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Mr. Gross' Telescope

“Stocks stink” – *Bill Gross, September 2002*

by *Walter S. Frank, Chief Investment Officer*

Bill Gross, the by-now guru-like bond fund manager for Pimco Funds, startled the investment community a few days ago when he wrote a piece called “Dow 5,000.” (The essay can be found at the Pimco Funds website, www.pimcofunds.com.)

The immediate reaction was to believe that Mr. Gross was predicting that the current bear market was going to take the Dow to 5,000, at which point the Dow would be “fairly valued”. Gross got to the number by calculating that at 5,000 the Dow would yield close to 3.5%. That yield represents “fair value” to Mr. Gross. But what Gross means by “fair value” (our words, not his) is different than you would expect. (More on that later).

At first glance it would seem that this is simply a bond market guru's skewed approach to the stock market. Why choose yield as a valuation yardstick? The market's yield no longer plays an important part in any current discussion of “fair value”. Bond yields (usually Treasuries), price-earnings ratios, earnings estimates, inflation rates are the stuff from which the rest of us calculate “fair value”.

But if you simply dismissed Gross' thoughts on this basis (“what makes a 3.5% yield so special?”) you would be missing the essence of his elaborate argument. And if you think he was forecasting the Dow over the next six months, you would also be missing the point.

In effect, Gross is not making any prediction at all about the stock market over the near- or intermediate-term. (He doesn't make that clear.)

To take a step back, Gross' thinking on the subject of stock market valuation is based on two recent publications (as he graciously acknowledges). One is a book by Dimson, Marsh and Staunton, *The Triumph of the Optimists*. The book is a monumental 101-year survey of investment returns. The other publication is an essay by Arnott and Bernstein in the March/April 2002 issue of the *Financial Analysts Journal*. The essay looks at the long-term outlook for stocks relative to bonds. Arnott and Bernstein go back over 100 years of returns and carefully disentangle the various forces that provided stocks with their superior returns over bonds during that period. They then see what that implies for the future.

For us, the operative word in all of this is long-term. Arnott & Bernstein come up with the conclusion that given where stocks are now (particularly their dividend yield), we can't expect stocks to outperform bonds in the future without a decline in the stock market.

Here is where Gross steps in. What he is saying, (assuming Arnott & Bernstein's analysis stands up) is that stocks have to go down in order to outperform bonds over the long-run. Nothing is implied by their work that stocks have to go down today. Nothing in their analysis refers to the fact that earnings today are at recession-type lows. Nothing in their conclusion refers to today's extraordinarily low Treasury rates or the outlook for inflation. Nothing says that today's short-run valuation models are useless.

It may well be that over the next 50-100 years stocks will not outperform bonds. Or that there will be extended periods when stocks stagnate, while bonds continue providing their returns. This year bonds are trouncing stocks.

But none of this tells us anything about the outlook for stocks over the next year, or over the next phase of the business cycle. If the economy finally starts picking up speed (and it will), can anyone doubt that stocks will outperform bonds during the upswing of the profit recovery? And this holds from current levels, not from Dow 5,000.

For anyone who moves his allocation around as the outlook for the various asset classes change, Bill Gross' argument is irrelevant. It may well be that over the decades ahead, bonds will be the asset class of choice most of the time. *Mr. Gross may be right*. His telescope may allow him to see far into the distant future. But for most of us it is what is at our feet that counts.

Market Trends

	Trailing 12-Mo Trend	Forward 6-Mo Estimate
Economy	Higher	Higher
Interest Rates	Lower	Flat
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

High-Yield Stirring

The high-yield (“junk”) bond market has come to life in recent weeks after a very rocky period in the spring and early summer. The funds started off the year promisingly, and it appeared that this year our portfolios would be able to reap the high returns that the funds were offering. But then came the accounting scandals. The scandals were bad enough in themselves for stocks and corporate bonds. But, in the event, it turned out that more than one of the companies involved were heavy issuers of high-yield bonds, World Com, for example. Shooting first and asking questions afterward, investors fled the high-yield market and the funds all moved into the red (“total return”) despite their high dividends.

In fact, “the period from May through July of this year is now the worst three-month period on record for the high-yield debt market,” writes Ben Warwick, a contributor to Real Money.com. “The Merrill Lynch High Yield Bond Index was off by more than 12% over that span,” he continued.

For about a month, though, the tide has turned, enough so that one of our portfolio high-yield funds, Buffalo High-Yield, moved into the black. We have been wondering what is happening. To find out, we spoke to Jeff Rippey, co-portfolio manager of the Columbia High-Yield Fund.

Back into the water

The first thing Rippey emphasized is that the selling had been overdone. The selling hit the entire high-yield market, but it was especially fierce for the telecomm sector or anything even remotely related to that sector. Now, says Rippey, “Telecomm is acting a little better.” That helps since telecomm remains an important, if highly speculative, component of the high-yield bond market.

The second thing he mentioned is that money is flowing back into the market, and this means into the high-yield funds. High-yield bond funds are important players in the high-yield market. When money flows into the funds, the high-yield market performs, when money doesn’t flow, that market has trouble.

When asked about his own fund, Rippey replied that “the flows have been big over the past four weeks.” In fact, he intimated that it has been challenging to put all the money to work. He also added that flows have been steady into his fund all year.

Why have the flows been growing? The answer appears obvious. It is all part of the great hunt for yields that is now going on, and the highest yields now are coming from the high-yield market. It is certainly not unrelated that as Treasury yields have come down into the 4% (and below) range, bond gurus, such as Bill Gross, mention higher risk bonds, such as emerging market and high-yield, as worth considering.

Along these lines, Rippey pointed out that as Treasury yields have dropped sharply, high-yield yields have not. The result is the differential in yields is now about 920 basis points (9.20%). This is huge. “The difference is now higher than last September, and is close to an all-time high,” according to Rippey.

No sure thing

We don’t have to remind any of our readers who have followed our portfolio advice that there is risk in high-yield bonds. We lived through the spring selling hurricane with the bonds in our portfolios.

As a good, cautious portfolio manager, Rippey mentioned that the recent short-term indicators for his market have been mixed. The default rates for high-yield bonds have not come down as rapidly as he expected. Since we spoke the latest monthly default rate has come down some. Another indicator he watches, the percentage of issuers at distressed levels, has gone down.

In the end, the key factor for the high-yield market is whether the economy dips into another recession. We think the odds of that are extremely low. In fact we see corporate cash flow growing, as the economy recovers, which will be positive for the high-yield market.

