

Investment Strategy Symposium

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1. Lessons of the Crash and Investor Evolution

Mitchell D. Eichen, J.D., LL.M.
Chief Executive Officer

2. Chaos in the Investment Management Industry – What It Means For You and Your Money

Stewart R. Massey
President

3. Municipal Bonds – Still a Safe Haven?

John Longo, Ph.D., M.B.A., C.F.A.
Investment Strategist

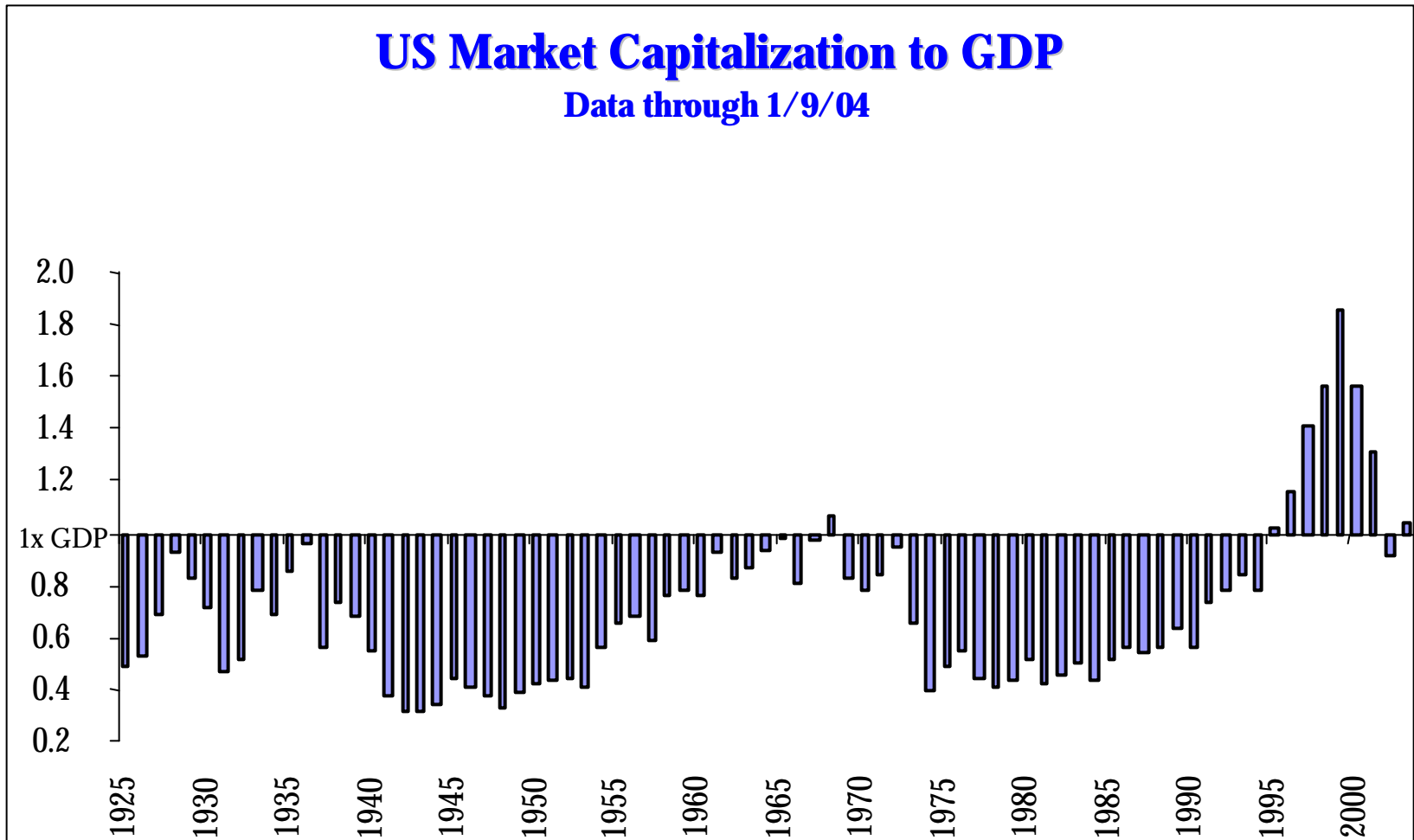
Greed Has Again Replaced Fear

- As the bear market fades into memory, investors are reverting to form.
- Investors feeling “safe” now that S&P 500 increased by 41.26% from March 2003 lows to the end of January 2004.
- Technology stocks again pacing advances.

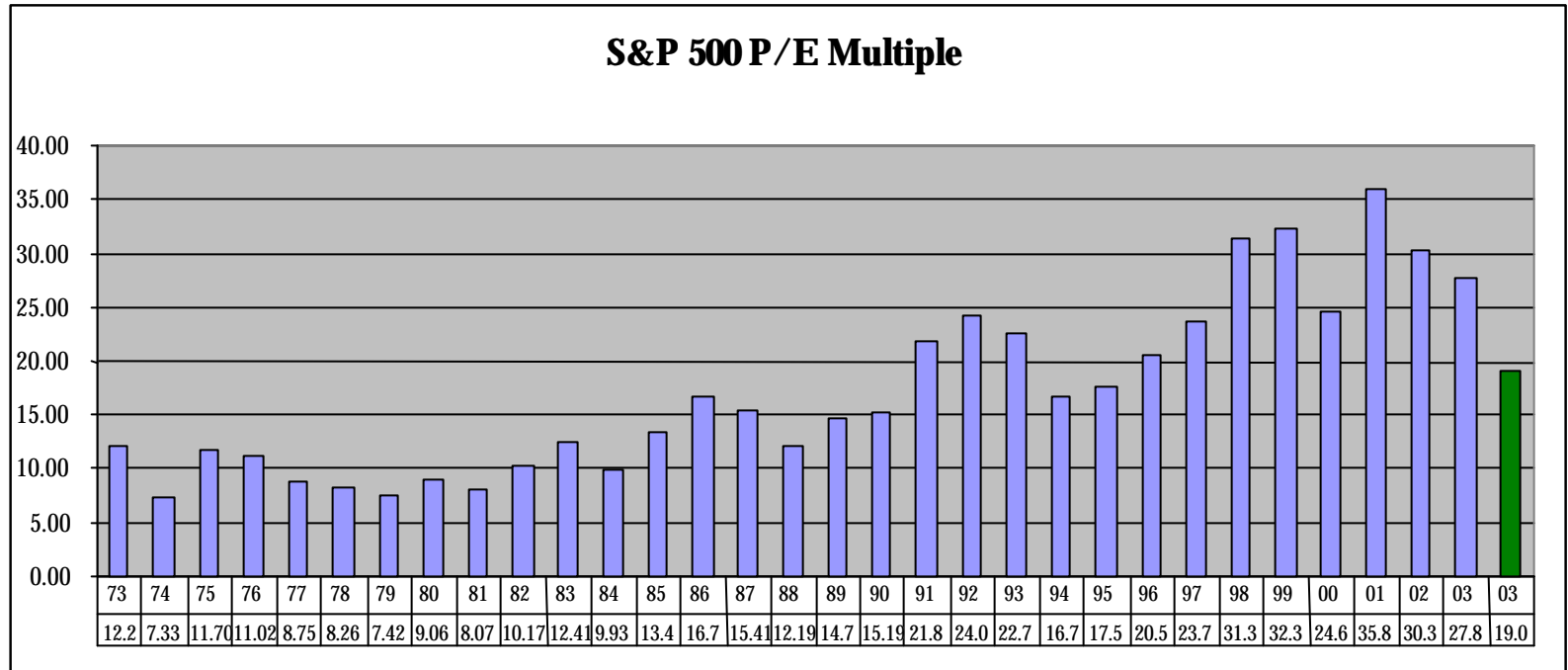
	1/31/03	9/30/03
– Tech Multiple:	29.24	38.50
– Non-tech Multiple:	16.77	14.35
– S&P Multiple:	19.04	18.75

