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STERLING'S WORLD REPORT

After the Fall

This summer's painful market meltdown makes it highly likely that the U.S. equity market will experience a third year in a row of negative returns – a dismal performance not seen since the 1930s and early 1940s.

An entire generation of investors has been completely disillusioned, having begun to believe that strong double-digit returns were a permanent fixture of equity markets. Many are now turning to real estate as the only way to build wealth, even as economists and policymakers begin to debate whether real estate markets are experiencing a “bubble” akin to what equity markets experienced in 1999 and 2000.

Markets are built on greed and fear, with the risk being that the emotions of the day are so dominant that investors learn the wrong lessons at the wrong time. For example, during the greed phase of the bull market, many investors became convinced that every dip in the market was an opportunity to buy, that diversification was foolish, and that valuation no longer mattered. All of those lessons have since been unlearned at great cost.

Now that we are well into the fear phase of the bear market, another risk is that many investors will overreact in the other direction and completely shun equity markets. Thoughts of growing assets patiently over time are easily abandoned as investors seek to avoid further losses and preserve what is left. The desire to avoid risk at all cost may cloud sound investment judgment and prevent investors from being exposed to equities at depressed prices.

Equities Now Priced to Outperform Bonds

Despite the harrowing period we have endured, we continue to believe that equity investment is one of the best ways for investors to benefit from

the economy's long-term growth. As shown in Chart 1, on an inflation-adjusted basis, global equities have tended to outperform global bonds by more than 3% per annum over the last 40 years. Moreover, the chart does not capture the tax efficiency of stocks versus bonds, since bond returns come largely through taxable coupon income instead of capital gains.

Chart 1 also indicates that big, multi-year swings in the relative performance of stocks versus bonds have been the norm historically. We have just been through one of the largest swings on record in favor of bonds. That reflects a massive swing in investor sentiment away from stocks and toward bonds, as unbridled optimism about growth and profits has been replaced by profound pessimism.

In early July, we pointed to Chart 1 as one reason among others for stepping up exposure to equities. That turned out to be poor timing in the short run, even if it turns out to be correct in the long run. Shocked by the WorldCom bankruptcy, U.S. investors pulled a record \$49 billion from equity mutual funds in July. That helped push the equity market to new bear-market lows, and extended the relative performance of bonds versus stocks into extreme territory. At one point in July, U.S. equities reached a point of being nearly 37% undervalued against bonds according to the Fed model, which compares the estimated earnings yield of the equity market to the yield on 10-year government bonds. Accordingly, we raised our exposure to equities in CI International Balanced Fund further in late July, and now have exposure of roughly 65% equities versus 35% fixed income.



After the Fall (cont'd)

Even with the rebound in equities since late July, Chart 2 indicates that the Fed model still shows equities undervalued by nearly 32% against government bonds. So unless one believes that the U.S. is entering into a multi-year deflationary slump, as in Japan in the last decade, equities are now priced to handily outperform bonds in coming years. Of course, with long-term government bonds yielding just over 4%, equities could do twice as well and still deliver single-digit gains.

Our best guess is that equities will deliver total returns in the 7%-to-10% range over the next decade. The lower end of the range would apply if equities simply go back to their normal pattern of outperforming bonds by 3% per annum. The higher end of the range would prevail if some of today's pessimism lifts, permitting equity valuations to return to "fair value."

Returns of 7% to 10% would be a far cry from the performance experienced during the bull market of the 1980s and 1990s. Such returns would represent reasonable results in a low-inflation climate and would imply that equity values rise by at least 100% over the next 10 years or so. That would be a radically more challenging environment for equity investors and investment managers compared to the go-go years of 20% plus returns per annum.

Coping with a Challenging Environment

As investment managers, what are we doing to cope with the more challenging environment? First, we are managing our own discretionary costs very carefully. Our focus is to invest in people and in research resources that can help us outperform the competition. At the same time, we are taking positive action that we think will help us with short-term portfolio protection as well as long-term positioning:

- We are focusing on managing risk through portfolio diversification.

We have always run broadly diversified portfolios, but the current environment of low inflation and relatively high corporate debt has created many more "risk events" (i.e., bankruptcies) than was the norm in the past. In response, we have increased diversification by owning a variety of asset classes and diversifying within those asset classes.

