3.2	1.1	0.7	25.10	32.00	0.70	fsw	
15	16	23	FSTEX	INVESCO Energy	Energy	*	*	*	4.0	1.9	-8.1	16.68	46.20	0.90	FSW	
16	19	14	VGHCX	Vanguard Sp Health Care (\$25k&1%r<5yr)	Health	*	*	*	7.9	-7.5	-8.2	106.70	19.10	0.47	fsw	
17	18	16	GATEX	Gateway Fund	Altern	*	*	*	4.7	-6.2	-7.9	20.45	7.00	0.32	FSW	
18	20	18	FIDSX	Fidelity Sel Fin'l Serv (3%&.75%r<30d)	FinServ	*	*	*	3.7	-5.0	-9.8	93.71	27.40	0.94	fsw	
19	23	20	RYFIX	Rydex Financial Services	FinServ	*	*	*	2.1	-5.6	-11.7	8.93	28.80	1.05	fsw	
20	17	17	FSENX	Fidelity Sel Energy (3%&.75%r<30d)	Energy	*	*	*	2.5	-6.2	-13.0	21.23	33.40	0.78	fsw	
21	22	21	FSFSX	INVESCO Financial Serv	FinServ	*	*	*	1.9	-7.8	-13.0	24.47	26.90	0.93	FSW	
22	21	24	RYEIX	Rydex Energy	Energy	*	*	*	2.5	-8.5	-18.5	9.12	27.50	0.64	fsw	
23	15	25	MERFX	Merger Fund	Altern	*	*	*	-1.8	-8.5	-12.8	13.26	5.42	0.13	FSW	
24	27	27	FSPHX	Fidelity Sel Health Care (3%&.75%r<30d)	Health	*	*	*	9.2	-14.8	-17.8	102.20	20.00	0.40	fsw	
25	28	19	RYHIX	Rydex Health Care	Health	*	*	*	10.8	-16.5	-18.6	9.43	19.60	0.41	fsw	
26	26	28	VGSUX	Vanguard Utilities Income	Utility	*	*	*	1.7	-11.9	-19.0	9.85	14.30	0.26	fsw	
27	24	26	FHLSX	INVESCO Strategic Health Science	Health	*	*	*	3.0	-16.1	-18.1	40.05	36.50	0.43	FSW	
28	29	37	FSTUX	INVESCO Utilities	Utility	*	*	*	1.1	-12.0	-31.3	8.67	17.60	0.57	FSW	
29	25	15	POSCX	Potomac Small Cap Plus	Levrgd	*	*	*	-4.4	-19.9	-22.5	8.36	-	-	FSW	
30	35	29	PSPLX	Potomac U.S. Plus	Levrgd	*	*	*	4.3	-23.6	-32.0	7.55	29.00	1.46	FSW	
31	31	35	FIUIX	Fidelity Utilities	Utility	*	*	*	0.7	-20.4	-36.5	9.27	20.40	0.83	Fsw	
32	36	31	RYNVX	Rydex Nova	Levrgd	*	*	*	3.8	-24.3	-32.6	18.27	29.60	1.49	fsw	

