

## Climbing a Wall of Worry

By Bruce White

**A bull market.** After three years of negative stock market returns, the last six months have had positive results. As of this writing, there has been a dramatic 31% rise in the S&P 500 index since March.

**A wall of data.** Most bull markets are accompanied by a “wall of worry,” meaning there is always doubt during a bull market that positive returns will be sustainable. Because the stock market is an auction market matching an equal number of sellers to an equal number of buyers every day, by definition, at all times there are equal numbers

of optimists and pessimists. Turning on the TV or reading the newspaper, we find “experts” quoting economic data to confirm personal bullish or bearish sentiments. It can be confusing for the individual investor who is not prepared to winnow the nonsense from the profound.

**Finding a balance in expectations.** For the last five years, returns have been enormously volatile, causing many to have both unrealistically modest and sometimes unrealistically aggressive expectations. The five year annualized



### Inside:

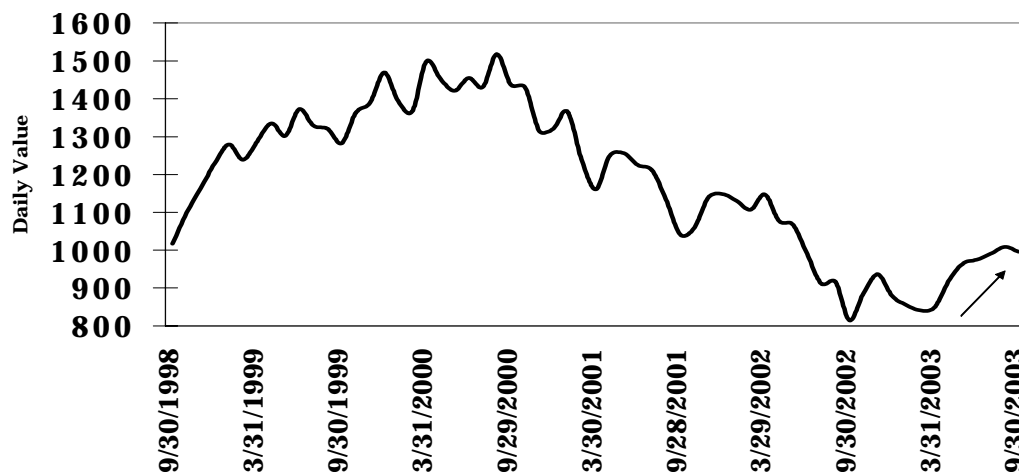
California: The Sixth Largest Economy in the World

by Peter Boyle  
Page 3

### Planned Giving News:

Donation of Income Interest (insert)  
by Ken Dike

Standard and Poor's 500 Index



Continued on page 2

28.5% return from 1995-1999 has not been exceeded, and the -14.5% three year annual loss 2000-2002 has not been seen since World War II. The average five year return of the stock market from 1926, according to Ibbotson, has been 10.9%. Return expectations, and therefore asset allocation and spending decisions, should be based on these longer-term averages, not recent experience.

**Why we are optimistic.**

Instead of finding data to support one's emotions, one needs to look to the economic numbers to judge if there is sustainable economic activity that will result in improving corporate earnings. After all, corporate profits are what we seek, because as owners of these successful companies we are rewarded with higher stock prices.

Of interest is how the increase in the stock market since March of this year has been concentrated in high technology stocks. There are many sectors and companies whose stock prices have not fully reflected the current positive earnings environment.

**Things to watch.**

1) The silly season. Political seasons (we started early in California) tend to bring many subjects up that distract investors. Politicians propos-

