

A LOOK AHEAD AT THE YEAR AHEAD

**Ten Investment Themes for 2004 and
Our Five Strategic Wealth Management Themes to Capitalize on
Them**



THE MDE GROUP, INC.

Your family's most trusted advisor

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MDE's Ten Investment Themes for 2004

We at MDE are strategic thinkers and long term investors. We firmly believe that no one can know the unknowable or predict the unpredictable. Therefore, we eschew market timing or rapidly changing strategies that rely on someone's ability to predict the future. Neither do we believe in ignoring the world around us and blindly following static buy and hold index-like strategies. The world around us is constantly changing and we must take these facts into account as we evolve our investment process to meet the challenges of an ever-shifting investment landscape.

With this in mind, we would like to share with you our thinking on some of the important factors we believe will play an important role in the year that has just begun. We do so with all due humility and the recognition that our ability to gaze into the future is no better than anyone else's. We can state with some confidence that some themes are likely to be correct, some incorrect, and some partially correct. We can also predict with great confidence that what will ultimately prove to be some of the major themes of 2004 are neither on our list, nor on anyone else's. With these important facts in mind, we humbly offer you our top ten investment themes of 2004.

1. ***Equity volatility will increase as the year progresses.*** Throughout much of 2003, the equity markets went one way – up. Last year, the largest correction after March 31st was only 4%, possibly lulling investors back into a false sense of security that, like the late 1990s, the equities could only move in one direction. This is reflected in the current “VIX” level, i.e. the price that investors are willing to pay for portfolio insurance. The current “VIX” level of 14.7 is not only near its 52 week low, but well below its 5 year average (24) and 10 year average (21). This signals investor complacency that generally sets in during momentum driven markets. However, investors hate uncertainty. Therefore, we should expect demonstrably higher volatility as political, corporate and macro economic uncertainty increasingly dominate the headlines – especially in the second half of the year.
2. ***Sector rotation and stock selection will take on increasing importance in the equity markets.*** Broad indices, such as the Russell 3000 and the S&P 500, posted outstanding performance in 2003. This performance came largely on the rebound of “beaten down” technology stocks that dominate such capitalization-weighted indices. Continued earnings momentum, and cash re-entering the markets, will likely remain strong during the first half of the year allowing technology stocks, and other speculative names, to remain inflated. Existing high price earnings multiples on these stocks will likely hit a glass ceiling, and may begin to contract in the second half of 2004. Tougher year over year earnings comparisons will cause the dominant names of 2003 to recede into the background while those neglected and undervalued names begin to garner attention.
3. ***Large capitalization and value stocks will lead the market as small capitalization and emerging growth stocks recede.*** As investor appetite for risk declines with the reemergence of market volatility, investors will seek refuge in high quality companies with real, predictable and sustainable earnings. Over the near term, chief among those forgotten industries vying for investor attention will be major U.S. pharmaceutical companies. These one time darlings of the investment community may no longer justify premium market multiples due to their perceived inability to sustain long term double digit top line growth. However, in many cases the multiples of these high quality companies have room for additional expansion, at least up to market levels, thereby providing some near term, low risk opportunities for investors.
4. ***Dividends will once again matter to investors – a lot.*** Historically dividends were a large component of long term total return on equities. This changed in the mid 1990s as capital appreciation drove the markets and dividend yields declined. One of the surprises in 2003 is that capital appreciation continued to drive the markets and that

the much touted reduction in dividend taxes had little impact on equity returns. This should change this year as investors seek the stability and consistency that high quality dividends provide – with the added bonus of tax efficiency for the taxable investor. Dividends will once again become a large percentage of equity total performance in 2004 and beyond as long term returns, on average, will be in the high single digits.