## Bond Funds

RANK	8/16 2002	Ticker Symbol	FUND NAME (Max. Load)	Conservative	Moderate	Venturesome	TOTAL RETURN			PRICE	Standard Deviation	Sec 30-Day Yield	Average Maturity	Modified Duration <sup>1</sup>	NTF/ wtf
							1 mo.	6 mo.	12 mo.	PER SHARE					
<b>Short Term</b>															
1		SCSTX	Scudder Short Term Bond	*	*	*	0.6%	2.1%	4.2%	\$10.62	0.76	3.45%	-	-	FSW
2		VFSTX	Vanguard Short Term Corporate	*	*	*	0.1	1.1	2.6	10.64	0.73	4.65	2.7	2.2	fsw
3		FSHBX	Fidelity Short Term Bond	*	*	*	0.3	0.6	1.8	8.79	0.83	4.27	2.8	1.9	Fsw
<b>Intermediate Term</b>															
1		VFITX	Vanguard Fix-Inc Intm. Treas.	*	*	*	2.7	7.1	9.9	11.59	1.40	3.76	7.8	5.4	fsw
2		FGOVX	Fidelity Government Income	*	*	*	2.1	3.7	5.6	10.37	1.50	3.83	9.1	5.1	Fsw
3		PTTDX	PIMCO Total Return Cl D	*	*	*	0.5	2.7	7.2	10.68	4.11	4.08	6.7	4.5	FSW
4		VBMFX	Vanguard Total Bond Market Index	*	*	*	0.8	2.1	4.1	10.16	1.24	5.03	8.8	4.1	fsw
<b>High Yield ("Junk")</b>															
1		NTHSX	Northeast Investors Trust	*	B	*	-3.0	2.9	-1.5	7.20	7.34	9.29	6.0	-	fsw
2		BUFHX	Buffalo High-Yield	B	B	*	-0.3	-1.7	-3.7	9.44	6.95	7.59	6.4	4.2	fsw
3		PRHYX	T. Rowe Price High Yield	B	B	*	-2.6	-3.1	-2.4	6.10	1.72	9.83	7.3	4.2	fsw
4		CMHYX	Columbia High Yield	B	B	*	-2.3	-4.5	-3.4	8.12	-	8.04	6.2	4.3	FSW
5		VWEHX	Vanguard High Yield Corporate	B	B	*	-3.9	-5.5	-6.7	5.64	1.52	9.75	6.5	4.4	fsw
6		SPHIX	Fidelity High Income	B	B	*	-2.7	-6.3	-10.1	7.17	1.28	10.61	5.6	-	Fsw
7		FHYPX	INVESCO High Yield	*	*	*	-2.9	-4.7	-21.7	3.06	1.49	11.27	6.1	3.9	FSW
<b>Zero Coupon</b>															
		BTTRX	Benham 2025	*	*	*	8.9	7.7	8.1	35.61	-	-	-	-	FSW
<b>Tax-Free Alternative</b>															
1		VWITX	Vanguard Muni Bond-Intermed	*	*	*	0.6	4.1	4.5	13.68	1.37	3.38	5.7	-	fsw
2		FLTMX	Fidelity Spartan Intermed Muni	*	*	*	1.1	2.8	3.7	10.21	1.50	3.25	7.9	5.3	Fsw
3		SRIMX	Liberty-SteinRoe Inter. Muni	*	*	*	0.7	3.2	2.9	11.59	1.32	3.63	8.4	6.0	FSW
<b>International</b>															
1		BEGBX	American Century Intl Bond	*	*	*	-0.6	15.1	11.7	11.43	2.57	3.03	-	-	FSW
2		RPIBX	T. Rowe Price Intl Bond	*	*	*	-1.1	13.7	7.7	8.76	2.29	2.89	8.5	6.1	fsw
3		PYGFX	Payden Global Fixed Income	*	*	*	1.4	3.4	5.3	10.12	3.34	3.17	7.6	5.6	fsw
<b>Strategic Income</b>															
1		JAFIX	Janus Flexible Income	*	*	*	1.4	1.4	1.9	9.35	1.42	4.73	8.1	5.3	FSW
2		RPSIX	T. Rowe Price Spectrum Income	*	*	*	-0.1	-0.1	-1.4	10.49	1.16	5.14	-	-	fsw
3		FNMIX	Fidelity New Markets Income	*	*	*	-3.1	-7.8	-6.1	10.34	7.15	8.27	-	-	Fsw

<sup>1</sup>Modified Duration—Average time individual bonds within a fund are actually held.

## ANALYSIS

### Performance Strong, Relatively Speaking

*MONEYLETTER* subscribers are always concerned with our portfolio performance, but the markets' recent volatility has spawned renewed interest. In response to subscriber queries about *MONEYLETTER*'s recent and intermediate-term performance, here's a mid-month update on how we've stacked up against the benchmark.

Although no one can be satisfied with absolute investment returns of late due to the action of the equity markets, *MONEYLETTER* has continued to deliver solid performance on a relative basis. All three of our asset allocation portfolios have outperformed the Vanguard 500 Index Fund, a market proxy, by a wide margin for both the year-to-date and three-year periods. This strong performance can be attributed, in large part, to *MONEYLETTER*'s fund selection system, which has done a nice job of putting subscribers in the right kinds of funds at the right time.