- “Beating the Benchmark” has once again become the investors’ mantra.

Creating Historical Perspective



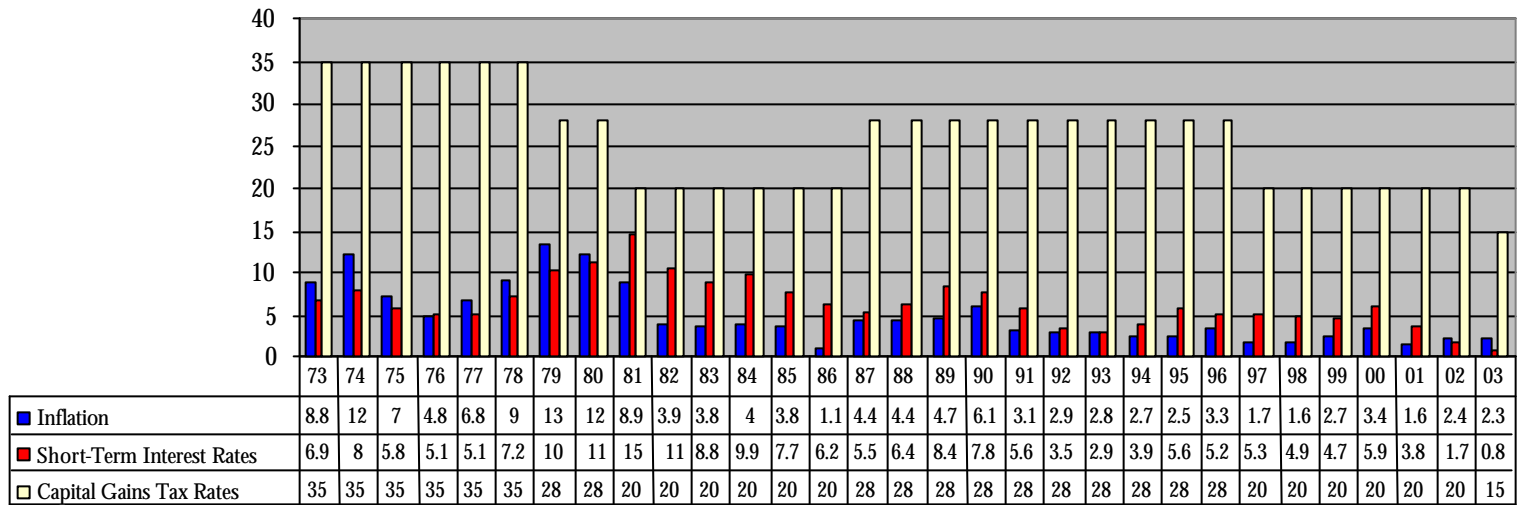
Creating Historical Perspective



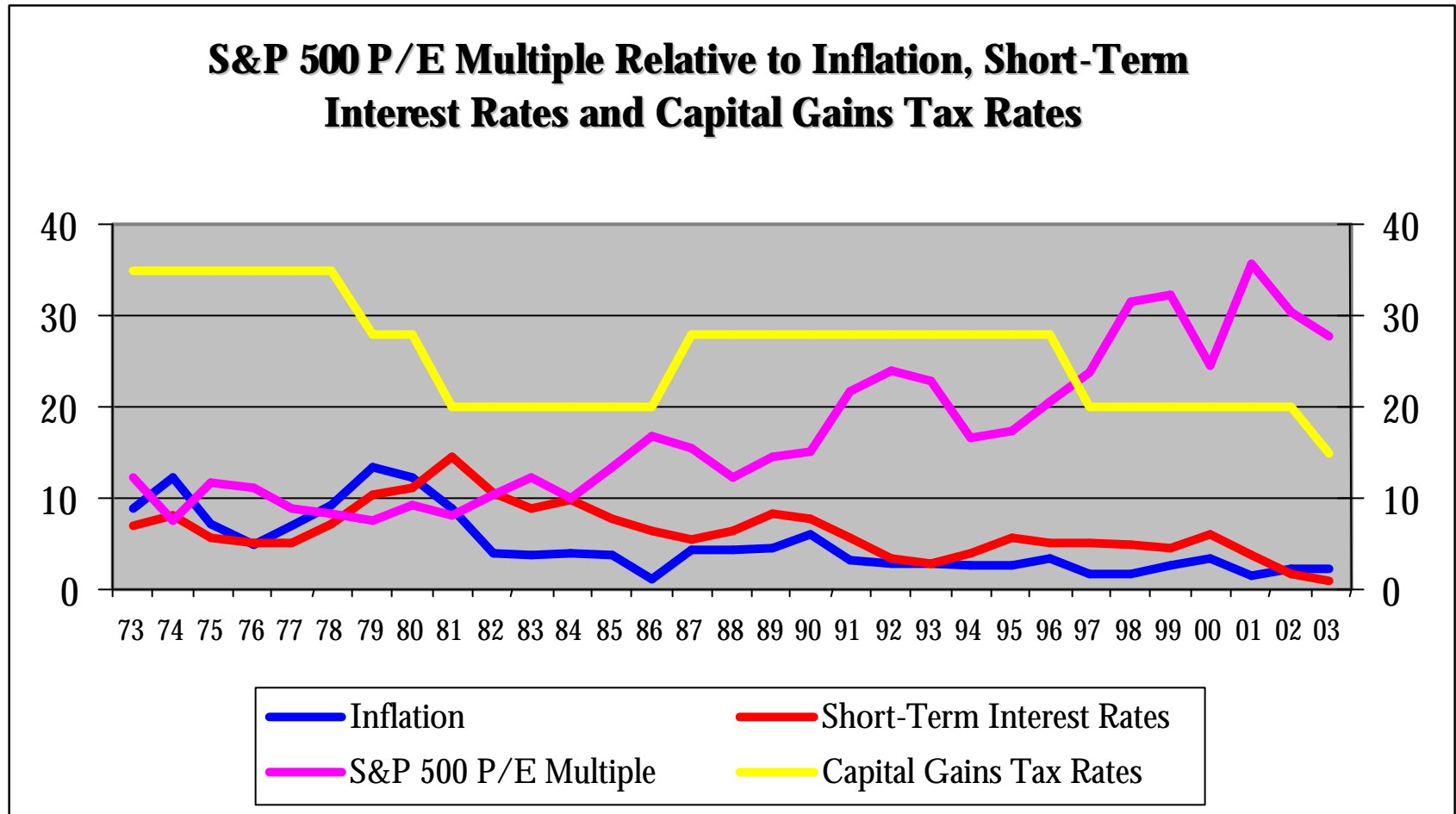
*Based on forward earnings

Creating Historical Perspective

Inflation, Short-Term Interest Rates, and Capital Gains Tax Rates



