

Self-Reinforcing Cycles

- ❖ Opportunity for Some
- ❖ Ultimately Disaster for Most
- ❖ Long-Term Reduction in Value For All

Self-reinforcing cycles are a concept several well known market forecasters and market timers have written about, most notably George Soros with his Theory of Reflexivity. Others have published extensively on recursive functions and feedback systems in finance which are also essentially self-reinforcing cycles.

Up Cycles - To me, the most obvious self-reinforcing cycle in the 1990's stock market rise was initially created by money flowing into mutual funds. **Here is how it worked** - The best performing equity managers received the highest performance ratings from Morningstar and Lipper, etc. Accordingly, they received the most amount of inflows of new money. What did they buy with that new money? The stocks they already owned in their Funds; thus, pushing the stocks they already owned up even more. So those stocks continued to be the top performers and the managers continued to get the highest performance ratings and the most amount new money...self-reinforcing...self-reinforcing, etc. - and without much regard to valuation.

The Top - The result was a stock market that went up and up and up - because people were forecasting the future based on the then-recent-past where they focused on return performance (again the past) and not valuation (an indication of the future). Finally, at some point the self-reinforcing system reaches a peak and begins self-reinforcing in the other direction - usually even faster.

Down Cycles - There are several self-reinforcing circumstances in the current down cycle:

1. Credit Lines: Many companies have lines of credit from banks. These companies pay the banks a fee for the credit line. Usually, the credit line is not drawn down. Unfortunately, **right when companies might need to draw down on that line of credit the most, covenants in the line of credit make the line unavailable to the potential borrower.** We just saw this situation with Texas Utilities ("TXU"-NYSE). A ratings downgrade of TXU triggered a technical cross default on its

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The Recession is Starting to Worsen - Asset Prices Could Gap Downward

Unfortunately, despite most optimistic commentary in the major media, the economy has just gotten far worse and we think it is most likely to fall off its declining precipice very soon. **At a certain time during this downward economic cycle, we believe the public at large will reach "a point of recognition" when they realize the economy is not coming back for a long long time.** At that "point" we will most likely see most asset classes **gap** down in value. The asset class currently with the largest downside risk is **real estate** which has been pushed up to completely unrealistic, NASDAQ-style - top levels as a result of the Federal Reserve lowering interest rates in its ill begotten attempt to keep the economy from plunging. Below are the best examples of the quickly weakening economy:

1. Plunging Consumer Confidence - U.S. Consumer Confidence plunged in October 2002 to a nine year low as job cuts and expectation of declining incomes in conjunction with record debt balances have undermined faith in the economic recovery. From the graph, you can see that Consumer Confidence peaked in

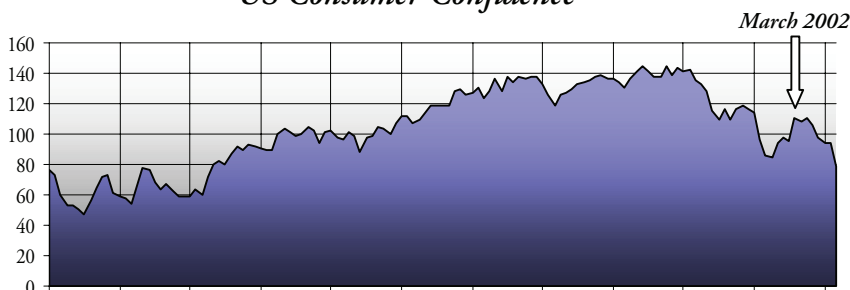
March (the middle spike of the downward tilting W in our June 12th WEALTH PRESERVER article; "What the Economy Might Look Like") and has now plunged five consecutive months. The index is the lowest since November 1993 when it was recovering from the 1990-1991 recession. **The main point is that the trend is down hard.** In addition, the consensus level of 56 Economists surveyed by Bloomberg News was 90 - the level came in at a much lower 79.40. **Thus, the average economist (sorry about that) was wrong.**

2. Automobile and Vehicle Sales have also Plunged - Given the plunge in Consumer Confidence it should not have been such a surprise that Vehicle sales also plunged in October 2002. Results for this October compared to last year's October are:

Chrysler Group	31% down
Ford	31% down
General Motors	32% down

Last year's October benefited from the first month of very aggressive zero

US Consumer Confidence



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percent financing (that we argued in the Second Quarter 2002 Wealth Preserver was a way to combat what was the possible start of deflation). Now, we continue to argue that the aggressive financing has resulted in an unsustainable spike in sales - that the pipeline is full (i.e. consumers have more automobiles (and payments) than they want), and now, sales will continue to drop. **The increased volume in sales of automobiles due to low cost financing over the past year is very similar to the run up in real estate due to low mortgage rates.** The even more aggressive sales incentives by automobile companies late this year has actually resulted in lower sales volume because consumers are "spent" - the real estate downturn is next and **the poorest Christmas selling season since 1989/1990 is very likely.**