We went into the high-yield bond market over eighteen months ago as an alternative reserve to money funds. We would have done better in money funds. But we believe the story will be different over the next eighteen months. \$

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Next Issue: Volume 23, No. 19

Mails: October 11, 2002
Internet: October 9, 2002, 12:00pm (ET)

Gloom, Gloom, Gloom

The last two weeks have been brutal ones for the stock market. Wall Street points to the economic news, profit estimates and Iraq as the causes. Certainly Wall Street can conjure up any number of reasons why stocks should be falling.

The concerns are real and we are not attempting to minimize them. We are particularly disturbed by the profit estimates. Thomson First Call has reported analysts have been cutting their earnings estimates for this quarter for some months, and the result is, as The Wall Street Journal reported, the estimates went from a 20.7% increase in April to 8.5% now. And estimates for the next quarter are also being cut.

This is not good news, to say the least, and stocks are being punished for it. These disappointing profit estimates are, obviously, a reflection of the disappointingly sluggish economy. Notice, we said sluggish, not declining, not double-dipping. Wall Street has a way of reading the economy from the performance of the market. For Wall Street, then, nothing good is coming out of the economy.

Certainly, what little we know about this month's activity has tilted toward even more sluggishness. Weekly unemployment claims have moved up. Reports and surveys tell us that store sales are O.K., but only O.K. It's not a picture of the expanding economy we expected would be in place by now.

What is happening, though, is that Wall Street's gloom has covered everything. There was the Philadelphia Fed survey showing that after a dip in August its business index had turned positive again. We see this report as sort of the canary in the coal mine. It was the Philly survey that first told us the economy had hit a speed bump in July. The new Philly survey did not make a dent on the market.

GM reports that while auto sales will be down from last month, they remain strong. The worries about the consumer appear overdone. None of this means that the economy is about to take-off. It does mean the recovery is continuing and that profits are increasing.

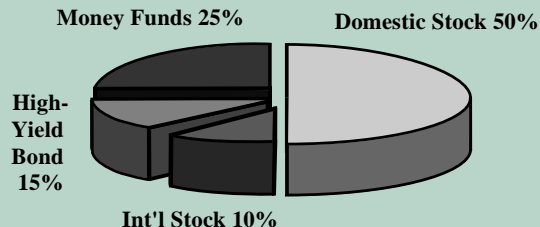
Meanwhile the market has come down sharply this month. It has come down enough, that even with the lowered profit estimates, the S&P is selling at 15.5 times the estimate of profits over the next twelve months. Looking at today's yield for the 10-year Treasury, the stock market is well undervalued. In time, the stock market will respond.

Portfolio changes

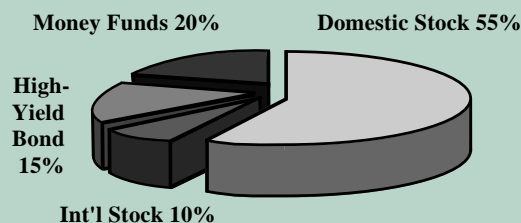
The Hotline of Tuesday, September 3, recommended the sale of Vanguard Small Cap Value Index in all three Vanguard family portfolios, to be replaced by Vanguard Convertible Securities. Here are the details as of Wednesday, September 4.

Vanguard Venturesome: Sell 2,054 shares of Vanguard Small Cap Value Index @ \$8.88 per share. Buy 1,801 shares of Vanguard Convertible Securities @ \$10.13 per share. Vanguard Moderate: Sell 1,874 shares of Vanguard Small Cap Value Index. Buy 1,643 shares of Vanguard Convertible Securities. Vanguard Conservative: Sell 1,260 shares of Vanguard Small Cap Value Index. Buy 1,105 shares of Vanguard Convertible Securities.

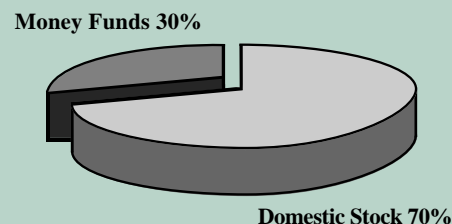
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Domestic Stock Funds