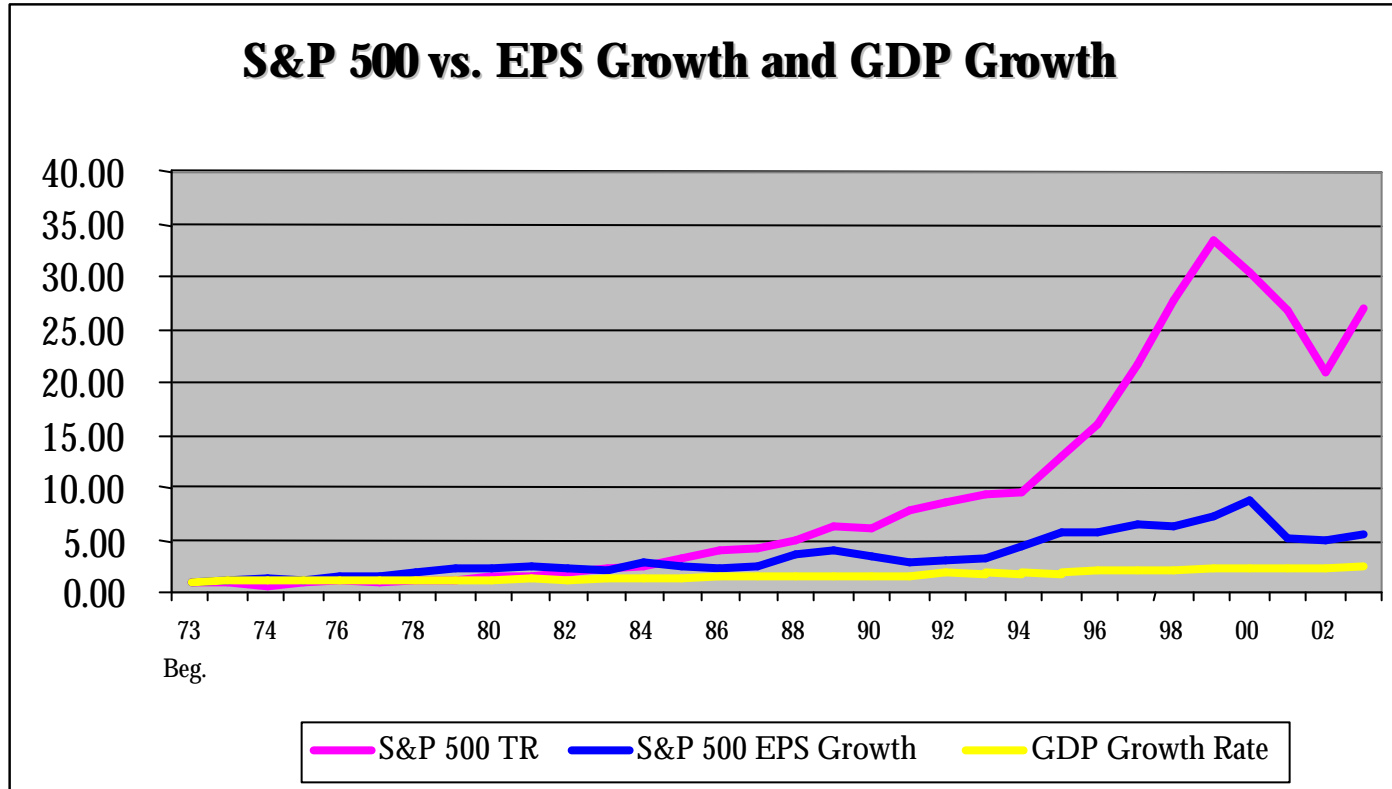
Creating Historical Perspective



Relative to where they were 30 years ago...

- P/E multiple is 127% higher today.
- Inflation is 74% lower today.
- Short-term interest rates are 88% lower today.
- Capital gains tax rates are 57% lower today.