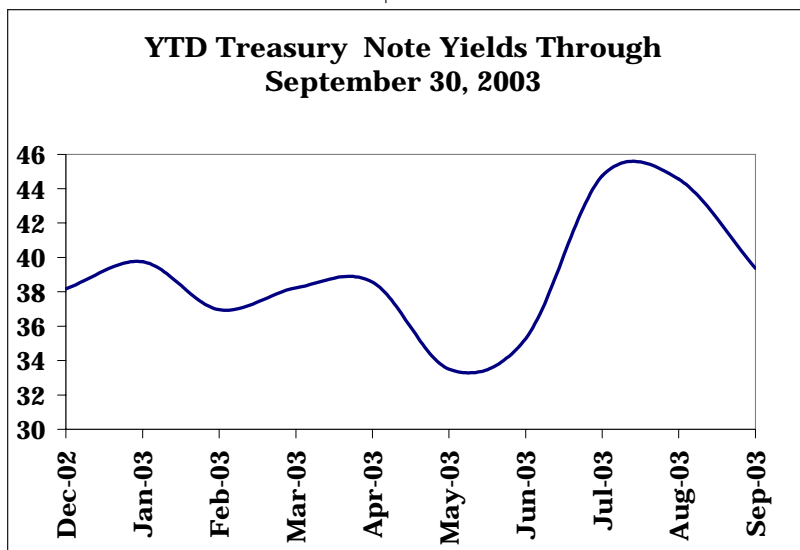
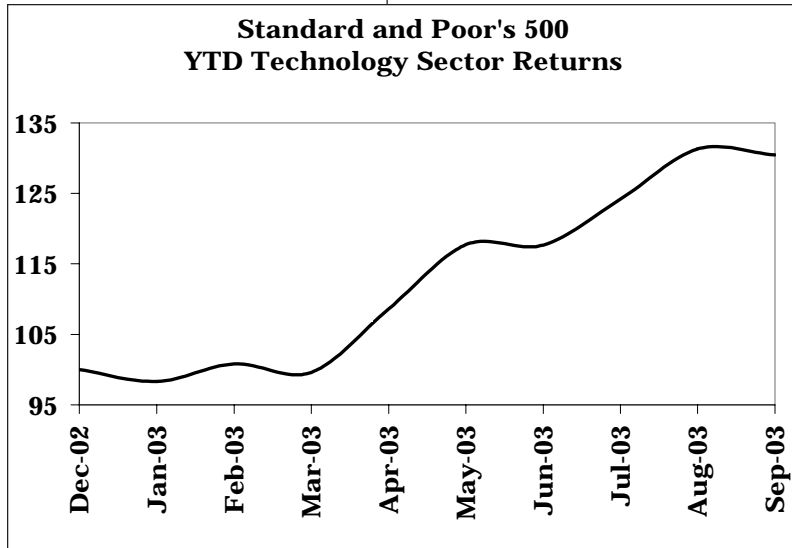
ing changes in tax policy and massive spending on new government programs do not mean that these things will come to pass without long legislative debate. 2) Does it feel like 1993? Then,

like now, there was massive fiscal and monetary policy stimulus that resulted in a disappointingly slow, jobs growth recovery from a shallow recession. The lagging nature of that stimulus showed results the following year with interest rates advancing from 6% to 8.5% amid concern about inflation. Economic growth in 1995 and 1996 was 2.7% and 3.6% respectively. Stock selection was important in 1993 as the indexes were nearly flat in a tight trading range. 3) We have seen wild turns in interest rates already this year and we expect more to come.

**Conclusion.**

At this time, we would favor equities over fixed income. Stock investments must be selective to focus on companies

with growing earnings potential in this environment. Remembering that the prices of bonds move inversely to interest rates, and longer term bonds' price deterioration may be significant, we would caution investors to accept the lower interest rates found in short to intermediate maturity bonds.



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# California, the Sixth Largest Economy

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By Peter Boyle

While most Californians were enjoying summer vacations, the state, whose municipal bond rating as recently as 2000 carried an AA rating, was unceremoniously downgraded by both Moody's and Standard and Poor's 500 to the lowest in the nation. The hard question facing holders of California general obligation debt is: now what? Buy, hold or sell?

Fact #1: As a result of a delayed budget adoption, a gubernatorial recall election and the legislature's inattention to the structural reforms need to achieve a balanced budget, the three main credit rating agencies downgraded California's general obligation debt to just one notch above "junk" status. California is now alone with the lowest credit rating in the nation.

Fact #2: The headline risk associated with this downgrade is far more dismal than the underlying credit risk, and the debt issued by the state of California is far from speculative.

How does one reconcile these seemingly contradictory facts? The answer is important to Clifford, our clients, and the millions who own California General Obligation bonds either directly or via mutual funds. Since Clifford has always held that we will generally not buy bonds with ratings less than single A, we have been forced to take a hard look at this turn of events.

Basically, the simple answer lies in the fact that California is the sixth largest economy in the

world and one of the most prosperous states in the union. However, unlike other countries, California cannot print money and is constitutionally required to adopt a balanced budget or at least the illusion of one. Reviewing California's rating as an analyst would, we examine some additional aspects of the state's debt situation.

Rank	Countries	(\$ billions)
1	<b>UNITED STATES</b>	<b>\$10,417</b>
2	Japan	\$3,979
3	Germany	\$1,976
4	United Kingdom	\$1,552
5	France	\$1,410
6	<b>CALIFORNIA</b>	<b>\$1,403</b>
7	China (excluding Hong Kong)	\$1,237
8	Italy	\$1,181
9	Canada	\$716
10	Spain	\$650

First, under California's Constitution, debt service on general obligation bonds falls behind only education in terms of funding priorities. As a result, this means that debt service comes before all other government programs, including the state's salaries. Based on 1999-2000 data, interest on

general debt accounts for only 1.74% of California's general expenditures, ranking it 39<sup>th</sup> among other states.