#### *MONEYLETTER* Portfolio Performance

Portfolio/Benchmark	YTD Return	3-Year Return
	8/16/02	8/16/02
ML Conservative	-4.5%	+25.4%
ML Moderate	-4.1%	+13.1%
ML Venturesome	-5.4%	+6.1%
Vanguard 500 Index	-18.3%	-27.5%

### Fund Reopens

Buffalo Small Cap (BUFSX) has re-opened, effective last month. This fund, currently ranked #172 on our Fund Scorecard, was #1 a year ago when small-cap growth was more in favor. Its 1-month, 6-month, and 1-year performance through 8/16/02 is as follows: 0.0%, -22.6%, and -14.7%. For more information call Buffalo at 816-751-5900.

### Reminder

This is a reminder that there will be three weeks between *MONEYLETTER* issues. The next issue will mail on Friday, September 13, 2002. Have a relaxing and safe Labor Day. \$

## MANAGED ACCOUNTS

For information on the "*MONEYLETTER* Managed Account" Program<sup>1</sup>, call Principal Resource Inc. toll-free at (800) 707-2060. Ask about PRI's free, no-obligation portfolio review.

Minimum investment is \$100,000.

<sup>1</sup>As an independent Registered Investment Advisor, Principal Resource Inc. will exercise discretion with regard to asset allocation and fund selection and may make investment decisions for client accounts that differ from recommendations found in *MONEYLETTER*.

## TOP-YIELDING MONEY FUNDS 7

### 100% U.S. TREASURY FUNDS

	7-Day	30-Day	1-Year
Gabelli US Treasury MMF	1.47%	1.47%	2.07%
Vanguard Treasury MMF	1.47	1.49	2.15
Fidelity Spartan US Treas MMF	1.45	1.47	2.05
Amer Century Capital Presv Fund/Inv	1.33	1.34	1.97
T Rowe Price US Treasury MF	1.33	1.35	1.99
CMA Treasury Fund	1.32	1.37	1.77
Dreyfus 100% US Treas MMF	1.25	1.25	1.87
Prudential Govt Sec Tr/US Treas/CI A	1.25	1.28	1.78
Schwab US Treasury Money Fund	1.15	1.16	1.77
DBAB Cash Reserve Treasury	1.13	1.15	1.72

### GENERAL PURPOSE TAXABLE FUNDS

	7-Day	30-Day	1-Year
PayPal Money Market Fund	1.86%	1.89%	-
Touchstone Money Market Fund	1.74	1.77	2.33%
TIAA-CREF Money Market Fund	1.62	1.64	2.21
Flex-fund Money Market Fund	1.61	1.66	2.19
Bunker Hill MMF	1.59	1.42	2.24
Aon Funds/Money Market Fund	1.58	1.59	2.02
McMorgan Principal Preservation Fund	1.57	1.58	2.20
RBB MMP/Sansom Street Class	1.57	1.62	2.27
Transamerica Premier Cash Res/Inv	1.57	1.57	2.21
Scudder Premium Money Mkt Shrs/AARP	1.56	1.57	2.07

### TAX-FREE GENERAL PURPOSE FUNDS

	7-Day	30-Day	1-Year
Strong Tax-Free Money Fund	1.28%	1.34%	1.63%
Vanguard Tax-Exempt MMF	1.28	1.34	1.66
Strong Municipal MMF	1.17	1.24	1.67
Amer Century T-F MMF/Inv Class	1.12	1.16	1.41
Scudder YieldWise Muni MF	1.12	1.16	1.63
USAA Tax Exempt MMF	1.09	1.14	1.49
Dreyfus BASIC Muni MM Portfolio	1.07	1.13	1.45
T Rowe Price Summit Muni MMF	1.07	1.14	1.53
Fidelity Municipal MMF	1.06	1.10	1.48
Scudder Tax-Exempt Money Fund	1.02	1.07	1.43

### TAX-FREE STATE-SPECIFIC FUNDS

	7-Day	30-Day	1-Year
Vanguard OH Tax-Exempt MMF	1.27%	1.33%	1.68%
Vanguard NJ Tax-Exempt MMF	1.12	1.17	1.57
Vanguard NY Tax-Exempt MMF	1.12	1.20	1.55
Vanguard PA Tax-Exempt MMF	1.12	1.20	1.61
Vanguard CA Tax-Exempt MMF	1.11	1.19	1.54
USAA Tax Exempt CA MMF	1.10	1.14	1.45
Fidelity OH Municipal MMF	0.99	1.05	1.43
Fidelity FL Municipal MMF	0.98	1.06	1.40
Fidelity PA Municipal MMF	0.96	1.04	1.40
Fidelity MI Municipal MMF	0.93	0.97	1.28

**Taxable equivalent yield = yield / (1—total effective tax bracket).** Funds are ranked by 7-day yields; 7-day and 30-day yields are compound yields as of 8/13/02. Third column refers to 1-year total return. Criteria for inclusion include: top-yielding unrestricted retail funds only, with minimum initial investment <\$25,000 and assets >\$100 million.