5. ***International equities will outperform domestic equities, but currency risk in parts of the world could mitigate these returns.*** U.S. equities are currently selling at a premium to their European and Asian counterparts making foreign markets more attractive than U.S. markets on a valuation basis. While U.S. markets may underperform their foreign counterparts in local currency terms, the returns to the U.S. investor will largely hinge on the performance of the dollar. After weakening dramatically against the Euro in 2003, the dollar may be poised for a rebound in the second part of the year as the European central bank may be forced to intervene to stop the rise of the Euro. This would lessen dollar denominated returns on European stocks to U.S. investors. However, Asia may prove more attractive to the U.S. investor. The dollar may weaken against the Yen thereby enhancing returns on Japanese stocks in dollar terms. In addition, China's economy will continue to grow rapidly as the government will continue to shore up troubled banks. India's economy will grow even faster as they continue to introduce economic reforms. As always, geopolitical risk abounds in these regions so investors must tread lightly.
6. ***M&A activity and IPOs will be back in vogue on Wall Street.*** After a three year hiatus during the bear market, M&A activity and IPOs began to become more prevalent towards the end of 2003. This trend will accelerate in 2004 as higher stock prices make both markets more attractive. In addition, look for foreign companies to become more active in this arena as their inflated currencies versus the dollar make U.S. companies more attractive to foreign buyers in local currency terms.
7. ***The Fed will remain on hold for much of the year.*** With the threat of inflation low, the Fed will remain accommodative for much of the year to ensure that the recovery continues to have sufficient fuel to keep it going. Given the upcoming presidential election the Fed may even wait until after the election to remain above the political fray. While it is nominally apolitical, underlying any Fed inaction may be Chairman Greenspan's sensitivity to the fact that his tight money policy throughout 1992 was blamed, at least in part, for the defeat of the President's father in his bid for re-election.
8. ***U.S. bonds will have a flat to negative year.*** With interest rates at 40 year lows, there will be upward pressure on rates as the economic expansion continues throughout the year. This will likely be the worst year for bonds since 1994 when the yield on 10 year Treasury bonds rose by 180 basis points leading to a loss in the bond market. If yields on the 10 year Treasury end 2004 in the 5.25% - 5.5% range from their current level of 4.05%, 10 year bonds could post low to mid single digit losses even after offsetting coupon payments.
9. ***Expect more rules, increased regulation, and additional criminal prosecutions on Wall Street and in Corporate America to further restore confidence in the U.S. financial markets.*** The SEC, NASD, NYSE, and crusaders like N.Y. Attorney General Elliot Spitzer, will continue their increased scrutiny, and regulation of financial institutions and publicly traded companies, while rule breakers will be subject to increased prosecution and penalties. Such actions will increase transparency of the subject entities, hold lawbreakers accountable in a highly public forum and improve investors' perception of integrity in the financial markets. This will serve to further restore confidence in these institutions and ultimately have a positive impact on the investing public and the economy.
10. ***While all eyes will be focused on the Presidential election, the outcome of the Senate races may have greater long-term impact.*** The American electorate remains nearly equally divided on political issues. Core constituencies on both sides of the political spectrum, between 35% - 40%, will remain passionate either for or against the President. However, national elections are won and lost in the middle, not at the fringes. If the

economy, and the stock market, continue their steady recovery, and if the international situation continues to stabilize, the swing voter will be hard pressed to change horses in midstream. While the presidential election will get all the attention this year, the political races with greater long term impact may actually be in the Senate where the Democrats have 19 seats in play compared to 15 for the Republicans. Many objective political pundits are suggesting that the Republicans may gain 2 - 3 seats thereby adding to their tenuous majority. Should this occur, and the House of Representatives remain effectively unchanged, then we could expect political gridlock for the next two years even if the Democrats retake the White House. Conversely, increased Republican control in the Congress, coupled with the reelection of the President, could bring many changes and have long ranging political and economic implications for many years to come. Whether such implications are positive or negative for our economy, and our country, will largely be a function of the political filter through which each individual views events.

MDE's Five Strategic Wealth Management Themes for 2004

Investment themes in and of themselves are interesting, but of little value. They make for good conversation, but the observations are only valuable if they are actionable. Therefore, coupled with our Ten Investment Themes we would like to offer Five Strategic Wealth Management Themes for 2004, along with specific techniques to implement them.

As a high net worth Wealth Management firm, MDE does not provide one size fits all solutions that all individuals can plug and play into their personal situations. Since everyone's situation is different, each solution must be customized for each individual's personal economic situation and/or emotional risk tolerance. As such, we use our Strategic Themes as a toolbox to build customized solutions for each of our clients. But underlying all of our Strategic Themes are several common premises – hiring the most talented managers whose interests are aligned with those of our clients; relieving these managers of artificial constraints and allowing them to think out of the box; and reducing the risk of loss while increasing the stability of returns over time.