RANK	9/20 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	-	-	-	HSGFX	Hussman Strategic Growth	MCGro	(H)	(H)	(H)	-1.0%	8.2%	21.3%	\$13.82	-	-	fsw
2	1	23	23	YACKX	Yacktman Fund	MC	B	B	B	-5.9	-2.3	20.0	11.40	18.2	0.55	FSW
3	14	47	47	AVALX	Aegis Value Fund	SCVal	B	B	B	-2.8	-6.6	10.2	12.63	18.2	0.31	fw
4	12	25	25	ARGFX	Ariel Fund	SCVal	B	B	B	-2.4	-9.8	15.0	35.98	18.9	0.40	FSW
5	4	26	26	EEQFX	Eclipse Small Cap Value	SCVal	B	B	B	-7.1	-9.0	17.0	11.73	18.6	0.75	FSW
6	5	32	32	RSPFX	RS Partners	SC	*	B	B	-3.3	-11.3	10.4	16.71	-	0.59	FSW
7	3	61	61	VUSVX	Vontobel U.S. Value (2%r<90d)	LCVal	B	B	B	-7.7	-9.2	10.5	18.92	22.0	0.44	FsW
8	69	1	1	CGMFX	CGM Focus	SCVal	*	H	H	-3.4	-19.2	28.9	19.28	55.1	0.02	fsw
9	9	70	70	PRWXC	T. Rowe Price Cap Appreciation	LCVal	B	B	B	-3.5	-9.4	3.8	14.18	10.7	0.24	fsw
10	11	24	24	RYTRX	Royce Total Return (1%r<180d)	SCVal	B	B	B	-4.4	-12.3	11.7	8.08	13.6	0.41	FSW
11	10	29	29	NBGNX	Neuberger Berman Genesis (closed)	SC	B	B	B	-4.9	-12.8	11.8	18.93	19.6	0.62	fsw
12	39	14	14	BSCFX	Baron Small Cap	SCGro	(B)	(B)	(B)	-3.8	-15.4	14.3	13.78	28.0	1.07	FSW
13	113	189	189	VCVFX	Vanguard Convertible Securities	Convrt	B	B	B	-0.2	-10.1	-5.6	10.15	20.4	0.69	fsw
14	18	34	34	BGRFX	Baron Growth	SCGro	B	B	B	-5.0	-14.2	11.3	27.06	25.4	1.06	FSW
15	29	110	110	FCNTX	Fidelity Contrafund (3%)	LCGro	B	B	B	-4.1	-11.9	1.9	38.69	20.1	0.84	fsw
16	19	15	15	PRSVX	T. Rowe Price S-C Value (closed,1%r<1yr)	SCVal	B	B	B	-6.4	-15.5	11.0	20.84	16.4	0.44	fsw
17	23	33	33	RYPRX	Royce Premier (1%r<180d)	SC	B	B	B	-4.5	-15.4	7.3	9.36	18.7	0.62	fs
18	6	21	21	FLPSX	Fidelity L P Stock (closed,3%&1.5%r<90)	SCVal	B	B	B	-8.0	-14.5	10.0	24.37	16.6	0.57	fsw
19	13	6	6	BERWX	Berwyn Fund (1%r<180d)	SCVal	B	B	B	-5.7	-16.4	10.0	18.23	18.7	0.41	fsw
20	15	77	77	TWEIX	American Century Equity Income	MCVal	(B)	(B)	(B)	-5.4	-13.5	1.7	6.32	15.1	0.44	FSW
21	42	18	18	NBFSX	Neuberger Berman Fasciano Inv	SCGro	(B)	(B)	(B)	-3.8	-17.8	9.2	30.33	15.7	0.67	FSW
22	67	95	95	MFOCX	Marsico Focus	LCGro	H	H	H	-4.7	-16.3	4.4	11.87	31.5	1.12	FSW
23	74	108	108	MUTHX	Mutual Shares (1%) CIZ	MCVal	H	H	H	-4.4	-13.9	-2.8	16.83	16.6	0.62	sw
24	96	17	17	PENNX	Royce Penn Mutual+ (1%r<180d)	SCVal	H	H	H	-3.7	-18.5	5.5	6.46	16.7	0.51	fsw
25	85	104	104	BEGRX	Mutual Beacon (1%) CIZ	MCVal	H	H	H	-4.5	-14.6	-3.5	11.34	15.9	0.58	sw
26	24	40	40	LLPFX	Longleaf Partners	MCVal	H	H	H	-7.2	-17.6	7.1	21.57	20.1	0.58	fsw
27	53	51	51	FDSCX	Fidelity Small Cap Ind.(1.5%r<90d)	SC	*	H	H	-3.9	-18.3	3.8	13.84	22.8	0.83	fsw
28	111	107	107	MGRIX	Marsico Growth & Income	G&I	H	H	H	-4.8	-17.2	2.4	12.08	29.7	1.08	FSW
29	2	59	59	CFIMX	Clipper Fund	LCVal	B	B	B	-10.8	-13.9	1.9	76.00	15.7	0.30	sw
30	22	31	31	CAAPX	Ariel Appreciation	MCVal	B	B	B	-6.7	-18.8	8.2	32.69	18.0	0.50	FSW
31	21	83	83	FFTYX	Fidelity Fifty+ (.75%r<30d)	LC	B	B	B	-6.7	-14.4	-4.5	15.00	28.2	0.87	Fsw
32	137	79	79	FCVFX	Fidelity Convertible Securities	Convrt	H	H	H	-2.2	-17.8	-2.8	15.74	27.4	0.89	Fsw
33	20	19	19	TRMCX	T.Rowe Price Mid Cap Value	MCVal	B	B	B	-6.8	-19.4	7.9	14.43	15.9	0.60	fsw
34	101	16	16	HRTVX	Heartland Value (1%r<90d)	SCVal	H	H	H	-5.0	-19.2	3.6	31.09	22.5	0.63	FsW
35	86	93	93	MQIFX	Mutual Qualified (1%) CIZ	MCVal	H	H	H	-5.3	-15.9	-4.3	14.05	16.9	0.61	sw
36	25	58	58	PRNEX	T. Rowe Price New Era	LC	B	B	B	-5.4	-18.4	1.4	19.85	26.7	0.72	fsw
37	26	74	74	DODGX	Dodge & Cox Stock	LCVal	H	H	H	-5.8	-18.0	0.9	85.61	19.8	0.64	sw
38	33	73	73	DNLDX	Dreyfus New Leaders	MCGro	H	H	H	-7.2	-17.5	1.3	33.71	25.2	0.92	FSW
39	38	68	68	STDIX	Strong Discovery+	MCGro	H	H	H	-6.5	-18.9	3.4	13.83	25.1	0.83	FSW
40	40	2	2	BPSCX	Boston Ptrns Smlcap Val (closed,1%r<1yr)	SCVal	H	H	H	-5.7	-20.0	4.6	14.81	-	0.52	FSW
41	27	75	75	HOVLX	Homestead Value	MCVal	H	H	H	-6.3	-18.0	0.3	21.69	18.1	0.59	
42	32	12	12	CRIMX	CRM Mid Cap Value Ins	MCVal	H	H	H	-6.0	-21.7	7.8	15.23	-	-	
43	34	231	231	CRMMX	CRM Mid Cap Value Inv	MCVal	H	H	H	-6.0	-21.8	7.6	15.15	-	-	FSW
44	45	111	111	SAOPX	Salomon Brothers Opportunity	LCVal	H	H	H	-7.4	-17.5	-1.2	38.97	16.5	0.58	sw
45	73	54	54	BARAX	Baron Asset	MCGro	H	H	H	-7.7	-21.4	8.3	36.54	28.1	1.22	FSW
46	97	185	185	SRFBX	Liberty-SteinRoe Balanced	G&I	H	H	H	-5.8	-16.1	-8.8	20.42	12.3	0.61	FSW
47	-	-	-	VSEQX	Vanguard Strategic Equity	MCGro	H	H	H	-8.1	-19.0	1.1	12.79	17.2	0.82	fsw
48	52	35	35	BEMVX	Berger Mid Cap Value	MCVal	H	H	H	-7.3	-20.9	4.6	14.08	23.3	0.80	FSW
49	134	218	218	TWCVX	American Century Vista	MCGro	*	H	H	-5.0	-16.9	-9.5	9.24	52.3	1.17	FSW
50	30	85	85	BVALX	Babson Value	LCVal	H	H	H	-8.2	-18.6	-1.0	36.62	20.6	0.70	FSW
51	17	46	46	LLSCX	Longleaf Partners Smallcap (closed)	SCVal	H	H	H	-10.1	-17.9	-0.1	19.78	17.0	0.45	fsw
52	37	72	72	TWVLX	American Century Value	MCVal	H	H	H	-7.3	-19.4	-0.5	5.82	20.4	0.59	FSW
53	193	135	135	ACBGX	Bonnel Growth Fund (.25%r<30d)	MCGro	H	H	H	-2.7	-20.6	-4.8	11.28	43.9	1.10	fsw
54	93	67	67	KAUFX	Federated Kaufmann Fund+ (0.2%)	MCGro	H	H	H	-5.4	-19.4	-3.6	3.48	33.5	0.86	FSW
55	43	39	39	LSSCX	Loomis Sayles Small Cap Value	SC	H	H	H	-7.8	-20.6	2.4	17.47	19.4	0.69	sW
56	28	-	-	SMCDX	Strong Mid Cap Disciplined	MCVal	H	H	H	-7.2	-22.2	5.3	14.43	23.4	0.92	FSW
57	7	27	27	LMASX	Legg Mason Special Investment Trust	MC	(H)	(H)	(H)	-9.7	-22.0	8.5	26.60	30.6	1.18	w
58	64	30	30	MERDX	Meridian Fund	SCGro	H	H	H	-9.1	-20.4	2.9	23.20	21.4	0.77	fsw
59	63	48	48	WPSRX	Westport Small Cap R	SCVal	H	H	H	-4.8	-21.1	-2.4	15.72	-	-	FSW
60	109	13	13	CRMSX	CRM Small Cap Value Inv	SCVal	S	S	S	-5.6	-22.7	2.0	17.15	-	-	FSW
61	55	43	43	BOGLX	Bogle Small Cap Growth (closed)	SCGro	H	H	H	-8.6	-21.1	2.4	16.58	-	-	
62	87	91	91	SRFCX	Liberty-SteinRoe Capital Opp	MCGro	S	S	S	-6.0	-22.8	2.5	17.08	35.2	1.26	FSW
63	31	41	41	FIDLX	Fidelity Value	MCVal	H	H	H	-8.5	-20.8	1.0	44.10	22.8	0.64	Fsw
64	157	7	7	RYLPX	Royce Low Priced Stock (1%r<180d)	SCVal	S	S	S	-4.6	-25.0	5.1	9.29	24.8	0.69	FSW
65	83	38	38	OTCFX	T. Rowe Price Small Cap Stock Fund+	SC	H	H	H	-7.3	-21.9	0.9	20.45	22.0	0.73	fsw
66	130	-	-	WBSNX	WmBlair S-C Growth N (1%r<60d)	SCGro	S	S	S	-6.5	-23.6	3.3	12.57	-	0.95	FSW
67	60	116	116	NICSX	Nicholas Fund	LC	S	S	S	-7.3	-20.2	-4.7	42.98	18.4	0.90	w
68	102	88	88	GABAX	Gabelli Asset	MC	S	S	S	-5.5	-21.0	-5.7	26.98	17.2	0.76	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

