ELYSIUM

WEALTH MANAGEMENT

# OUTLOOK – SECOND QUARTER 2002

## Equity Markets

The first quarter had it all… the market rallied and plunged… rallied and plunged… and at the end of three months was +0.35% from where it started (S&P500). It was a quarter that saw the economy roar back to life as the consumer continued to do their "patriotic" duty and shop (and go deeper and deeper into debt.) It was a quarter that saw the word Enron turn into a verb, adjective and pronoun in the English language. And it was a quarter that saw the commencing of ground war fighting in Afghanistan, fierce rhetoric involving Iraq and daily suicide bombers targeting Israel. In conclusion – it was a quarter of uncertainty.

Investment analysts have recently been in front of the grand jury and U.S.Congress trying to attest to the fact they are independent. Yet it is fascinating to read the April 1, 2002 "U.S. Strategy" report from Merrill Lynch that highlights:

-"valuation remains extraordinarily stretched"

-"any market rally will be met by a flood of equity issues"

-"the "sell-side indicator" has a 12 month expected return of -18% (extraordinarily accurate over the past 17 years)."

-"our dividend discount model says that bonds will outperform stocks over the next 12 months."

Yet the report concludes, "no change to our 5-6% expected return," though there is no actual statements in the entire 3 page report that say anything to back up this expectation! As one person commented, "how can you expect partial advice from a firm whose motto is "Be Bullish"!

Then we come back to the issue of valuation. According to Merrill Lynch's analysis of each of the 500 stocks in the S&P500, the market is currently valued at 30 times their estimate for 2003! This can hardly be viewed a buying value. If we examine the great bull run from l982 to 2000 the S&P500 had a compound annual return of 15.3%. Yet, interestingly 7.2% (or roughly one-half) of that return was derived from the fact that the Price-Earnings multiple moved from 8 in l980 to 32 in 2000. This was matched by the fact that interest rates declined from 14% to 5%. Thus, if the public believes that for the next 20 years the S&P500 will again earn 15% per year they must believe 3 things:

1. Long-term sustainable interest rates will fall from 5% to 3%.
2. Price-Earnings multiples will move to 100.
3. Or, corporations will double their earnings power *every year*.

We believe that none of these three will happen. Thus, the best that could be achieved will be a 7-8% return in the stock market over this extended time frame. It is interesting to note that the annual compound rate of return for the U.S. stock market over the past 3 years is -0.7! Elysium's philosophy of selecting sound business is to purchase and to earn income through options will be the only way to profit in this environment.

**Options**

We talk a lot about how options improve your return. In the current quarter, our JDS Uniphase strategy was a good example. On February 22 we purchased JDSU at $4.85 per share. We also sold the April 5 call option for $0.65 per share. What this means is that if JDSU stays at $4.85 per share, the return is 15%. If the stock goes to $5, the return is 19%. If the stock drops 10%, you actually make 4%. As long as the stock goes up by less than 20% in 2 months, you make more using the option strategy than by buying and holding the stock only. On top of that, how else can you make 4% on a stock that goes down 10% in 2 months? Options are a win-win strategy that is hard to beat.

**Fixed Income Markets**

As the economy was roaring back to life, bond investors have become concerned about a revival in the inflation rate. A jump in CPI to 2.3% in March fueled this belief and bonds reported an overall decline of 1.05% for the quarter. We anticipate that, with the recovery, the central banks in most countries will start to increase short-term interest rates. However, we do not anticipate a resurgence in inflation and thus believe that long-term interest rates will find support at or near their current levels of 6%. With the recovery, our strategy of owning corporate vs. government bonds will continue to pay-off.

**CEO Fund**

The market often makes lows in the spring and or in the fall. With market valuations so high, we were of the belief that the market risk this spring was very high. As a result of that belief, we have been willing to achieve only modest returns in the CEO Fund in the past quarter. This is due to the fact the CEO Fund was very highly hedged during the quarter and going into the second quarter. In bad times, it is just as important to maintain wealth as it is to grow wealth. The US market was down slightly for the quarter(S&P100) while the CEO Fund value was up just over 1%. The return was below our long term objective but in line with our current risk management philosophy. The current risk of loss is very small in relationship to the market risk. We will revisit that strategy upon a significant market correction.