1. ***Blur the lines between investments.*** For years the investment community has been obsessed with placing labels on investment managers. Managers were either pigeonholed as fixed income or equity, large or small cap, value or growth. The Morningstar Style Box has become a religion with style drift becoming a crime. These artificial constraints have tied managers' hands and increased their individual volatility as they were stuck in their box – even when their box did not work. We at MDE believe we should not hold managers to such artificial standards. We should blur the lines between investments styles. By way of example, among the techniques we use to implement this theme are the following:
 - ◆ We hire global managers who have the flexibility to invest both in the U.S. and abroad to find the best values anywhere in the world – not merely International or U.S. with a fixed allocation to each.
 - ◆ We hire managers who specialize in high dividend stocks whose tax favored dividends provide better after tax returns than municipal bonds, while still retaining the capital appreciation of stocks.
 - ◆ We hire managers who specialize in convertible bonds that have characteristics of both stocks and bonds.
 - ◆ We hire fixed income managers who can buy bonds across the credit spectrum and move up and down the yield curve as market opportunities present themselves.
2. ***Become more benchmark insensitive and increase emphasis on absolute returns.*** Just as the investment community has become obsessed with the Style Box, so has it become obsessed with “tracking error to a benchmark” – at least until the benchmark posts negative returns. If a manager is benchmark sensitive, this too places artificial constraints on a manager. A manager is forced to buy investments contained in a benchmark, in rough proportion to their representation in that benchmark, even if the manager does not like the

investment. While this is a crutch behind which those less talented managers can hide, this constraint will prevent the truly talented manager from employing their best ideas and hamper their long-term returns. Therefore, we are increasingly seeking those managers who do not follow the crowd and think independently of the herds with a focus on producing consistent absolute returns for clients irrespective of how a benchmark is composed or how it performs. By way of example, we implement this theme as follows:

- ◆ We hire multi-cap managers who can move between large and small cap stocks as market conditions change.
 - ◆ We hire style agnostic managers who can buy value or growth stocks as opportunities present themselves. We do not hire managers that “hug the benchmark.”
 - ◆ We hire market neutral hedge fund managers, in various asset classes, who seek to make a profit in their respective discipline irrespective of market performance.
 - ◆ We take a great deal of time to understand how many units of risk our clients are taking for each unit of return they receive.
3. ***Increase the tools in the manager's toolbox.*** Today there are a wide variety of techniques available to investment managers. Yet most traditional long only managers, in both the stock and bond worlds, are prevented from using most of these tools. Therefore we invest with managers who have more flexibility, as well as the talent to use the larger toolbox available to them. By way of example, we implement this theme as follows:
- ◆ We hire managers who use option strategies to increase income and decrease risk.
 - ◆ We hire long/short hedge fund managers who have the talent to sell stocks short so they can make money in both rising and falling markets.
 - ◆ We hire managers with specific expertise to exploit inefficiencies in inefficient markets such as the merger and acquisition arena.
4. ***Increase focus on after tax returns.*** It has long been said that “it is not what you earn, but what you keep.” This is especially true for our high net worth, taxable clients. By way of example, we implement this theme as follows:
- ◆ We hire managers who employ high dividend strategies, not only for the stability they bring to a portfolio as discussed above, but also for the high after tax income these strategies generate.
 - ◆ We hire managers who employ covered call overwriting, not only for the increased income, but also for the ability to offset loss carry forwards and realize this income tax free.
 - ◆ For those clients who have substantial tax losses, we work with specialists to create highly vetted and safe strategies that generate capital gains to absorb these losses.
 - ◆ For those clients without tax losses, we proactively harvest losses throughout the year to be used to offset current and future gains.
5. ***Look outside the traditional fixed income markets for fixed income returns.*** With interest rates at 40 year lows, there is more near term risk in bonds than in stocks. Therefore, in addition to traditional fixed income risk management techniques, such as shortening the duration of a bond portfolio, we are looking outside the bond world for fixed income type returns. By way of example, we implement this theme as follows:

- ◆ We seek income producing investments whose principal value will not decline in a risky interest rate investment.
- ◆ We seek to partner with experienced real estate professionals to bring us private real estate investments, in which our clients will collectively have a substantial interest and where we can negotiate favorable terms on their behalf. Our targeted return for these investments is current tax deferred cash flow of 5% - 7% per year with long-term capital appreciation potential and little downside risk. In exchange for these benefits, investors must be willing to accept limited liquidity.
- ◆ We seek arbitrage opportunities to exploit spreads between different types of investments that provide uncorrelated and relatively stable returns.

We at MDE look forward to the opportunity to discuss our Ten Investment Themes with you as well as the ways in which our Five Strategic Wealth Management Themes can be custom tailored for your personal situation.