

Summer Commentary 2003

FIXED INCOME OUTLOOK

AN OVERVIEW OF FIXED INCOME

As we write this issue (8/22/03), the equity markets continue their recovery. The tremendous amount of fiscal and monetary stimulus to the economy appears to be paying off. Though the GDP for the United States grew at 2.4% in the second quarter (slightly below normal), it appears that growth will recover to at least 3% for the second half of the year, with even more aggressive forecasts of 5%.

After looking at a method of stock selection in our previous newsletter, we felt it was important to examine the selection of fixed income securities in this issue. Having a portion of one's assets allocated to fixed income is important for many investors. Doing so serves a number of different purposes from reducing the volatility of an account to providing the income necessary to support one's lifestyle in retirement. Account volatility is reduced because bonds tend to experience less price movement in comparison to stocks. Reducing volatility is of particular interest for people who are in retirement and cannot replace the assets they have accumulated, as well as those for whom safety of principal is a primary concern.

The importance of diversifying one's holdings through the use of bonds can be seen over the last five years. During this time period, a balanced portfolio, which included bonds, outperformed an all equity portfolio

by a wide margin. The addition of an extra layer of diversification helped to insulate the portfolio from the declines in the equity market. While one can argue that this time period in the market has been an anomaly, it shows the importance of protecting your assets from the decline in equity markets.

WHY BUY INDIVIDUAL BONDS?

The purchase of individual bonds is especially imperative today due to the low level of interest rates. When you own the individual securities, and the bond matures as scheduled, you truly have a fixed income. If a bond fund is purchased, the amount of payment fluctuates depending on what is held in the fund and the current interest rate environment. Also, as interest rates rise the price of the fund is likely to decline. While the price of individual bonds will decline in the short term, as they approach maturity the price of the bond will move toward par. Therefore, you expect the bonds to pay off at par.

CATEGORIES OF FIXED INCOME UTILIZED

There are two principal categories of fixed income investments Lehrer Management Company, Inc. utilizes. First are tax-free municipal bonds. If the investor is a resident of the state from which the bonds are issued, the income from these bonds is free of state and federal taxes. However, if the investor is not a resident of the state, the income received is subject to state taxes. Our purchases of municipal bonds vary in credit quality from non-rated to AAA insured bonds. We feel that allocat-



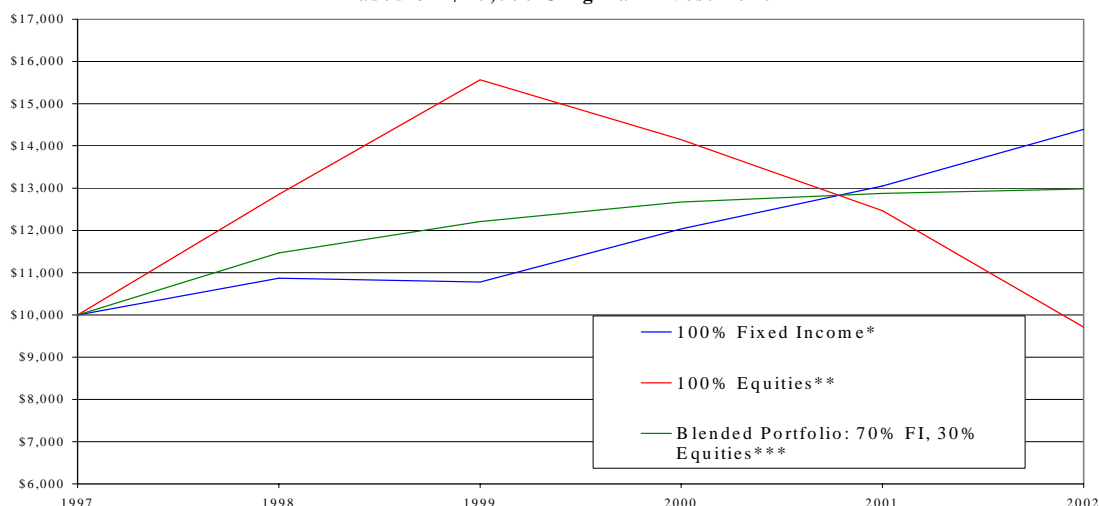
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Comparison of Returns over Five Years from 01/01/1998-12/31/2002
Based on \$10,000 Original Investment



ing a portion of one's municipal bond purchases to non-rated bonds is justified given the considerably higher yield and marginal increase in risk.

The second category of fixed income investments is taxable securities. Types of taxable securities we utilize include treasuries, agencies of the U.S. government, and corporate bonds. When purchasing corporate bonds, we look for investment grade (BBB) or higher quality investments. The primary factor to consider when making the decision to invest in taxable versus tax-free investments is the investment's effect on taxes of the investor.

Given the price movement of bonds, caution must be exercised when investing. The prices of bonds have an inverse relationship with interest rates, meaning as rates rise, the price decreases. In the previous years, we often purchased bonds with long maturities of 20 to 30 years. We found that this provided long-term interest rates on bonds that often were redeemed substantially before maturity. With interest rates steadily declining over the last few years, adaptation of our strategy has been necessary. Though interest rates have recovered from the 45 year nadir of a few weeks ago, they are still historically low. Knowing that an increase in interest rates seems to be the most likely direction of movement, a defensive posture is necessary. This posture calls for minimum commitment

to long term bonds and an emphasis on short to intermediate term instruments.

In addition, the recent steep move of the 10 year treasury has increased yields nearly 50% in just over eight weeks. This has created a buying opportunity in intermediate corporate and municipal bonds. With current yield levels that have not been seen since prior to September 2001, we are slowly committing funds to this area of the yield curve where appropriate.

IS NOW THE TIME TO INVEST IN FIXED INCOME SECURITIES GIVEN THE LOW LEVEL OF INTEREST RATES?

A practice that we actively use in selecting equities is the diversification of investment not just by security, but by time as well. This concept carries over to fixed income decision making. Though interest rates have risen off the 45 year lows they reached just last month, they are still below their recent averages. Given the inverse relationship of price and interest rates mentioned earlier, it is important to break up investment decisions into many small investments. Doing so helps to spread the risk of investing over time. Key considerations in deciding if a fixed income investment is appropriate include credit quality, time to maturity, and any call features of the bond.

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* Based on the time-weighted yearly return of the Standard and Poors 500

** Based on the time-weighted yearly return of the Lehman Aggregate Bond Index

*** Based on the returns of the above referenced indices in the indicated proportions