The state allocates 4.52% of general fund receipts to debt service. The California Municipal Bond Advisor, a research newsletter dedicated to California municipal bonds, states that an acceptable rule of thumb for municipal analysts is as much as 5% to 5½% of general fund receipts.

Second, while California's debt per capital (including lease-revenue) has been rising steadily since the mid-90's to a current level of \$819.40, California ranks 20<sup>th</sup> at about the national average of \$810. Interestingly, Massachusetts, a AA-rated state, has a debt per capita of \$3,267.

Lastly, since it is the citizens that states turn to as the ultimate funding source for all expenditures, an important statistic relates to the citizenry's per capita income. California ranks 10<sup>th</sup> at \$32,702 (2001 data) in per capital income. As the earlier chart indicates, debt per capita is 2.55% of per capita income. In this final statistic, California is below the national average and ranks 23<sup>rd</sup> overall. By contrast, Massachusetts

*Continued on page 4*

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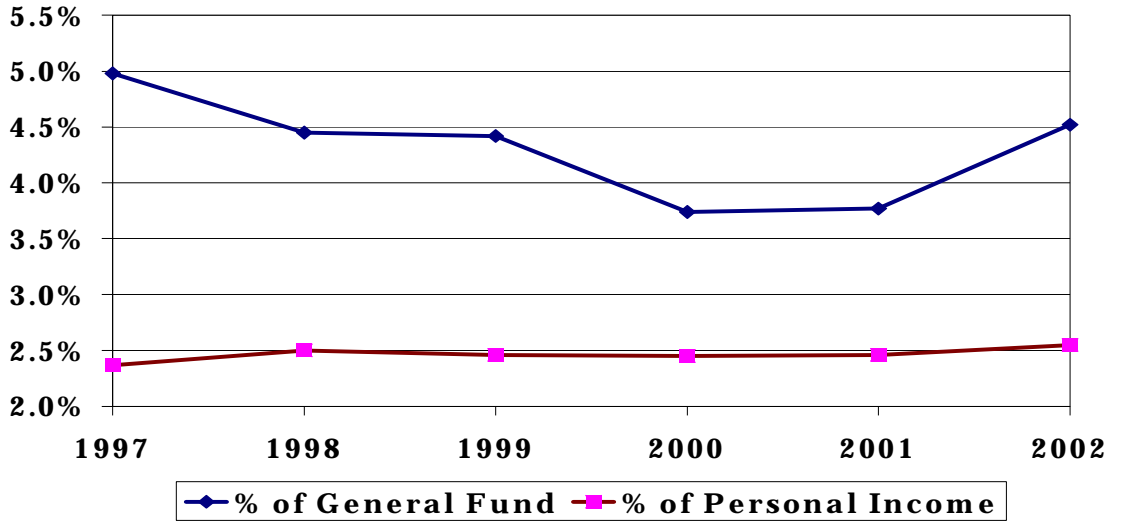
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**Debt Service Ratios**



and New York, both AA-rated by S&P, have ratios of 10.4% and 5.9% respectively.

Each day the state's bond rating remains at these levels, it cost the government more in added interest cost—a windfall for bondholders. A final word of caution: our comments here are strictly limited to our perspective on the state's general obligation bonds. We still consider other state, regional and local bonds to have higher

The intent here is not to diminish the financial mess in which California finds itself, nor the fiscal pain that future governors and legislatures will have to address, but instead, to put the current risk of holding and purchasing California General Obligation debt into perspective. California's ranking in these statistics does not deserve the country's lowest status. Instead, we believe the recent set of ratings downgrades were meant to send a message of investor frustration brought on by apparent inaction in Sacramento. However as investors, the state's predicament is our gain.

CALIFORNIA'S NATIONAL RANKING PER CAPITA INCOME (2001)		
Rank	States	(\$)
1	<b>Connecticut</b>	<b>\$42,435</b>
2	Massachusetts	\$38,907
3	New Jersey	\$38,509
4	New York	\$36,019
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10	<b>CALIFORNIA</b>	<b>\$32,702</b>
	National Average	\$30,472

levels of risk and, with few exceptions, limit our purchases to bonds with insurance backing their cashflows.

Sources: Municipal Bond Advisor; California State Comptroller