3. Office Vacancy Rates Increase to 16% -

The nation's office-vacancy rate has continued to climb, hitting almost 16% according to a 10-2-02 article in the WALL STREET JOURNAL. "The recovery from this sustained period of negative demand is not just over the horizon," said Lloyd Lynford, CEO of Reis Inc., the New York research firm, which conducted the survey. Steve Sakwa, an analyst with Merrill Lynch pegs the national office-vacancy rate at a similar 17%. The all-time high office-vacancy rate is 19%, reached during the recession in 1991, according to Reis. Accompanying the rise in vacancies has been a decrease in rents. We at Stamper Capital have seen these trends in Santa Cruz in both office and residential rental markets.

4. Long Interest Rates May Have Bottomed

- The yield of the United States Treasury Long Bond, the proxy for long term, high quality interest rates, shot up during October 2002 from around 4.65% (a forty year low) by 55 basis points to 5.20%. This rise in yields cause the price of the U.S. Treasury Long Bond to drop from almost 112 down to around 103 or by 8%. This drop is rather large and could be the change in trend from falling long term rates to rising long term rates. (From this example, you can see that increasing rates results in falling prices of bonds - this relationship generally holds for real estate too). This possible change in trend is very important since housing mortgage rates are pegged, directly or indirectly, at a

Benefits of Diversification Usually Collapse at the Worst Possible Time

Do not think you are protected from declining asset prices because you are "diversified." If you look at charts of multiple asset classes over long periods of time, you will see that the different asset classes all peak separately but converge together at the bottom. The dispersion of the recent market top is easily seen by looking at the recent stock market peaks: While the NASDAQ and the DOW peaked in early 2000, the Value Line peaked about two years later in early (2002). As for convergence, just look at the bear market of 1973/1974. The DOW, the S&P 500, and NASDAQ all bottomed together in September 1974. Thus, our point is that the benefits of diversification collapse when people need them the most. We believe that in this cycle it is prudent to be invested in only the safest investments - high quality, short term bonds and money markets.

spread to this rate. **The housing market, the housing mortgage market, and the bond market, all, individually (each on its own), dwarf the equity market - so not only will rising interest rates wreak havoc on the values of these assets but they will exacerbate the already faltering economy much more than the decline in the stock market has.** Unfortunately, we believe it will be enough to change the recession into a depression.

5. International Financial Markets Continue to Worsen in October 2002- Japan's well known 225 stock Nikkei average dropped to its lowest level in 13 years to 8,685 which is 78% below its December 1989 market top. Importantly, in late 2001, the index broke a ten year support line and now has put in a lower low. Germany's DAX also put in a recent low. Its recent bottom is down 60% - the lowest level since its early 2000 top. The FTSE EUROTOP 100 is down 51% from its August 2000 top, a three year low. The French CAC is down 57% from its September 2000 top, also a three year low. The Dow Jones Industrial Average also put in a three year low in October, as did the NASDAQ, the S&P 500 and most other U.S. indexes. **The point here is that all world equity markets are continuing in a downward trend.**

Conclusion - Some market prognosticators

think that October 8th or 9th, 2002 could be "the bottom" and the beginning of "the recovery." Many markets have put forth rebounds since that time; however, the people forecasting the bottom are the same people who missed the stock market peak and have already called for several market bottoms and for several economic recoveries. Their forecasting records are very poor and, therefore, we give them little credibility. While these forecasters could be right, a bottom could be at hand; unfortunately, we believe the events outlined above demonstrate that the U.S. economy is still on track for a depression the magnitude of the early 1930's. In addition, numerous times previously we have identified what we believe is fair market value for the stock market - it is considerably lower than the current 8,500 on the Dow - more like 5,000 for fair value and 2,100 or lower for a major bottom. That valuation knowledge coupled with the recent events outlined above give us the feeling that the public is close to the "point of recognition" when they realize that the economy, stock markets, real estate markets, etc. are going to continue to drop and not come back for a long time and not until major market lows. **Once everyone is sick of investing and wants nothing to do with it, we will know we have passed the bottom.**



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credit agreement which made the funds unavailable right when TXU needed them. In addition to a declining stock price due to weakening credit fundamentals, the withdrawal of the line of credit caused the stock price to drop further. This type of situation will continue to cause stock prices to "gap" down.