5

Domestic Stock Funds (cont.)

RANK	9/20 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	
69	123	55	FMLIX	Fidelity New Millennium (3%) (closed)	MCGro	S	S	S	-7.4	-22.9	1.9	20.98	59.0	1.67	fsw	
70	92	64	MPSCX	MSI Small Cap Value (closed)	SCVal	S	S	S	-6.4	-21.3	-3.6	14.23	25.5	0.77	fsw	
71	41	49	VIMSX	Vanguard Mid-Cap Index+	MC	H	H	H	-8.3	-22.3	1.5	9.64	26.2	1.02	fsw	
72	48	100	NCTWX	Nicholas II	MCVal	S	S	S	-7.6	-20.9	-4.0	15.48	21.3	1.00	w	
73	44	50	PESPX	Dreyfus Mid Cap Index	MCGro	S	S	S	-8.3	-22.5	1.0	17.23	25.8	1.02	FSW	
74	80	9	VISVX	Vanguard Small-Cap Value Index	SCVal	S	S	S	-8.3	-23.8	4.1	8.32	-	0.70	fsw	
75	71	143	FDEQX	Fidelity Disciplined Equity	LC	S	S	S	-7.3	-20.3	-6.5	17.82	19.7	0.94	Fsw	
76	89	62	VEXMX	Vanguard Extended Market Index	MC	S	S	S	-6.8	-22.4	-2.0	18.13	31.4	1.17	fsw	
77	16	76	OAKMX	Oakmark Fund	MCVal	(H)	(H)	(H)	-9.7	-20.2	-3.8	29.46	20.6	0.59	FSW	
78	84	5	IZZYX	ICM/Isabelle Small Cap Value	SCVal	S	S	S	-9.0	-23.2	2.7	9.97	26.5	0.67	FSW	
79	79	-	TASCX	Third Avenue Small-Cap Value	SCVal	(S)	(S)	(S)	-9.1	-20.2	-4.8	12.86	17.5	0.58	FSW	
80	47	114	TWEBX	Tweedy, Browne American Value	MCVal	S	S	S	-8.7	-20.1	-6.5	19.27	15.2	0.51	fsw	
81	8	87	OAKLX	Oakmark Select (closed) (2%r<90d)	MCVal	(H)	(H)	(H)	-11.4	-18.8	-5.9	22.77	26.2	0.83	FSW	
82	59	137	SLASX	Selected American Shares	LCVal	S	S	S	-9.0	-20.6	-6.4	24.44	20.5	0.92	sW	
83	98	140	TWHIX	American Century Heritage	MCGro	S	S	S	-6.7	-21.6	-8.0	8.84	32.1	0.98	FSW	
84	132	172	CLSPX	Columbia Special+	MCGro	*	S	S	-6.2	-21.8	-8.5	14.92	37.1	0.97	FSW	
85	62	22	BPMCX	Boston Partners Mid Cap Value	MCVal	S	S	S	-8.1	-24.5	0.4	8.93	18.3	0.76	FSW	
86	151	224	JAVLX	Janus Twenty (closed)	LCGro	S	S	S	-5.6	-20.9	-12.5	29.08	38.1	1.43	FSW	
87	50	102	PRFDX	T. Rowe Price Equity-Income	LCVal	S	S	S	-8.1	-21.7	-6.8	19.24	16.7	0.53	fsw	
88	-	-	VUVLX	Vanguard U.S. Value	LCVal	S	S	S	-8.4	-22.4	-5.1	9.33	-	-	fsw	
89	70	179	FGRIX	Fidelity Growth & Income (3%)	G&I	S	S	S	-8.0	-20.8	-10.1	29.77	16.7	0.80	fsw	
90	90	152	TWCUX	American Century Ultra+	LCGro	S	S	S	-8.4	-23.0	-6.9	21.20	28.7	1.28	FSW	
91	195	186	USAUX	USAA Aggressive Growth	MCGro	*	S	S	-4.4	-24.2	-10.7	20.46	57.2	1.68	w	
92	145	-	TAVFX	Third Avenue Value	MCVal	S	S	S	-7.9	-23.5	-8.0	29.29	16.0	0.61	FSW	
93	148	45	NAESX	Vanguard SmallCap Index+	SC	S	S	S	-7.6	-25.5	-3.5	15.13	26.7	0.87	fsw	
94	82	122	FEQTX	Fidelity Equity-Income II	G&I	S	S	S	-8.9	-23.1	-8.1	16.30	17.2	0.74	Fsw	
95	197	228	SGRTX	Strong Growth 20+	LCGro	*	S	S	-6.3	-21.6	-15.9	10.52	47.6	1.23	FSW	
96	36	125	VWNFX	Vanguard Windsor II	LCVal	H	H	H	-9.0	-22.1	-10.8	20.56	18.5	0.65	fsw	
97	35	180	PFVLX	Preferred Value	LCVal	S	S	S	-10.1	-21.9	-9.9	14.65	19.5	0.79	w	
98	88	37	WAAEX	Wasatch Small Cap Grth+(closed,2%r<60d)	SCGro	S	S	S	-9.1	-25.3	-2.9	24.04	37.8	1.15	FSW	
101	51	117	VEIPX	Vanguard Equity-Income	LCVal	H	H	H	-8.7	-22.6	-10.8	18.08	16.0	0.55	fsw	
217	209	148	VHCOX	Vanguard Cap Opp (\$25,000&1%r<5yr)	MCGro	H	H	H	-9.9	-33.0	-17.6	15.52	38.1	1.06	fsw	

