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Second Quarter Newsletter

June 13, 2003

The stock market is finally showing signs of life after all these years, and year to date the S & P 500 Index is up around ten percent. Corporate bonds including high yield bonds are also showing strength with gains this year similar to the stock market. It's not so much that the economy is showing strength; on the contrary it looks like unemployment and economic weakness are continuing. Rather it's the resolve that Alan Greenspan, Chairman of the Federal Reserve Bank, is showing in his fight against the slide toward deflation.

Investors are getting mixed signals these days on which path the economy is taking. When Greenspan spoke a couple of weeks ago, he indicated the biggest risk is that falling prices could send the U.S. into a dangerous spiral of Japanese-style deflation. The Fed's preoccupation with deflation has investors piling into bonds, which will increase in value if rates keep tumbling. Ten-year treasury notes are yielding about 3¼%, their lowest yield in 45 years. At the same time, prices for many key expenditures, including healthcare and tuition, continue to rise. For many consumers these price increases make inflation seem more of an immediate threat than falling prices. The major stock indexes, including the S & P 500 and the NASDAQ, peaked in the spring of 2000, and three years later they are below water from five years ago. The major indexes are up strongly over the last two months, and the stock indexes are back up to levels not seen since the summer of last year. Even with these gains, the S & P 500 Index is about 36% below where it was at its height in the spring of 2000. The technology-laden NASDAQ Composite Index is still about 68% below where it was in March of 2000.

When deciding where to employ their funds, investors and asset managers must make a fundamental calculation on whether the economy is headed towards falling prices or rising prices. Each scenario calls for a different portfolio and investment strategy. As an investment manager, I will be watching the different asset classes closely, since deflation is usually bad news for stocks. It means companies lose their ability to raise prices, which squeezes corporate profits. Those fearing deflation are loading up on low maturity bonds, which would provide a steady cash flow in a world of falling prices. This is one reason bonds have fared so well over the last few months. Bonds appreciate in value as interest rates fall, but they have the market risk of losing value if interest rates begin to rise again. Alan Greenspan has hinted that interest rates may stay down for as far as the eye can see.

Falling prices aren't a common occurrence in the US. The last recorded bout of deflation was more than 50 years ago and was mild when compared to the deflation that occurred during the Great Depression of the 1930s. In periods of deflation, short-term interest-bearing or near-cash investments are king. That is because the dollars you have today will buy more tomorrow as prices fall.

International bonds may do well too because they benefit from the same forces that propel bond prices higher. With international bonds, value is added as the dollar declines relative to the currencies of another country in which you hold the bonds. Additionally, deflation is bad for real estate investments because prices would tend to come down. Over the last three years as stock prices have declined, many investors have repositioned their wealth in real estate, by remodeling their home or buying a second home as well. Monies targeted for retirement are hard to recover from a home. You have to live somewhere and that would mean selling your primary residence and moving to a less expensive place in order to recover your investment.

If we have a run of mild deflation, dividend-paying stocks from companies that can drive sales based on volume and innovation instead of price increases may do well. Utility stocks and other industries with a history of paying stable dividends have done very well lately, with an extra kick from the recently passed legislation reducing the income tax on dividends. Utility stock funds have played an important role in recent gains for investor portfolios.

In contrast, the stock market generally thrives in a period of mild inflation. Such periods like the 1990's often have strong economic growth in raising consumer incomes, both of which are good for corporate profits. Those investors anticipating inflation may be loading up on stocks, precious metals purchased in the form of mutual funds of mining companies and real estate. Some commodities tend to perform strongly in an inflationary environment.

The current decline in the dollar relative to other currencies bears watching closely. Gold and precious metals funds usually do well in periods when the dollar is dropping relative to foreign currencies. The effect is to raise prices of imports, of which U.S. consumers are strongly dependent. Rising prices from a declining dollar is an inflationary force, but it also allows manufacturers to sell their goods to foreign customers at more competitive prices. Dr. Quincy Krosby, Economist for Deutsche Bank, estimates that 30-40% of the larger S & P 500 companies are getting a majority of their profits from overseas; a ten percent lower dollar can translate into a two percent increase in profits. The advantage of the lower dollar is significant and with deflation the largest concern, rising import prices with inflationary overtones is not a big concern to the Bush Administration.

If you have quit putting money away for retirement or discontinued periodic savings, now may be the time to start again. An article in *The Wall Street Journal* on May 1, 2003, expressed concern about the 401K changes many Americans will face.

A host of growing problems is deepening the effects of the bear market for the estimated 52 million people with 401(k)s. At least a dozen major employers have cut or suspended contributions to their 401(k) plans since the start of last year. As many as 25% of people with 401(k) plans that allow loans have raided them for extra cash. Fewer workers are participating in their plans, and some of those who still do have made precisely the wrong responses to the downturn, including taking too little risk.

The result is that the 401(k) is looking increasingly like a tattered promise, and there is growing concern that millions of Americans won't have enough for retirement. The 401(k) was created two decades ago as a way to let employees save for retirement while deferring taxes. The effect has been to turn employees into their own pension managers. For many workers, the 401(k) and Social Security are all that stands between them and bleak retirement.

If you need help restarting your savings program, call and we can help give you direction for investing.

We have a new face around the office this summer. Margaux Meyer, a teacher at a southwest elementary school, will be spending the summer working for us part-time. She is also working on her MBA at Indiana Wesleyan and has a great deal of interest in our business.

If you haven't checked our website lately, log on and see the changes we've made. We've added a lot more disclosure and explanation about our programs, as well as some new pictures.

Also if you haven't seen us for a while, please stay in touch so we can review your important long-term investment goals.

Sincerely,
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President