Creating Historical Perspective



**Average
Annual
Increase**

11.20%

5.74%

3.00%

P/E Multiple Expansion Drove Much of the Growth Over Past 30 Years

S&P 500 Growth as a Multiple of EPS: **1.95.**

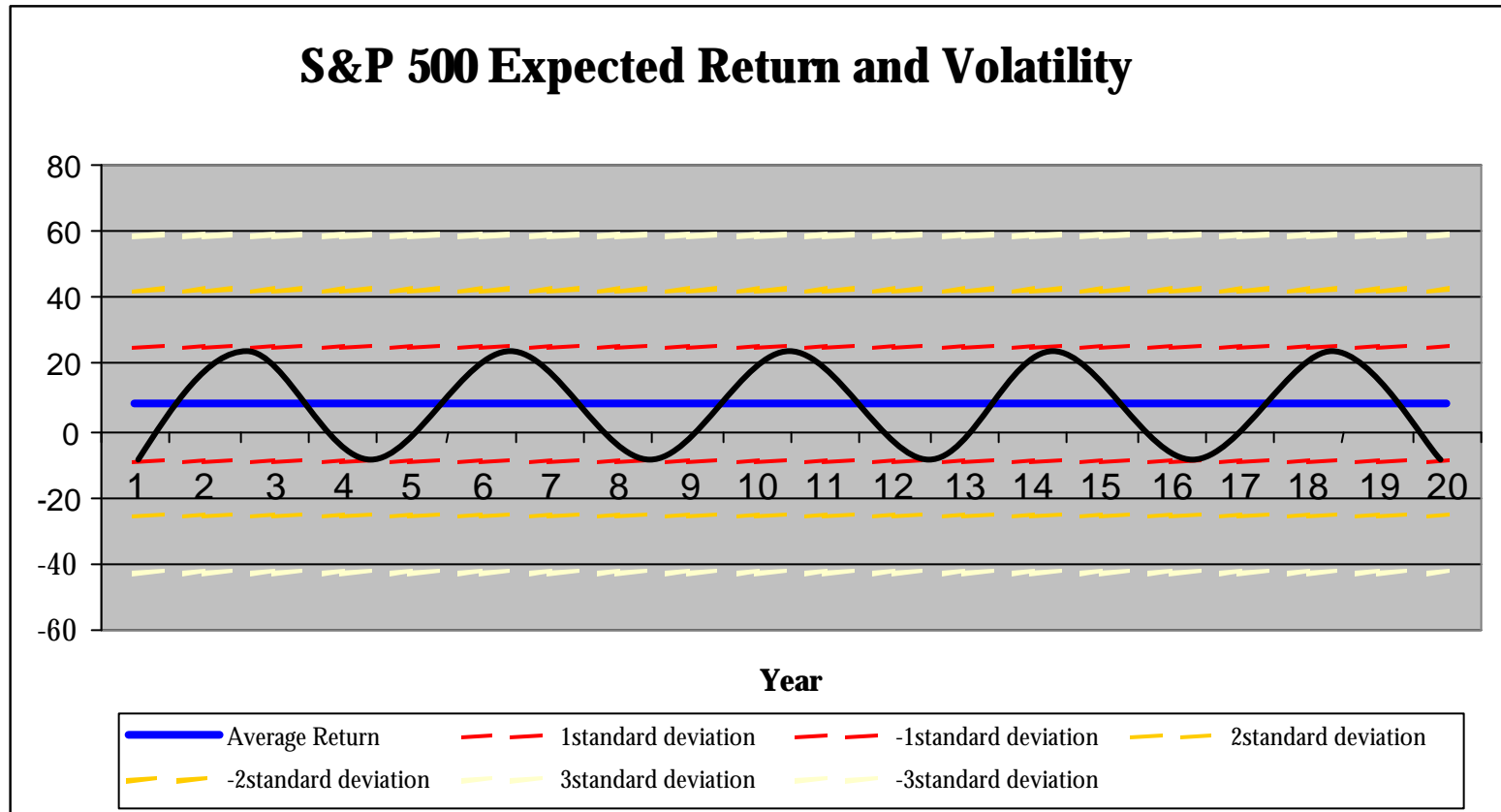
% Growth in S&P Driven by Multiple Expansion vs. EPS: **51.25%.**

Setting Realistic Expectations

$$\begin{array}{ccccccc} \text{GDP} & + & \text{Productivity} & \times & \text{Multiple} & + & \text{Dividends} & = & \text{Total} \\ \text{Growth} & & \text{Enhancement} & & \text{Expansion} & & & & \text{Expected} \\ & & & & & & & & \text{Return} \end{array}$$

$$3\% + 3\% \times 1 + 2\% = 8\%$$

... But Growth Will Not Be Linear



Expected Return

8%

68% Confidence Interval (1 std)

-9% to 25%

95% Confidence Interval (2 std)

-26% to 42%

99% Confidence Interval (3 std)

-43% to 59%

How Can MDE Help You Evolve in a Changing World

1. Blur the Lines Between Investments
Increase Focus on After-Tax Returns.

Example 1: High Dividend Managers

	Multiple	Dividend	Std. Dev.
S&P 500	19	1.75	17
High Div. Mngr.	12	4.5	15

Added Bonus: Tax-Efficiency

- New tax law taxes dividends at 15%.
- A 4.5% dividend delivers 3.82% after taxes, equivalent to a 10-yr. municipal bond.

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Example 2: Convertible Bonds with Covered Calls

$$\begin{array}{ccccccc} \text{Yield on Convertible Bond} & + & \text{Premium on Calls} & = & \text{Stand Still Return} \\ 5\% & & 5\% & & 10\% \end{array}$$

Average Correlation of Convertibles vs. Underlying Stocks = 60%

Expected Return in Bull Market= 16%

Stocks Increase by 10% x 60%= +6%

Stand Still Return in Flat Market= 10%

Stocks Decrease by 10% x 60%= -6%

Expected Return in Bear Market= 4%

Added Bonus: Tax-Efficiency

- Premiums on calls are taxed as short-term capital gain.
- If client has tax losses, tax gains can be offset by losses.
- That makes 5%, or half of the stand still return tax-free.

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The Traditional Investment Management Business is Changing...

- Once a vaunted profession that focused on performance, the rise of “style boxes” created benchmarks that managers were forced to conform to.
- Portfolio managers would buy stocks and sectors they didn’t like just to stay close to their benchmarks.
- “Closet indexing” became the norm.
- As markets surged in the 90’s, investment managers became marketing machines. Their focus became size and scale, not performance.

The Traditional Investment Management Business is Changing...

Example of Benchmark Sensitivity (Sector Weights)

Sector	Equity Composite in %	Russell 1000 Value Index in %
Financial Services	35.8	37.0
Technology	6.5	7.1
Health Care	3.9	3.3
Consumer Discretionary & Services	10.5	10.0
Consumer Staples	6.0	5.9
Other	1.4	1.3
Producer Durables	4.2	4.0
Other Energy	1.9	1.8
Autos and Transportation	2.7	2.2
Integrated Oils	8.4	2.2
Materials and Processing	5.5	5.3
Utilities	13.1	12.7

The Traditional Investment Management Business is Changing

Examples of Benchmark Insensitivity (Sector Weights)

Sector	Equity Composite in %	Russell 1000 Value Index in %
Financial Services	27.4	35.8
Technology	25.3	6.5
Health Care	23.4	3.9
Consumer Discretionary & Services	15.1	10.5
Consumer Staples	4.7	6.0
Other	4.0	1.4
Producer Durables	0.0	4.2
Other Energy	0.0	1.9
Autos and Transportation	0.0	2.7
Integrated Oils	0.0	8.4
Materials and Processing	0.0	5.5
Utilities	0.0	13.1

The Traditional Investment Management Business is Changing...