Dow Jones
NASDAQ
S&P 500

-10.0% -24.0% -4.7%
-11.3 -33.4 -17.0
-9.8 -26.6 -14.1

indexes do not
include dividends

International Stock Funds

1	1	-	MACSX	Matthews Asia Growth&Income (2%r<90d)	Pacific	B	B	B	-0.8%	0.7%	29.3%	\$10.60	14.4	-	FSW
2	11	7	PRASX	T. Rowe Price New Asia	Pacific	*	B	B	-7.5	-15.0	24.5	5.80	33.6	-	fsw
3	19	-	DRFMX	Dreyfus Emerging Market (1%r)	intl	*	(B)	(B)	-5.3	-15.1	18.1	10.78	21.8	-	FSW
4	2	58	MJFOX	Matthews Japan Fund (2%r<90d)	Japan	*	H	H	-4.4	-5.1	-9.3	9.18	-	-	FSW
5	4	47	VNEPX	Vontobel International Equity (2%r<90d)	Int'l	B	B	B	-6.3	-8.1	0.5	11.70	21.1	-	FSW
6	5	22	BJBIX	Julius Baer Intl. Equity A	Int'l	B	B	B	-4.4	-11.5	3.7	19.32	28.8	-	FS
7	14	8	SCOPX	Scudder Pacific Opportunity (2%r<1yr)	Pacific	*	B	B	-8.3	-16.2	20.4	8.15	33.5	-	FSW
8	9	1	FSEAX	Fidelity SE Asia (3%&1.5%r<90d)	Pacific	*	B	B	-8.5	-18.4	25.9	10.31	38.5	-	fsw
9	20	6	MAPTX	Matthews Pacific Tiger (2%r<90d)	Pacific	(B)	(B)	(B)	-8.1	-17.2	21.0	8.00	47.1	-	FSW
10	16	54	VPACX	Vanguard Pacific Stock Index	Pacific	*	H	H	-4.2	-9.2	-6.6	6.22	24.7	-	fsw
11	12	57	FJPNX	Fidelity Japan (3%&1.5%r<90d)	Japan	*	H	H	-4.0	-8.7	-8.5	8.62	34.8	-	Fsw
12	15	23	FPBFX	Fidelity Pacific Basin (3%&1.5%r<90d)	Pacific	*	H	H	-5.4	-12.8	3.3	13.12	30.0	-	Fsw
13	39	26	ICHKX	Investec China & Hong Kong	Pacific	*	H	H	-7.4	-14.5	7.3	10.08	39.2	-	FSW
14	6	12	OAKEX	Oakmark Intl Small Cap (closed,2%r<90d)	Int'l	(H)	(H)	(H)	-7.7	-16.8	12.1	10.62	25.6	-	FSW
15	26	2	FEMKX	Fidelity Emerging Mkts (3%&1.5%r<90d)	Int'l	(B)	(B)	(B)	-7.1	-19.0	15.1	7.05	32.9	-	fsw
16	17	16	PFIFX	Preferred International	Int'l	H	H	H	-7.6	-14.7	3.6	10.36	17.4	-	w
17	45	3	MNEMX	Montgomery Emerging Mkts (closed)	Int'l	*	H	H	-5.5	-19.3	11.4	7.60	31.6	-	FSW
18	44	5	VEIEX	Vanguard Emerg. Mkts Stk Index (0.5%r)	Int'l	*	H	H	-6.1	-19.8	12.4	7.38	32.3	-	fsw
19	3	4	OAKGX	Oakmark Global (2%r<90d)	Global	(H)	(H)	(H)	-7.7	-19.5	13.8	11.72	-	-	FSW
20	24	55	SJPNX	Japan Fund (Scudder) (2%r<180d)	Japan	*	H	H	-4.7	-10.5	-13.7	6.28	31.4	-	FSW
21	21	59	PRJPX	T. Rowe Price Japan	Japan	*	H	H	-4.7	-11.0	-13.6	5.52	28.6	-	s
22	18	25	FDIVX	Fidelity Diversified Inter'l (1%r<30d)	Int'l	H	H	H	-7.2	-15.4	-1.7	16.62	20.4	-	Fsw
23	23	13	OAKIX	Oakmark International (2%r<90d)	Int'l	H	H	H	-6.0	-20.1	4.7	12.82	24.3	-	FSW
24	13	21	USIFX	USAA International	Int'l	H	H	H	-7.4	-17.1	-1.7	14.48	18.1	-	fw
25	10	19	FIGRX	Fidelity International G & I 0	Int'l	(H)	(H)	(H)	-8.8	-17.2	0.3	16.33	22.0	-	Fsw
26	7	15	HAINX	Harbor International	Int'l	(H)	(H)	(H)	-8.3	-18.4	1.8	25.76	17.8	-	sw
27	8	-	FIVFX	Fidelity Aggressive Intl. (1%r<30d)	intl	H	H	H	-8.5	-21.8	8.5	10.40	25.6	-	Fsw
28	31	18	TBGVX	Tweedy, Browne Global Value	Global	S	S	S	-6.4	-18.4	-4.2	16.07	14.6	-	fsw
29	54	50	PRIDX	TR Price Intl Discovery (closed,2%r<1yr)	Int'l	S	S	S	-5.1	-18.1	-9.9	15.58	37.1	-	fsw
30	36	-	GRGRX	Gabelli Intl. Growth	intl	H	H	H	-6.8	-18.8	-6.2	11.46	21.0	-	FSW
31	27	38	CMISX	Columbia International Stock	Int'l	S	S	S	-9.1	-18.2	-7.1	9.98	22.2	-	fsw
32	35	44	TWGGX	American Century Global Growth	Global	H	H	H	-7.4	-19.0	-8.0	5.15	-	-	FSW
33	-	-	VTRIX	Vanguard Intl. Value	int'l	S	S	S	-10.0	-20.7	-2.8	18.45	15.9	-	fsw
34	33	28	USAWX	USAA World Growth	Int'l	S	S	S	-6.8	-21.3	-6.2	11.69	20.0	-	f
38	29	29	VWIGX	Vanguard International Growth	Int'l	H	H	H	-10.2	-21.8	-6.3	11.84	17.6	-	fsw