This has resulted in (1) significant positions in emerging market equities, which have been attractively valued and benefit from low interest rates; (2) significant positions in mid-cap securities, which have offered more attractive relative valuations than large caps; (3) significant positions in corporate and high-yielding debt, which have been relatively cheap compared to equities while offering a preferred position in firm's capital structure in the event of adverse developments.

- We are putting greater analytical focus on fundamental analysis of balance sheets and corporate capital structure.

We have developed a number of quantitative screens to help us keep ahead of the crowd in identifying bankruptcy risks. This type of vigilance is necessary because there are now a large number of companies with very high financial leverage. Chart 3, for example, depicts U.S. corporate debt-equity ratios ranked by firm size (measured in terms of stock market capitalization). As shown, the smallest firms currently tend to have extremely high leverage as seen in

G5 EQUITY-TO-BOND REAL RETURNS RATIO

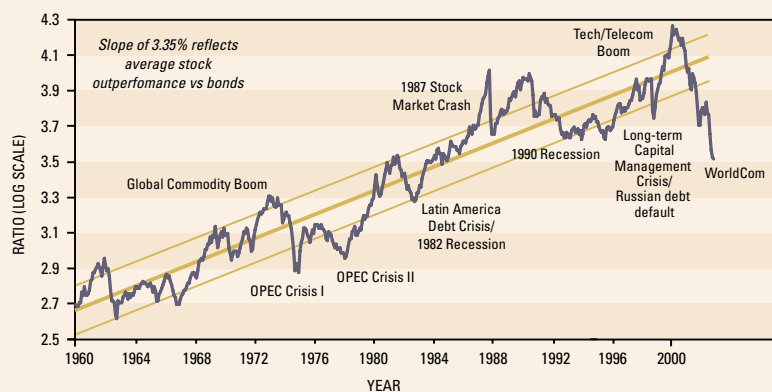


Chart 1: Adjusted for inflation, global equities have outperformed global bonds by a bit more than 3% per annum since 1960. The latest period of equity underperformance is one of the worst on record, and suggests sentiment against equities is overdone.



After the Fall (cont'd)

their debt-equity ratios. Even though overall debt ratios may not look too bad, there is a large group of companies with very risky debt characteristics.

Our focus on balance sheet issues does not mean we will never own a company with a high debt ratio. Such companies can be great investments, as when Chrysler managed to avoid bankruptcy in the late 1970s. But the current high level of financial leverage around the world suggests to us that successful equity investors will need to focus on understanding balance sheet issues for some time to come.

- We are enhancing our fundamental research capabilities.

Over the past two months we have hired two more investment professionals with strong backgrounds in securities valuation and global investing. Greg Gigliotti is portfolio manager and analyst, assisting my co-manager Bob Beckwith on stock selection for global portfolios, with particular emphasis on Europe. Greg was a colleague of Bob's at Goldman Sachs Asset Management, where he was a senior portfolio manager focusing on growth and income equity funds. Prior to that, he was a senior analyst for Mutual Series Funds, where he worked with

renowned fund manager Michael Price and focused much of his efforts on global and European investments.

More recently, we have hired Lara Alden, who was Greg's colleague as an international equity analyst at Mutual Series Funds. After having earlier worked as a financial analyst in private equities in the early 1990s, Lara later focused on European equity analysis at Mutual Series. She took a well-timed break from the markets in the last two years to earn an MBA from Northwestern University's highly regarded Kellogg Graduate School of Management.

- We remain focused on the long term.

There is no denying the seriousness of the stock market's current problems, and risk management must continue to be an important focus of any money manager. We are in the business of taking risk, and we believe that to do so effectively often requires a contrarian bent. That means a willingness to see long-term secular opportunities at a time when market participants tend to be focused primarily on short-term risks.

For example, the health-care sector has come under major pressure this year as markets focused on growing competition from generic drugs, increased regulatory risk, and lack of leadership from the Food and Drug Administration. Everything we know about demographics suggests growing demand for new drugs and therapies in coming years, with great opportunities for those companies with the right products. Accordingly, we have been selectively adding to our exposure in health care in recent months in response to improved valuations.