- Performance woes and legal pressures are creating catalysts for change.
- A good part of the investment management industry is in chaos.
- Talent is leaving the large multi-product firms.
- Clients are re-examining benchmarking, absolute return strategies, and indexation.

...Money is on the Move...

- Large institutional investors have moved billions into absolute return strategies over the past several years.
- American households with investment capital of \$5 million or more have 6% of their capital in mutual funds compared with 11% two years ago (Spectrum Group survey).
- NY State Attorney General Eliot Spitzer called mutual fund fees “grossly out of control...” (Bloomberg).
- Investment in index funds remains active.
- Japanese investments in hedge funds tripled in 2003 to \$2 billion (Goldman Sachs and Frank Russell).

Make Way for the Reemergence of the Investment Professional

- A class of money managers is emerging that focuses on performance, not scale.
- Not all of these managers are hedge funds.
- Some managers are benchmark aware, others are benchmark insensitive.
- An important question to ask is, “How many units of risk am I taking for each unit of return I’m receiving?”

Is Benchmarking Rational or Relevant?

- Indices are capitalization-weighted.
- Largest stocks have disproportionate effect.

Example: S&P 500

Top 5 stocks: 1% of number of stocks
13.61% of index weight

Top 10 stocks: 2% of number of stocks
22.75% of index weight

Top 20 stocks: 4% of number of stocks
33.60% of index weight

Small Numbers of Stocks Have Large Impact on Performance

S&P 500 Performance Attribution 1998-2003

2003 S&P 500 Total Return: 28.78%				
YTD				
Name	Percentage of Index	12/31/03 Weight	Weighted Return	Perform. Contrib.
Top 5 Stocks	1.00%	13.61%	3.15%	10.94%
Top 10 Stocks	2.00%	22.75%	7.41%	25.75%
Top 20 Stocks	4.00%	33.60%	9.19%	31.94%

2001 S&P 500 Total Return: -11.93%				
2001				
Name	Percentage of Index	12/31/01 Weight	Weighted Return	Perform. Contrib.
Top 5 Stocks	1.00%	14.72%	1.49%	-12.50%*
Top 10 Stocks	2.00%	24.83%	2.02%	-16.97%*
Top 20 Stocks	4.00%	36.59%	0.55%	-4.61%*

*would have been 2.57%, 5.34%, and 17.69% without the 2 big performers

1999 S&P 500 Total Return: 21.04%				
1999				
Name	Percentage of Index	12/31/99 Weight	Weighted Return	Perform. Contrib.
Top 5 Stocks	1.00%	17.30%	11.78%	56.00%
Top 10 Stocks	2.00%	26.25%	15.39%	73.12%
Top 20 Stocks	4.00%	38.98%	24.11%	114.58%

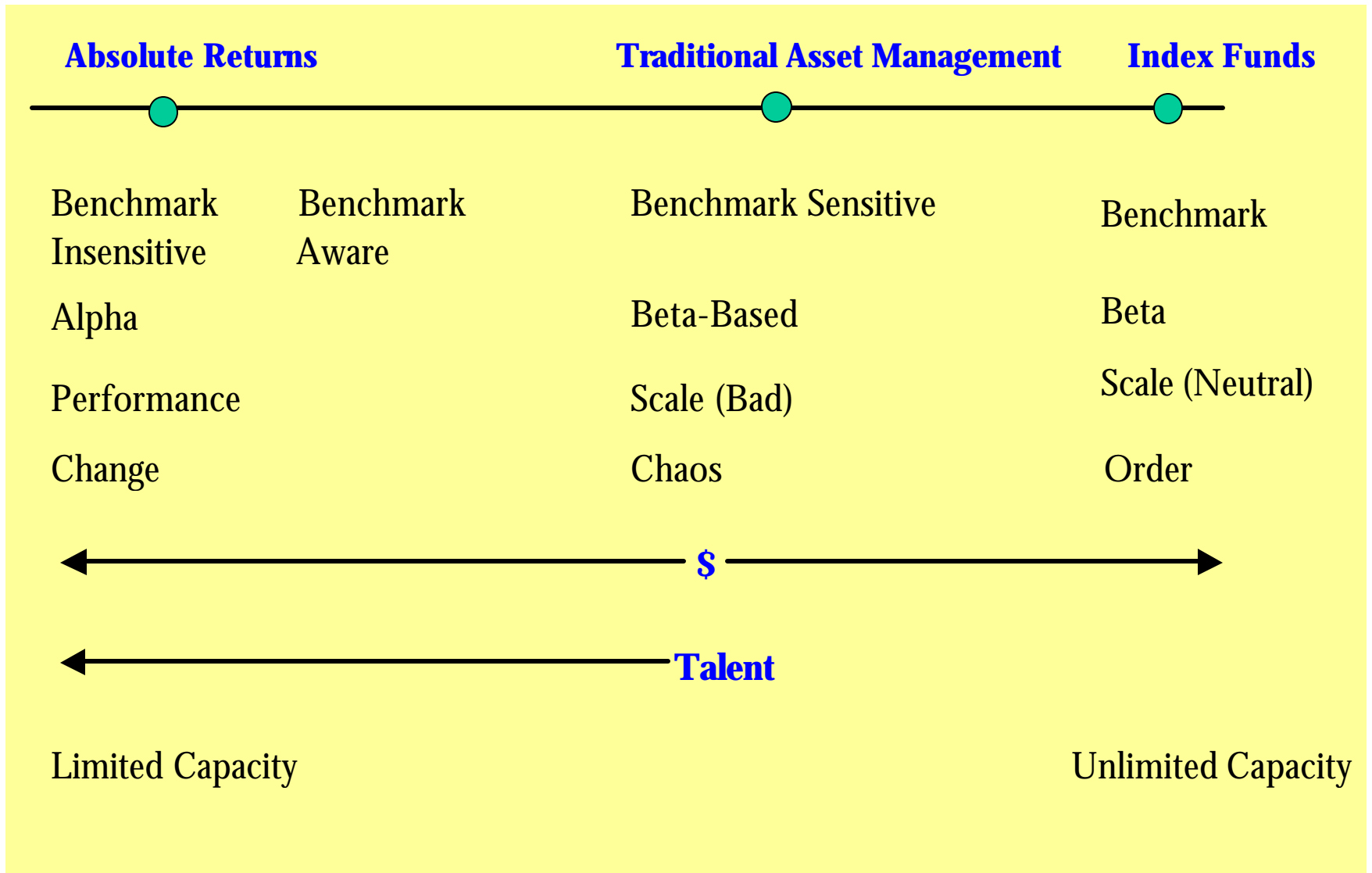
2002 S&P 500 Total Return: -22.10%				
2002				
Name	Percentage of Index	12/31/02 Weight	Weighted Return	Perform. Contrib.
Top 5 Stocks	1.00%	14.37%	-2.97%	13.44%
Top 10 Stocks	2.00%	23.61%	-4.75%	21.51%
Top 20 Stocks	4.00%	35.38%	-6.04%	27.32%