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FUND SCORECARD & RECOMMENDATIONS

Specialty Funds

RANK	9/20 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	-	-	-	BGEIX	Amer. Cent. Global Gold (1%r<60d)	Gold	*	*	*	20.6%	29.9%	64.6%	\$8.67	45.30	0.69	fsw
2	-	-	-	USERX	U.S.Global Gold Shares (.25%r<30d)	Gold	*	*	*	20.4	25.4	74.0	4.89	36.40	0.69	sw
3	-	-	-	USAGX	USAA Precious Metals & Minerals	Gold	*	*	*	16.3	23.7	62.4	10.43	46.80	0.87	w
4	-	-	-	FSAGX	Fidelity Sel Gold (3%&.75%r<30d)	Gold	*	*	*	18.2	22.4	61.2	22.56	49.20	0.89	fsw
5	-	-	-	SCGDG	Scudder Gold	Gold	*	*	*	16.6	27.7	48.6	10.56	36.70	0.74	FSW
6	-	-	-	FGLDX	INVESCO Gold (3%)	Gold	*	*	*	14.5	24.9	50.0	2.61	39.20	0.72	FSW
7	-	-	-	VGPMX	Vanguard Precious Metals (closed,1%r<1yr)	Gold	*	*	*	10.7	6.2	33.7	10.77	43.10	0.87	fsw
8	-	-	-	STMDX	Stratton Mthly Div REIT (1.5%r<120d)	RealEs	*	*	*	0.7	0.9	26.7	27.40	14.50	0.21	fsw
9	-	-	-	CSRSX	Cohen & Steers Realty Shares (1%r<180d)	RealEs	*	*	*	1.9	-0.8	14.8	45.05	16.20	0.25	FSW
10	-	-	-	VGSIX	Vanguard Special REIT Index (1%r<1yr)	RealEs	*	*	*	0.9	-1.4	15.3	12.52	14.40	0.17	fsw
11	-	-	-	FRESX	Fidelity Real Est Investment (.75%r<90d)	RealEs	*	*	*	0.4	-0.8	14.1	18.92	15.10	0.21	Fsw
12	-	-	-	CGMRX	CGM Realty	RealEs	*	*	*	-2.4	-5.1	19.8	14.15	15.80	0.26	fsw
13	-	-	-	RSCOX	RS Contrarian	Altern	*	*	*	-6.4	-3.5	5.2	9.75	23.50	0.72	FSW
14	-	-	-	MERFX	Merger Fund	Altern	*	*	*	1.7	-7.7	-5.2	13.53	5.42	0.13	FSW
15	-	-	-	GATEX	Gateway Fund	Altern	*	*	*	-4.7	-12.4	-4.6	19.51	7.00	0.32	FSW
16	-	-	-	VGENX	Vanguard Sp Energy (1%r<1yr)	Energy	*	*	*	-6.8	-17.6	5.8	23.03	32.00	0.70	fsw
17	-	-	-	FSTEX	INVESCO Energy	Energy	*	*	*	-5.8	-18.5	0.7	15.40	46.20	0.90	FSW
18	-	-	-	FHLSX	INVESCO Strategic Health Science	Health	*	*	*	-2.2	-18.3	-13.4	39.29	36.50	0.43	FSW
19	-	-	-	VGHGX	Vanguard Sp Health Care (\$25k&1%r<5yr)	Health	*	*	*	-6.9	-17.9	-8.7	98.46	19.10	0.47	fsw
20	-	-	-	FSPHX	Fidelity Sel Health Care (3%&.75%r<30d)	Health	*	*	*	-4.0	-17.8	-15.4	98.68	20.00	0.40	fsw
21	-	-	-	FIDSX	Fidelity Sel Fin'l Serv (3%&.75%r<30d)	FinServ	*	*	*	-10.9	-20.0	-2.0	84.12	27.40	0.94	fsw
22	-	-	-	FSFSX	INVESCO Financial Serv	FinServ	*	*	*	-10.8	-21.7	-3.9	22.01	26.90	0.93	FSW
23	-	-	-	FSENX	Fidelity Sel Energy (3%&.75%r<30d)	Energy	*	*	*	-7.3	-22.6	-8.6	19.34	33.40	0.78	fsw
24	-	-	-	RYHIX	Rydex Health Care	Health	*	*	*	-6.1	-21.8	-16.9	8.91	19.60	0.41	fsw
25	-	-	-	RYFHX	Rydex Financial Services	FinServ	*	*	*	-13.2	-23.6	-5.4	7.82	28.80	1.05	fsw
26	-	-	-	RYEIX	Rydex Energy	Energy	*	*	*	-7.2	-26.1	-13.3	8.28	27.50	0.64	fsw
27	-	-	-	FSTUX	INVESCO Utilities	Utility	*	*	*	-7.5	-23.3	-28.8	8.08	17.60	0.57	FSW
28	-	-	-	VGSUX	Vanguard Utilities Income	Utility	*	*	*	-10.2	-24.5	-23.1	8.94	14.30	0.26	fsw
29	-	-	-	POSCX	Potomac Small Cap Plus	Levrqd	*	*	*	-10.1	-32.8	-9.8	7.55	-	-	FSW
30	-	-	-	FIUIX	Fidelity Utilities	Utility	*	*	*	-7.0	-29.4	-36.2	8.70	20.40	0.83	Fsw
31	-	-	-	PSPLX	Potomac U.S. Plus	Levrqd	*	*	*	-14.9	-37.7	-22.1	6.53	29.00	1.46	FSW
32	-	-	-	RYNVX	Rydex Nova	Levrqd	*	*	*	-14.7	-38.6	-23.0	15.81	29.60	1.49	fsw