## MONEYLETTER SIGNAL

### iMoneyNet's Money Fund Report Averages (MFA) 7-day yield vs. The Signal

Date	Signal	MFA	Av. Mat.
08/06/02	1.44%	1.27%	55 days
08/13/02	1.43%	1.26%	54 days

*Signal Portfolio Status = 100% in Domestic Stock Funds*

## PIMCO Total Return:

Manager Bill Gross and the rest of the PIMCO team have earned high accolades over the years for their bond fund management, and with good reason. PIMCO's Total Return fund has beaten the Lehman Brothers Aggregate in each of the past seven years, a feat few have succeeded in accomplishing. In fact, as of June 30, the fund's total return of 10.65% ranked it fifth out of 339 Lipper category peers (intermediate-term bond funds). Looking longer term, an 8.91% annualized return since its 1987 inception places it sixth out of 201 funds in existence during the same time frame.

### Telecom stake a drag

The fund is known to underperform for short periods, however, and in June of this year the fund's total return trailed that of its benchmark. The primary culprit? An early move into telecommunications bonds and an underweight of longer maturity bonds, which delivered the best price appreciation in a falling interest rate environment.

Given the huge size of the Total Return fund, (\$53 billion for all of its classes), Gross relies on interest rate and sector bets rather than individual bond selection to contribute to total returns. Most recently, the manager has kept the fund's duration (a measure of interest rate risk) near that of its benchmark—a neutral stance. The fund was also heavily invested in mortgage securities, which contributed positively to recent results.

Yet, its corporate stake, overall, was a drag, primarily because news of potential accounting fraud at WorldCom hurt the fund's telecommunications holdings, including Sprint, AT&T Wireless, Deutsche Telecom, and France Telecom. Gross has been convinced that this sector of the corporate market has been, and is, substantially undervalued. He cites the increasing instances of corporate wrongdoing and the Enron and WorldCom experiences, which plunged markets into extremely oversold conditions. However, he also acknowledges that the fall in telecom bond prices went further than he anticipated.

### Market analysis

Gross relies on PIMCO's long-term macroeconomic outlook combined with an assessment of short-term factors to set the fund's sector selection and duration. Currently, Gross sees the U.S. economy at a major inflection point—poised to shift from a disinflationary environment to a reflationary one. Over the past years, forces

such as globalization of economies, technological innovation, a shrinking government, and central bank tightening have supported lower inflation. But many of those factors are coming to an end.

### Bond Quality and Top Holdings (% of Assets)

AAA	46%	FNMA	7.2%
Government	23	Eurodollar Futures	4.3
A	15	Ubs Financial	3.2
BB	11	Danske	1.5
AA	2	Morgan Stanley	0.7

as of June 30, 2002

PIMCO foresees fiscal and monetary stimulus ahead in an effort to restore corporate pricing power. Increased defense spending is likely in the face of political unrest. The dollar is likely to fall, adding to inflationary pressures. Finally, with inflation rising, interest rates are likely to rise over time.

Still, Gross and PIMCO see only a modest rise in inflation, as other anti-inflationary pressures will hold the rate of inflation to no more than 4% at its cyclical peak. The modest reflation will result in pressure on investment returns—PIMCO is forecasting returns of around 6% for bonds and a bit less for stocks over the next three-to-five years.

### Strategy

So what is Gross' strategy? He aims to limit price risk and look for bonds that offer extra yield with a margin of safety. He is looking to corporate bonds to offer a yield premium over Treasuries, but will focus on stable credits with strong business models and accounting practices. He will maintain portfolio duration near the benchmark. Mortgages and high-quality emerging market bonds will also be emphasized to add yield to the portfolio. Issues from developed non-U.S. nations also present an attractive opportunity.

PIMCO Total Return is available in a number of classes. The Class D shares are available with no transaction fee at the usual discount brokers. \$

*PIMCO Total Return (PTTDX)*  
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*Stamford, CT 06902, (888) 877-4626*  
*Minimum investment: \$2,500/\$1,000 IRA*

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