2000 S&P 500 Total Return: -9.10%				
2000				
Name	Percentage of Index	12/31/00 Weight	Weighted Return	Perform. Contrib.
Top 5 Stocks	1.00%	13.80%	0.94%	-10.35%*
Top 10 Stocks	2.00%	23.42%	0.26%	-2.89%*
Top 20 Stocks	4.00%	35.77%	0.32%	-3.55%*

*would have been 1.49%, 24.55%, and 24.88%, without the 3 big performers

1998 S&P 500 Total Return: 28.58%				
1998				
Name	Percentage of Index	12/31/98 Weight	Weighted Return	Perform. Contrib.
Top 5 Stocks	1.00%	13.55%	9.92%	34.70%
Top 10 Stocks	2.00%	22.54%	15.82%	55.36%
Top 20 Stocks	4.00%	36.00%	22.98%	80.41%

The Investment Management Spectrum



In Summary

- Benchmarks create a “false race” for investment returns. You can’t “eat” relative performance.
- Large brand name firms are under pressure to change their business model.
- Investors are not getting value for the fees they are paying.
- Money is on the move.
- Investment talent is on the move.
- Manager selection and due diligence are becoming more important as the investment management business continues to fragment.

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Investment Strategist

The MDE Group's View on Munis

Q: Are municipal bonds still a safe haven for investors in search of income and capital preservation?

A: No!

The MDE Group is currently recommending that its clients significantly reduce exposure to municipal bonds. (The actual magnitude of the reduction depends on the client's particular situation.)

Why Are Munis Not A Safe Haven?

- 1) If interest rates do not move, you may do better in alternative low / moderate risk, high-income investments.

Many investors are fooled by the optical illusion of coupon income. Coupon income or current yield is NOT equal to the total return you receive from the bond.

Why Are Munis Not A Safe Haven?

- 2) Interest rates are near historical lows. If they rise you may lose money (if you sell before maturity) and experience a decrease in your standard of living.

**Q: How
Would
You
Describe
The
Woman
In The
Picture?**



THE MDE GROUP, INC.
Your family's most trusted advisor

Optical Illusion of Coupon Income

Example:

\$1 million (face value) of AAA munis.

Coupon Rate = 5% = \$50,000 in income per year.

Maturity Date = 10 years (Jan. 2014).

Current Yield To Maturity = 3.45%.

Current Market Price of muni portfolio = \$1,128,300.

Optical Illusion of Coupon Income

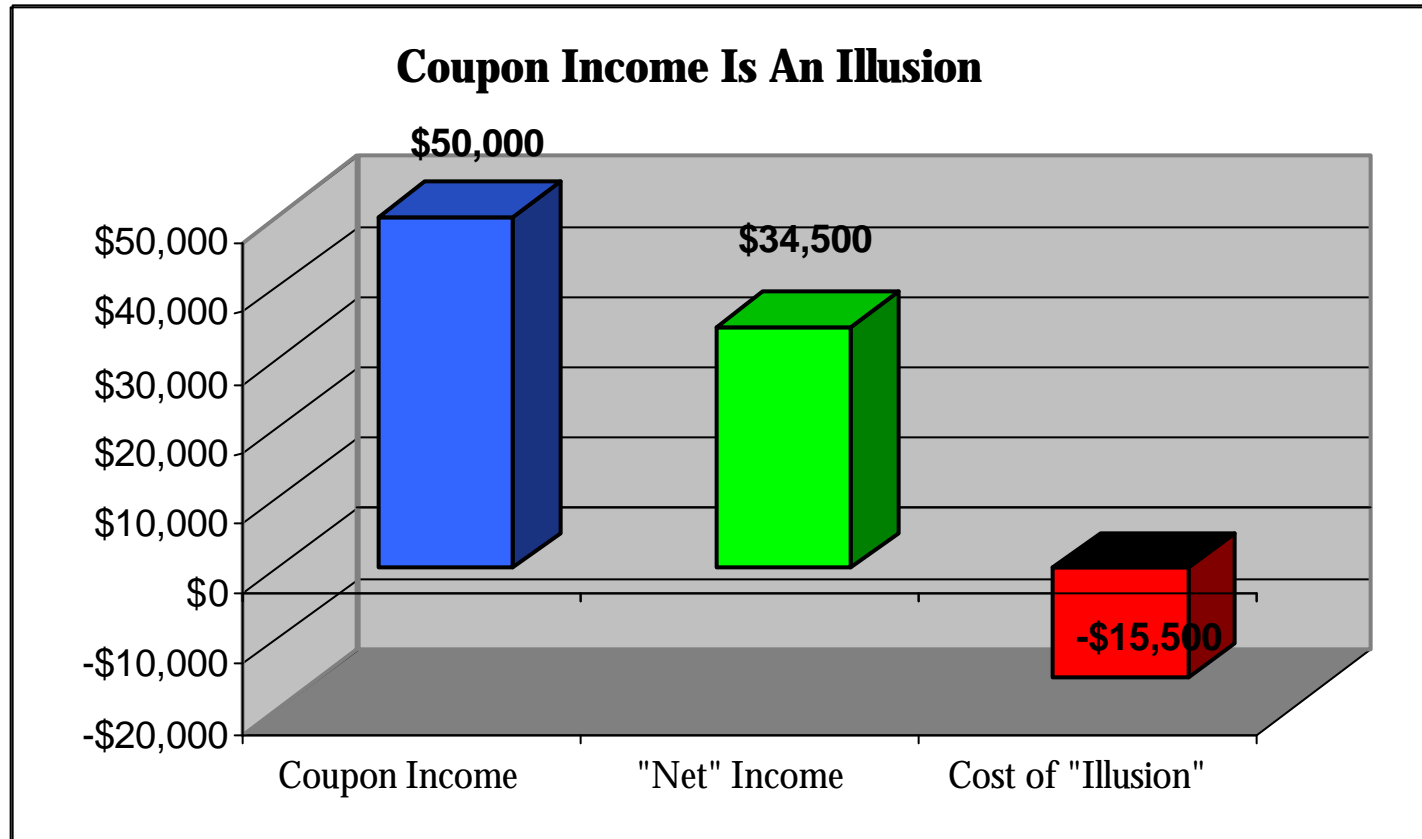
Example (continued):

Although you receive coupon payments of \$50,000 each year your NET return is much lower.