Bond Funds

RANK	9/20 2002	Ticker Symbol	FUND NAME (Max. Load)	Conservative	Moderate	Venturesome	TOTAL RETURN			PRICE	Standard Deviation	Sec 30-Day Yield	Average Maturity	Modified Duration ¹	NTF/ wtf
							1 mo.	6 mo.	12 mo.	PER SHARE					
Short Term															
1	SCSTX	Scudder Short Term Bond		*	*	*	0.8%	3.8%	3.9%	\$10.69	0.76	3.25%	2.4	1.8	FSW
2	VFSTX	Vanguard Short Term Corporate		*	*	*	1.2	3.4	3.1	10.76	0.73	4.30	2.7	2.2	fsw
3	FSHBX	Fidelity Short Term Bond		*	*	*	0.7	2.5	1.9	8.90	0.83	4.06	2.7	1.9	Fsw
Intermediate Term															
1	VFITX	Vanguard Fix-Inc Intm. Treas.		*	*	*	2.5	13.5	11.3	11.94	1.40	3.42	8.0	5.6	fsw
2	FGOVX	Fidelity Government Income		*	*	*	1.5	8.4	6.7	10.61	1.50	3.64	9.2	5.1	Fsw
3	PTTDX	PIMCO Total Return CID		*	*	*	1.5	6.7	8.1	10.88	4.11	3.95	6.6	4.3	FSW
4	VBMFX	Vanguard Total Bond Market Index		*	*	*	1.7	6.0	5.5	10.34	1.24	5.11	7.3	3.9	fsw
High Yield ("Junk")															
1	BUFHX	Buffalo High-Yield(2%<180days)	B	B	*	0.9	-0.9	3.4	9.47	6.95	7.08	6.4	4.2	fsw	
2	CMHYX	Columbia High Yield	B	B	*	2.9	-1.9	2.3	8.33	-	7.07	5.8	4.0	FSW	
3	PRHYX	T. Rowe Price High Yield	B	B	*	1.6	-3.4	4.2	6.21	1.72	9.29	6.9	4.3	fsw	
4	VWEHX	Vanguard High Yield Corporate	B	B	*	2.7	-3.8	2.7	5.77	1.52	9.39	6.6	4.4	fsw	
5	NTHSX	Northeast Investors Trust	*	B	*	-2.4	-2.4	3.0	7.07	7.34	9.49	5.8	-	fsw	
6	SPHIX	Fidelity High Income	B	B	*	3.3	-4.6	-0.6	7.40	1.28	9.79	5.4	-	Fsw	
7	FHYPX	INVESCO High Yield	*	*	*	2.8	-4.1	-10.4	3.12	1.49	10.76	6.1	3.9	FSW	
Zero Coupon															
	BTTRX	Benham 2025		*	*	*	6.1	29.0	24.4	38.69	-	-	-	-	FSW
Tax-Free Alternative															
1	VWITX	Vanguard Muni Bond-Intermed		*	*	*	1.8	6.8	5.9	13.86	1.37	3.17	5.7	4.6	fsw
2	SRIMX	Liberty-SteinRoe Inter. Muni		*	*	*	1.9	7.1	5.1	11.77	1.32	3.71	8.4	5.4	FSW
3	FLTMX	Fidelity Spartan Intermed Muni		*	*	*	1.5	5.8	4.6	10.37	1.50	3.10	8.2	5.3	Fsw
International															
1	BEGBX	American Century Intl Bond		*	*	*	1.1	15.6	10.8	11.50	2.57	3.07	-	-	FSW
2	RPIBX	T. Rowe Price Intl Bond		*	*	*	0.0	13.1	5.3	8.71	2.29	2.85	8.5	6.1	fsw
3	PYGFX	Payden Global Fixed Income		*	*	*	1.5	6.5	6.8	10.27	3.34	2.95	7.6	5.7	fsw
Strategic Income															
1	JAFIX	Janus Flexible Income		*	*	*	1.7	6.2	4.6	9.59	1.42	4.46	8.5	5.7	FSW
2	RPSIX	T. Rowe Price Spectrum Income		*	*	*	-0.3	-0.2	1.5	10.50	1.16	5.09	-	-	fsw
3	FNMIX	Fidelity New Markets Income		*	*	*	-0.2	-9.1	-2.0	10.44	7.15	8.30	-	-	Fsw

¹Modified Duration—Average time individual bonds within a fund are actually held.

Vanguard Index Fund Lags

Q As a subscriber to your *MONEYLETTER*, I am frustrated. Let me explain. On August 23rd you said, "For now small cap value is apparently still the preferred way to go." Then you put a "sell" recommendation on Vanguard Small Cap Value Index (VISVX) on September 13th. In my case, I purchased VISVX on April 22, 2002 at \$11.46 per share and sold on September 18th at \$8.55, a loss of 24.5%" (actually -25.4% —ed.).

— B.P., New Hope, MN

A As a brand new subscriber to *MONEYLETTER* in August of this year, we are not sure what may have contributed to your purchase of Vanguard Small Cap Value Index shares in April of this year. We do, however, recognize the difficulty in providing fund recommendations appropriate for both new and long-time readers. As you can see in past issues, the fund was first held in *MONEYLETTER*'s investment models dating back to March 2001. While the market over the past couple of months has sold off sharply, the loss experienced in that position during the 3/01–9/02 period was 4.25%.

In the issue you quote from (August 23, 2002) an examination of the fund rankings shows that half of the Top 10 funds were "small cap value" funds, which is consistent with our observation. One key difference, though, is that those top performers are actively managed funds. In the case of the Vanguard fund, which does not benefit from stock selection as a management tool, the index fared poorly in comparison. It was subsequently sold in the *MONEYLETTER* Hotline on September 3rd. Since July 1998, index driven investment strategies have, for the most part, dramatically under-performed funds or strategies focusing on principles of stock selection. That's a decided weakness if one confines investments to the Vanguard family only. \$

MANAGED ACCOUNTS

Principal Resource Inc. (PRI) is the provider of the "MONEYLETTER Managed Account Program."¹ If you lack the time, discipline or patience to successfully manage your mutual fund investments, PRI can execute the strategies you see in *MONEYLETTER* for you.

Contact PRI and ask about a free, no-obligation Portfolio Review. Minimum Investment is \$100,000.

- * **TOLL-FREE:** (800) 707-2060
- * **FAX:** (508) 429-0940
- * **E-MAIL:** info@priadvisors.com
- * **WRITE:** Principal Resource Inc.
360 Woodland St.
Holliston, MA 01746

¹As 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*.