2. Defined Benefit Pension Plans: On October 2, 2002 we noted that United Airlines ("UAL"-NYSE) announced that its **Defined Benefit Pension Plan had swung from a \$1.5 billion surplus to a \$2.5 billion deficit because falling stock prices had impaired the value of the plan's investments.**

Here is how it works - Some companies have agreed to provide a specific dollar level (hence "Defined") of benefits to retirees. These companies typically fund these retirement liabilities by investing in stocks and bonds. Thus, the companies are now investment companies in addition to their normal line of work since they are making the investments themselves rather than laying off the risk by purchasing retirement policies from an insurance company. **In the up cycle**, the assets in these plans were going up quite a bit faster than the promised benefits, so these companies "raided" the excess and ran it through their income statement to make their performance look better (General Electric is apparently a master at these types of accounting manipulations; GE does this to make its earnings look smooth and to hit its earnings targets in addition to ballooning its income). **Now the downcycle:** The value of the underlying assets has been dropping as the stock market has been dropping but, of course, the "defined" benefits stay constant so now these companies retirement plans have become "underfunded." Importantly, this underfunding must be accounted for on the balance sheet and must ultimately be funded with cash or be depreciated by a company bankruptcy reorganization. That type of reorganization is exactly what happened to LTV steel in the late 1980's and early 1990's. This self-reinforcing cycle caused the LTV stock to go to essentially zero; the secured, first mortgage debt got paid 100% on the dollar; **the pension plan was deemed senior unsecured debt and got about 25 cents on the dollar.**

This is a "global market" self-reinforcing cycle - **All of these companies with defined benefit plans were self funding their pension plans by investing in the stocks of other companies who were also investing their plan assets in the stocks of other companies just like a giant pyramid.** The more the stocks went up, the more their pension plan investment investments rose, the more they "raided the plan" to make their earnings go up - the more their stock price went up - **all in a big circular self-reinforcing system.** They all went up together and now they are all going down together.

Most older large capitalization companies which have labor unions are going to have this

problem. Recently, it has shown up in the financial statements or announcements of Ford ("F"-NYSE) and General Motors ("GM"-NYSE) both of which recently suffered credit downgrades due in part to declining profits but also due to increasing deficits in funding their defined benefit pension plans. General Motors indicated that its pension plan may be underfunded by \$23 billion at year end. Boeing ("BA"-NYSE) said it may take a \$4 billion fourth quarter charge to reflect the declining value of plan assets, thus, causing its share price to decline by 5% the day of the announcement. **On October 17th, 2002 shares of Northrop Grumman ("NOC"-NYSE) fell 13% after the company reported a quarterly loss and said it could not provide a 2003 forecast because of the declining value of its pension assets.**

3. Lower Credit Ratings - Higher Borrowing Costs - Along with this theme of a self-reinforcing down cycle are credit down grades. As we demonstrated above under Credit Lines (above), lower debt ratings can cause the unavailability of the line of credit which can exacerbate a decline in a stock's price. **In addition, a lower credit rating most often results in an increase in a company's cost of borrowing.** This increased borrowing cost is exactly what has happened to GM and Ford - when they were downgraded (to just above Junk Bond status), the prices of their bonds dropped (when bonds drop in price, interest rates rise) and their cost of borrowing rose. **Now here is the self-reinforcing cycle - the downgrade caused their cost of borrowing to rise, which again causes their credit quality to deteriorate which will eventually cause them to be downgraded again, which will result in their cost of borrowing rising etc, etc, etc.**

4. High Tech Venture Capital Funding - Similar to the self-reinforcing investment cycle of the Defined Benefit Plans was the **overfunding of highly leveraged junk bond companies in the middle 1980's and the high technology companies in the late 1990's.** In the middle 1980's highly leveraged companies issued more debt than they required and invested the proceeds in the junk bonds of other highly leveraged companies; thus, creating the pyramid which allowed the junk market to be launched and attain some level of liquidity and stability until it unwound with the Drexel bankruptcy.

In the 1990's it was high tech companies like Microsoft, Intel, and Cisco, and others providing venture capital to start up high techs. **The up cycle** - Much of this "funding" was really a reflection of sales of products from the funders to the startups - the larger companies funded the startups so the startups could buy their products. Thus, much of the larger companies' "investments" also got reflected in sales back to themselves from the small startups when the startups made purchases from the larger companies with the proceeds of the investment cash which they had received from those they were now purchasing from. In addition, the investor's would make purchases from the start ups. **(The key is that there were numerous related**