It is a FACT that the value of the muni bond portfolio must shrink to \$1 million at the maturity date of the bonds.

Your NET return is approximately \$34,500 (or \$15,500 less than many believe) due to the portfolio convergence to \$1 million.

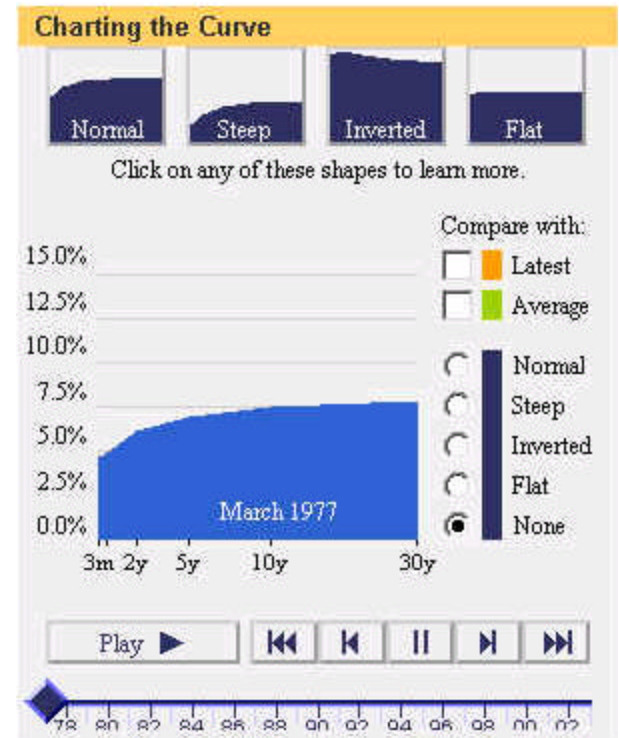
Optical Illusion Quantified



How Low Are Interest Rates?

Let us take a look at how current interest rates compare to historical levels.

[Living Yield Curve \(Smartmoney\)](#)



What Happens To Your Portfolio If Interest Rates Rise?

Example:

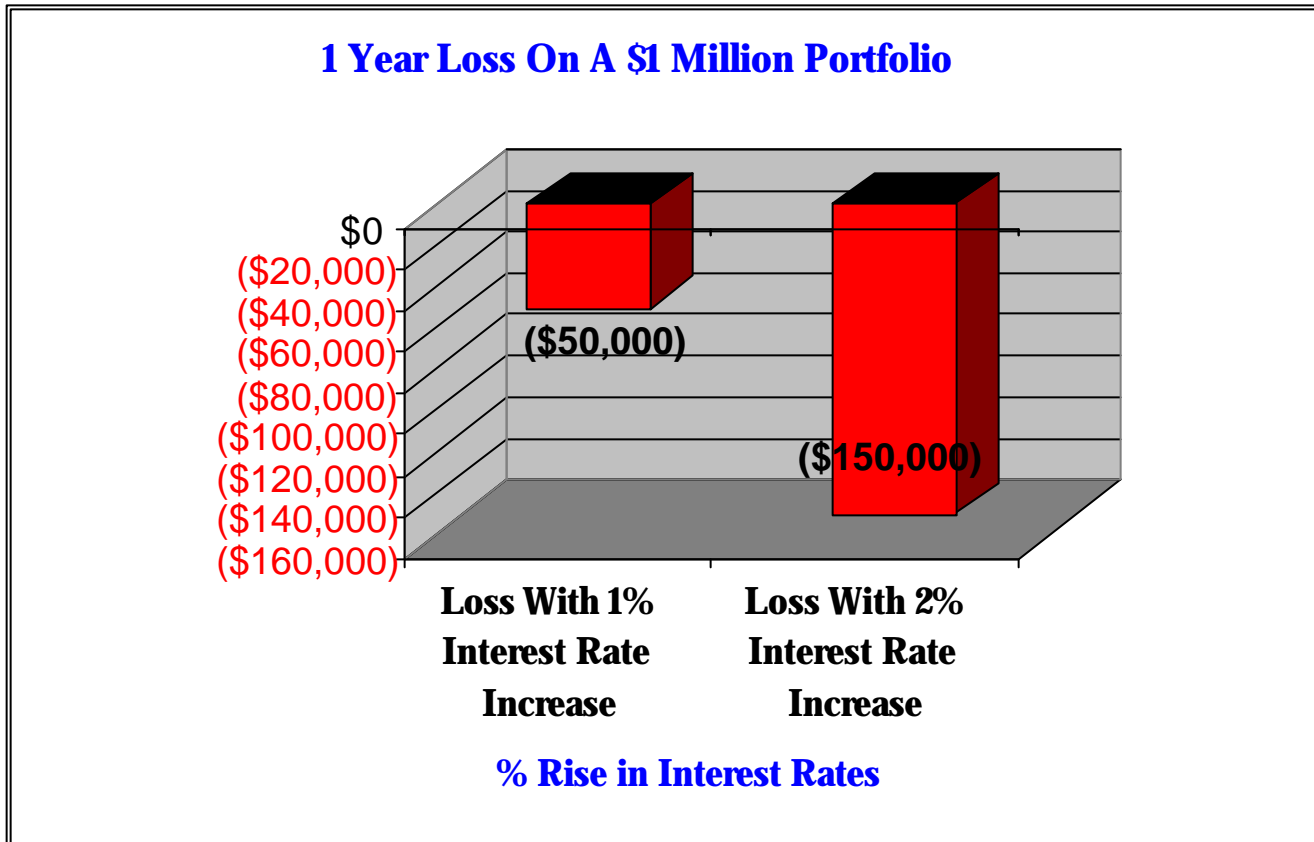
- \$1 million muni portfolio.
- Coupon rate = 5% = \$50,000 in income.
- Effective maturity (duration) = 10 years.
- Assume a 1% rise in long-term interest rates.

What Happens To Your Portfolio If Interest Rates Rise?