Likewise, we continue to believe that investment in information technology will return as a key driver of capital spending in coming years, despite the industry's current problems. Recent market weakness has served up technology companies with price-earnings multiples well below the market average, which is something we have not seen for years. Against that backdrop, we have been selectively increasing our exposure in the technology sector as well, while paying

THE FED MODEL

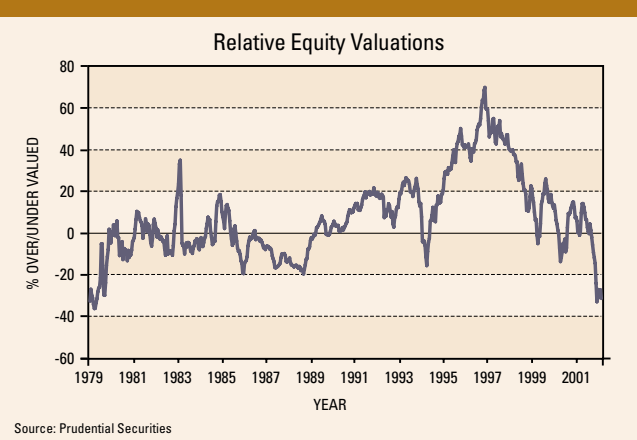


Chart 2: According to the Fed model, the U.S. equity market was more than 30% undervalued against 10-year Treasury bonds at the end of August.



After the Fall (cont'd)

close attention to valuation and balance sheet risks.

Will Falling Bond Yields Stimulate Global Growth?

These are trying times for optimists. With a U.S.-Iraq war on the horizon, there are no guarantees that things won't get worse before they improve again. That said, we continue to believe that financial markets have already factored in a great deal of bad news about the economy and international risks. Cash may be king for now, but in the U.S. it currently takes about \$60 to buy one dollar of interest income for the next 12 months. At that rate, it would take nearly 70 years for investors to double their money on an after-tax basis!

Many forecasters are now downgrading their outlook for global growth following the stock market slide in recent months. However, it may actually be time to raise growth forecasts since the sharp drop in bond yields could turn out to stimulate higher consumption and capital spending later this year and into 2003. This possibility is especially evident as we look at the

boom in mortgage refinancing that is going on in the U.S. and other countries in response to lower rates. At a minimum, the stimulus coming from lower long-term interest rates and lower U.S. taxes suggests that fears of a double-dip recession are quite overdone.

As frustrating as the market is currently, our job is to try to look through extremes of optimism and pessimism and maintain a steady investment discipline. Our belief is that global economic conditions will turn out to be better than the current consensus suggests, and that investors will be rewarded for maintaining exposure to equities through this challenging period. As students of financial history, we are well aware that periods of market turmoil have often provided investors with some of the greatest opportunities to make great returns, and are focusing our research process accordingly. Even with prospects for more subdued returns over the next decade, we know that recoveries from major bear markets are often spectacular. In fact, the current bear market ranks among the seven worst bear markets over the last 100 years, and the average 12-month advance from those bear market bottoms was 50%.

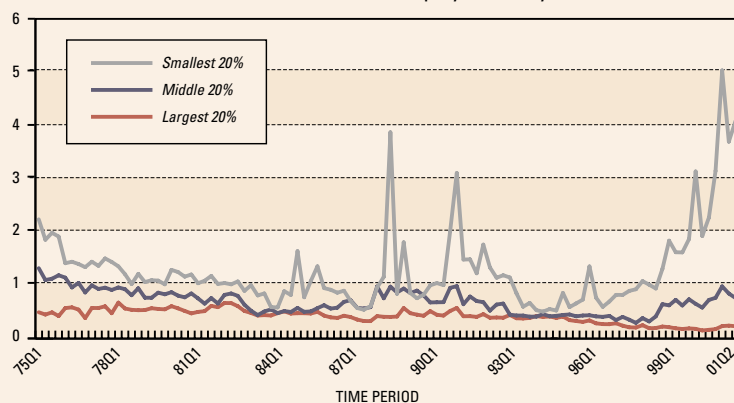
We believe that this is an excellent time for investors to review their holdings and reexamine their investment objectives and asset allocation, so that appropriate adjustments can be made to position portfolios for better results when the environment improves. It is precisely at times like this, when most investors would prefer not to think about the markets, that a few key decisions can have important results in protecting assets and positioning portfolios for better returns.

Sincerely,

*William Sterling, Global Strategist
CI Global Advisors LLP*

LOTS OF LEVERAGE

U.S. Nonfinancial Firms Debt-to-Equity Ratios by Firm Size



Source: New York Federal Reserve Bank and Compustat

Chart 3: As measured by debt-to-equity ratios, there are an unusually large number of firms with risky balance sheets, particularly among the smallest firms. This suggests the need for continued scrutiny of balance sheet issues.