100% U.S. TREASURY FUNDS

	7-Day	30-Day	1-Year
Gabelli US Treasury MMF	1.46%	1.46%	1.91%
Vanguard Treasury MMF	1.44	1.45	1.98
Fidelity Spartan US Treas MMF	1.38	1.40	1.89
CMA Treasury Fund	1.31	1.31	1.62
Amer Century Capital Presv Fund/Inv	1.30	1.29	1.80
T Rowe Price US Treasury MF	1.25	1.26	1.80
Dreyfus 100% US Treas MMF	1.17	1.20	1.70
Prudential Govt Sec Tr/US Treas/CI A	1.17	1.19	1.63
Schwab US Treasury Money Fund	1.10	1.12	1.59
DBAB Cash Reserve Treasury	1.06	1.10	1.54

GENERAL PURPOSE TAXABLE FUNDS

	7-Day	30-Day	1-Year
PayPal Money Market Fund	1.81%	1.83%	-
Touchstone Money Market Fund	1.74	1.75	2.17%
Scudder Premium Money Mkt Shrs/CI S	1.58	1.57	1.90
Scudder YieldWise Money Fund	1.58	1.57	1.94
TIAA-CREF Money Market Fund	1.58	1.59	2.04
Aon Funds/Money Market Fund	1.57	1.56	1.85
Flex-fund Money Market Fund	1.57	1.57	2.00
Scudder Premium Money Mkt Shrs/AARP	1.57	1.57	1.90
McMorgan Principal Preservation Fund	1.55	1.54	2.00
Transamerica Premier Cash Res/Inv	1.55	1.56	2.04

TAX-FREE GENERAL PURPOSE FUNDS

	7-Day	30-Day	1-Year
Strong Tax-Free Money Fund	1.42%	1.35%	1.53%
Vanguard Tax-Exempt MMF	1.40	1.33	1.57
Strong Municipal MMF	1.28	1.22	1.56
Scudder YieldWise Muni MF	1.23	1.18	1.51
USAA Tax Exempt MMF	1.22	1.16	1.40
Amer Century T-F MMF/Inv Class	1.20	1.17	1.33
Dreyfus BASIC Muni MM Portfolio	1.17	1.12	1.36
T Rowe Price Summit Muni MMF	1.15	1.08	1.42
Fidelity Municipal MMF	1.14	1.10	1.38
Scudder Tax-Exempt Money Fund	1.13	1.07	1.33

TAX-FREE STATE-SPECIFIC FUNDS

	7-Day	30-Day	1-Year
Vanguard OH Tax-Exempt MMF	1.38%	1.32%	1.58%
Vanguard PA Tax-Exempt MMF	1.28	1.21	1.50
Vanguard NY Tax-Exempt MMF	1.26	1.20	1.46
Vanguard NJ Tax-Exempt MMF	1.22	1.17	1.47
Vanguard CA Tax-Exempt MMF	1.20	1.17	1.46
USAA Tax Exempt CA MMF	1.19	1.16	1.37
Fidelity FL Municipal MMF	1.08	1.05	1.31
Fidelity OH Municipal MMF	1.08	1.03	1.33
Fidelity PA Municipal MMF	1.08	1.02	1.31
Fidelity NY Municipal MMF	1.06	0.98	1.20

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 9/17/02. 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.

COMING NEXT ISSUE

MONEYLETTER's New "Select" Portfolio
Seeking maximum long-term growth

Hussman Strategic Growth: Hedging to Avoid Volatility

John Hussman stresses that the Hussman Strategic Growth Fund is not a bear fund, a hedge fund, a market neutral fund, a value fund, or even a small-cap fund. Rather, it is a diversified U.S. equity fund seeking long-term capital appreciation, which places an added emphasis on capital preservation in unfavorable market conditions.

Looking at its one-year return through June 30, a period that certainly contained unfavorable market conditions, the fund did remarkably well. In fact, the fund's total return of 22.24% for that one-year period trounced the Russell 2000 Index, which declined 8.59% and the S&P 500, which lost 17.99% in the same time frame. Moreover, the fund's success in achieving capital preservation in unfavorable market conditions is evident when looking at peak to trough losses during that 12-month period. The worst such loss for Hussman Strategic Growth was 2.79%. That contrasts markedly with worst peak to trough declines for the two indexes above of more than 20%.

How did Hussman, who is the manager of the fund and also chairman and president of Hussman Econometrics Advisors, achieve these results? In the fund's portfolio he held a fully invested position in more than 100 favored stocks, while owning an offsetting short sale of equal size, using the Russell 2000 and S&P 100 indexes. That hedged position was the primary source of returns during the period. However, Hussman points out that had the stock holdings not been hedged, the fund's stocks alone would have earned a positive return of just under 5%.

Disciplined strategy

In addition to hedging market risk by selling short major market indexes in an amount up to the value of its stock holdings, the manager also may leverage the amount of stock it controls to as much as one and a half times assets—typically by purchasing call options on individual stocks. The latter strategy is used when market conditions are believed to be favorable. How does Hussman decide which strategy to employ and to what extent? Hussman and his team develop their view of “market climate” in two dimensions: valuation and trend uniformity. If valuation is favorable, then stock prices appear reasonable in light of expected earnings, dividends, revenues and cash flows. For trend uniformity to be favorable, price trends must be generally advancing across a wide range of securities, industry groups, and capitalization sectors. It's important to note that Hussman is trying to identify what the trends are at the present, he is not attempting to

Top Five Sector and Holdings (% of Assets)

Textiles & Apparel	9.7	Zale Corp.	2.1
Specialty Retail	9.1	Borders Group	2.1
Leisure Equip. & Prods.	5.7	Liz Claiborne	2.0
Hotels, Restaurants, Leisure	5.4	Calloway Golf	2.0
Household Durables	4.8	Diebold, Inc.	1.8

as of June 30, 2002

forecast future market direction. Each unique combination of favorable and unfavorable trend uniformity and valuation conditions carries its own average historical expected risk and return parameters—and its own implications for what combination of hedging and/or leverage will be used.

Stock picking is similarly disciplined. A company's fundamentals (revenues, earnings, cash flows, dividends, balance sheet quality) are coupled with an analysis of price trends and trading volume. The goal is to pick stocks that exhibit at least one of the following: favorable valuation; positive surprises in earnings and growth rates; and favorable price strength and trading volume. Hussman does not use a “stop-loss” system of selling stocks, but rather seeks to sell lower ranked holdings on short-term strength, and buy higher-ranked stocks on short-term price weakness. Currently, Hussman favors reasonably priced, steadily growing stocks, especially consumer discretionary and staples, and health care, to which he has added recently.

Negative trends persist now

As this is written, Hussman characterizes the “market climate” as showing unfavorable valuations with trend uniformity favorable by a “tenuous” margin. The fact that stocks did not enjoy a sustained rally following news that Iraq would allow unconditional inspections, along with a swoon in financial stocks, implied that the market anticipates troubles in the near future. Thus, the fund has the majority of its portfolio hedged against market fluctuations. Hussman does remind investors, however, that while they are investing according to the “market climate” they have identified, short-term price actions can deviate from the prevailing trend, which may temporarily work contrary to the fund's investment stance. Still, with the biggest pullback in price since the fund's July 2000 inception at only 6%, it seems that Hussman's strategies are working. There is a redemption fee of 1.5% for shares held less than six months. \$

*Hussman Strategic Growth (HSGFX)
Hussman Funds, P.O. Box 46707
Cincinnati, OH 45246; (800) 487-7626
Minimum investment: \$1,000; \$500 IRA*

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