Example (continued):

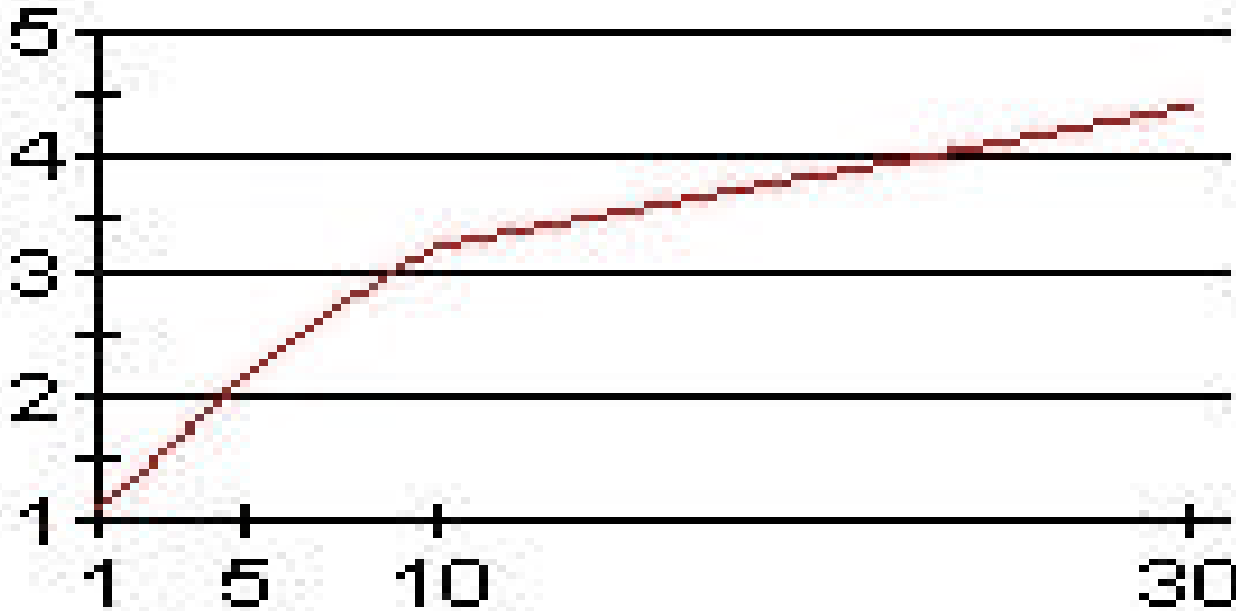
- Change in value of \$1 million portfolio = $-10 * 1\%$
= loss of 10% = \$100,000.
- Coupon received = 5% = \$50,000 in income.
- Net LOSS = 5% or \$50,000.
- A 2% rise in interest rates would result in a 15% loss over the year or \$150,000.

Interest Rate Risk Quantified



The Current Yield Curve

- What do you see? What does MDE see?



Chinese Ideogram For Crisis

The current landscape for municipal bonds?

**The Top Part
Is The Symbol
For Danger**



**The Bottom Part
Is The Symbol
For Opportunity**

The MDE Group Perspective

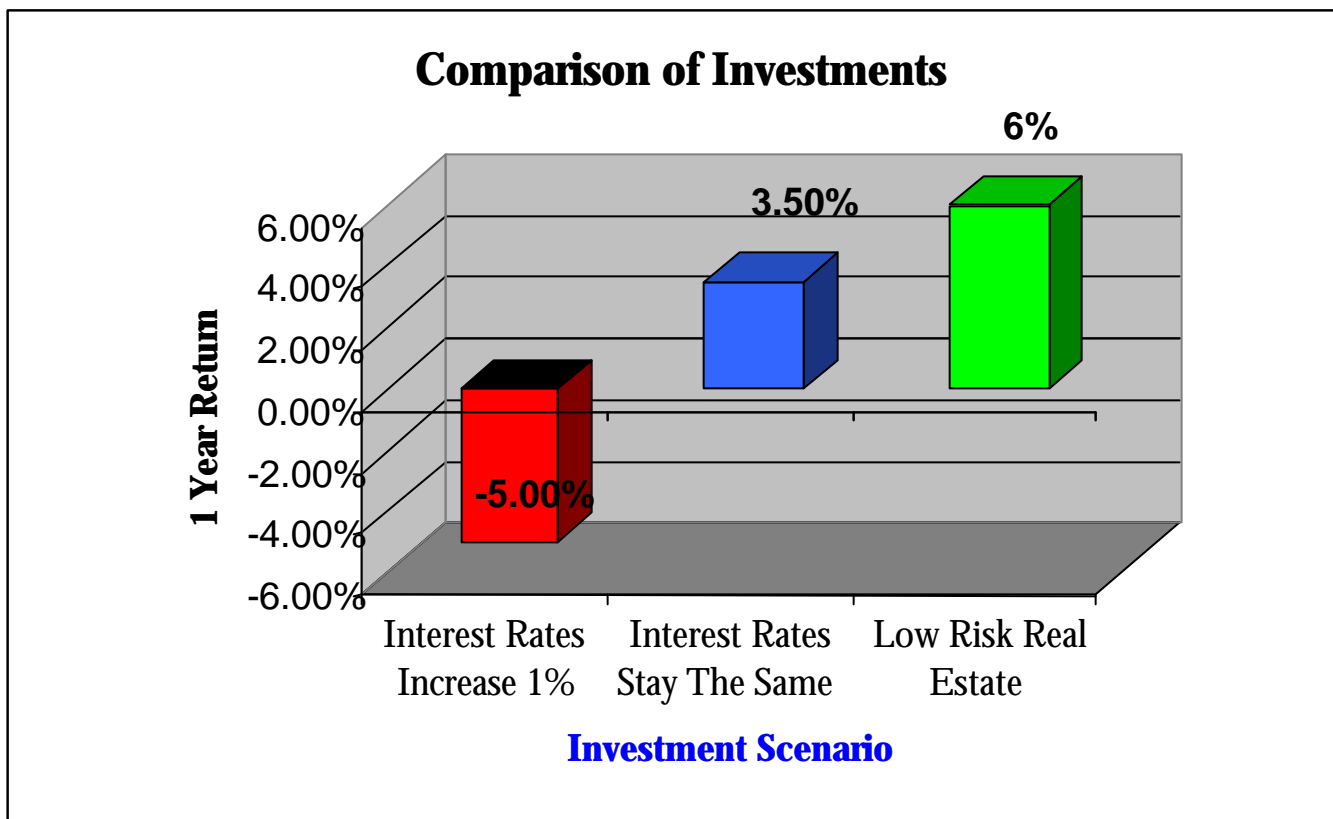
- While others see only danger in the fixed income market (or worse, see nothing), we at The MDE Group see opportunities for our clients.



MDE Is Recommending Or Exploring The Following Muni Alternatives

- Ultra-short term bond funds
- Low risk, high income real estate investments
- High dividend yield, low risk stocks
- Diversified domestic & international bond funds
- Convertible bonds and option overwrites
- Overlays on existing muni portfolios
- Step up and floating bonds

Comparison of Investments



MDE Sees Opportunities

- We'd be happy to talk to you and find the opportunities that best relate to your financial goals and objectives.