transactions between related companies that resulted in sales (back and forth) and investment value that would never have been recognized if the startups had simply been subsidiaries rather than stand alone companies - thus, in a way, another pyramid.) Then, based on increasing sales to the startups (in large part from their owners), the value of these startups started to rise. Somewhat later, these startup high techs would do an initial public offering (IPO) and the venture capital investment's value would go up and be recognized through the investor's income statement as increased earnings, thus making the larger companies earnings look better than they really were (since it was a one time ultimately unrepeatable event - although they repeated it by doing the same thing with many companies) and running up their stock price even more. **Now the down cycle** - Sales from the large investing companies to the startups eventually completely dried up (when the startups ran out of their investment capital). Thus, the large investing companies saw their sales drop, resulting in a drop in their stock price. In addition, sales of the startups back to their owners dried up resulting in dramatic drops in their stock prices. **Now, the circular part** - because the values of the startups dropped, the large investing companies had to drop the amount they were valuing their investments at on their books, thus, causing their profits to drop and their balance sheets to look worse - causing their stock price to drop.....and so on and so on. Until the NASDAQ dropped more than 70% from the high. A great example of this cycle is the fortunes of Cisco ("CSCO"-NASDAQ), which created dramatic demand for its products through its investments in internet startup companies. Cisco, considered a world class company, currently has an equity-market capitalization of \$84 billion even though its stock price has dropped from \$80 in early 2000 to \$12 today - an 85% drop.

5. Employee Compensation with Stock Options - With respect to these high tech companies, we should really include the concept of paying employees, in a large part, with **stock options** rather than fully with cash and not running that option expense through the income statement, but diluting ultimate stockholder value by increasing the number of shares. **It is a self-reinforcing cycle** - not running compensation through the income statement and granting options has the effect of overstating earnings (which would likely run up the stock price) and, if the options have a vesting period, also results in the illusion of stronger than normal demand for the stock. Of course, **after the vesting period ends, the cycle will tend to reverse itself as employees sell off the stock they were previously restricted from selling.**





Our Fund Performance

Stamper Capital & Investments, Inc. has managed the Evergreen High Income Municipal Bond Fund since June 1990. The \$897 million fund has been repeatedly recognized by Morningstar as a top-performer among its class, with the highest ratings in the overall and three-year periods. Stamper Capital & Investments, Inc. is a Registered Investment Adviser that specializes in the municipal bond market and is dedicated to helping investors earn the maximum return per the amount of risk taken. **Check out our website at www.risk-adjusted.com to find out more about how our strategies can reduce your overall portfolio risk, while maintaining equity-sized returns!**

Short-Term Municipal Bond Fund Category, Morningstar Rankings

Period As of 9-6-02	E.H.I.M.B.F.* Rank	Number of Competitors	Category Average Total Return	E.H.I.M.B.F. Tax-Free Total Returns	Pre-Tax Equivalent Total Return	Morningstar Ratings ² (5 stars possible)	Percentage Ranking
1 Year	30	102	3.54%	4.02%	6.55%	★★★★★	Top 10%
3 Years	7	90	5.07%	6.07%	9.89%	★★★★★	Top 10%
5 Years	31	80	4.27%	4.49%	7.31%	★★★★	Top 67.5%
10 Years**	9	27	4.81%	4.98%	8.11%	★★★★★	Top 32.5%
Overall	-	-	-	-	-	★★★★★	Top 10%

*E.H.I.M.B.F. = Evergreen High Income Municipal Bond Fund, subadvised by Stamper Capital & Investments, Inc.
** Results from the B shares. A share estimate: 4.81 + .75 basis points = 5.56% or 9.05% pre-tax equivalent

The above chart summarizes the performance of our mutual fund client. We also offer Private Account Management with different strategies and greater opportunities to earn higher yields. **To give you an idea of the types of strategies available and the potentials offered through our Private Account Management, be sure to check out our website at: www.risk-adjusted.com.**

Stamper Capital & Investments, Inc.
1011 41st Ave., Suite A
Santa Cruz, CA 95062
888-206-6295

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Disclaimer: Prior Performance achievements are not necessarily an indication of future performance. In other words, past performance does not guarantee future results. There are many types of risks and returns, and the trade-offs among them can result in different positive or negative returns depending upon the subtleties of the specific credit and security characteristics.
1. The pre-tax equivalent total returns are figured based on the highest Federal income tax bracket of 38.6%, no state taxes were included in the calculation.
2. Morningstar's proprietary ratings reflect historical risk-adjusted performance within a narrow investment category. Morningstar calculates a Morningstar Rating based on a Morningstar Risk-Adjusted Return measure that accounts for variation in a fund's monthly performance, including the effects of sales charges, loads and redemption fees, placing more emphasis on downward variations and rewarding consistent performance. The ratings are subject to change every month. Morningstar ratings are calculated from the fund's three-, five- and ten-year (or life of fund, which ever is shorter) average annual returns in excess of 90-day U.S. Treasury Bill returns (on a monthly basis) with appropriate fee and tax adjustments and a risk factor that reflects the fund performance below 90-day T-bill returns (on a monthly basis). The top 10% of the funds in each category receive the highest a rating of five stars. The next 22.5% receive four stars, the next 35% receive three stars, the next 22.5% receive two stars, and the final 10% receive one star. Each share class is counted as a fraction of one fund within this scale and rated separately, which may cause slight variations in the distribution percentages.