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MEASURING UP

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DELIVERING
THE PROMISE

2002

Reading Between the Lines

IN THIS
ISSUE

A recap of domestic and international stocks and bonds.

The year 2002 proved to be a tumultuous one for investors, as it began with much uncertainty. Bears were convinced that the market was overvalued, earnings would continue to disappoint, and the threat of war would keep stocks in the red.

Bulls commenced the year “cautiously optimistic,” hoping to build on 2001’s fourth quarter momentum, as well as an easing Federal Reserve policy. After all, it had been six decades since the markets had finished in negative territory for three consecutive

calendar years. While both factions were able to support their positions based upon objective research, they were unaware of the deception that was behind those numbers.

With hindsight being 20/20, had investors delved further into the financials of the companies claiming to be able to grow at 20% annually for the next five years, they may have realized how lofty those expectations were. Skeptical investors might have seen the excessive leverage that was being used to attain such hyper growth by companies like Enron, Global Crossing, and a number of other firms that would eventually file for bankruptcy in 2002. Others could have concentrated on the lack of cash flow to support ongoing operations. Unfortunately, many of these red flags were ignored during the “Era of Irrational Exuberance,” as investors instead relied upon corporate executives’ lofty earnings outlooks and Wall Street’s biased research.

FIGURE ONE

2002 Performance - Major Market Indices

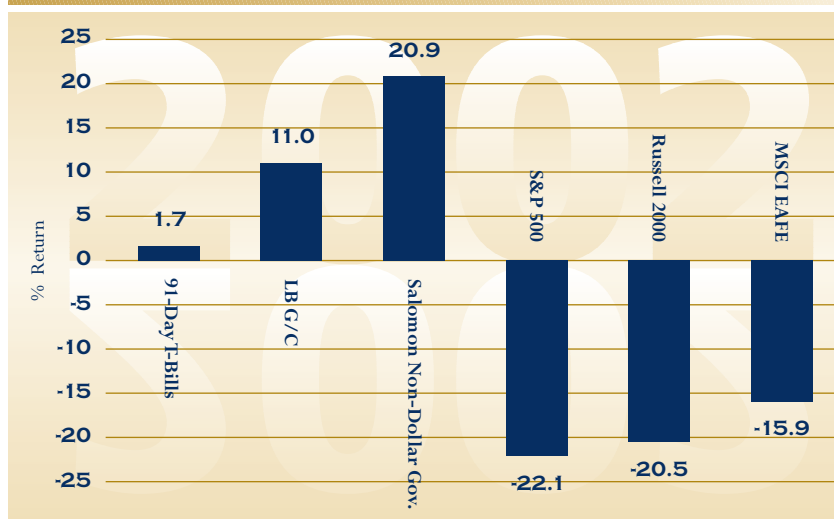
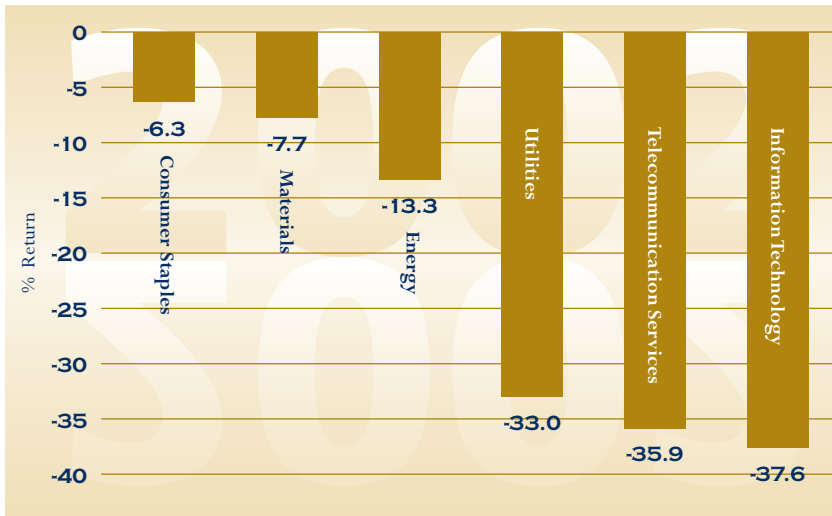
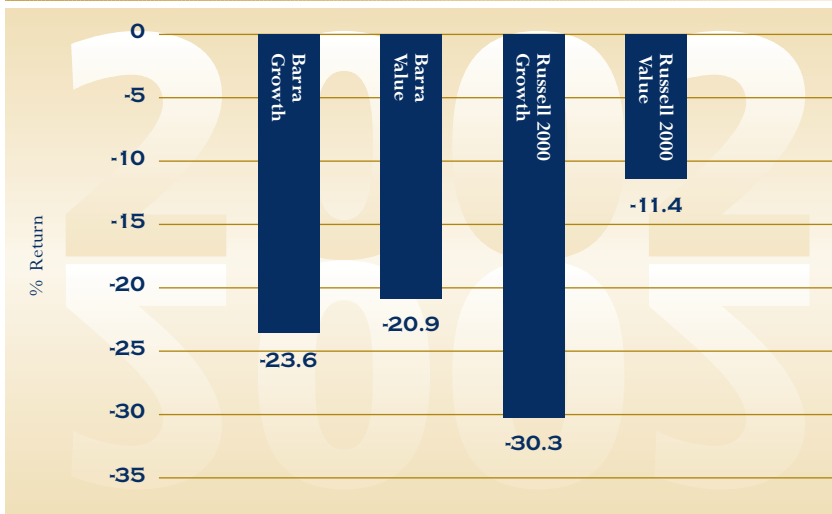


FIGURE TWO
Best and Worst of 2002 - Domestic Equity Sectors



While excessive debt and dwindling cash flow can be uncovered by researching the financial statements of companies, fraud and corruption tend to be more difficult if not impossible to detect. Newspapers seemed to have added a standard corporate scandals section to go along with the comics and sports pages. The list of delinquent firms was a who's who of the market darlings of the late 90's. Examples included WorldCom improperly booking \$3.8 billion in expenses as capital expenditures and Adelphia Communications excluding billions of

FIGURE THREE
2002 Performance Domestic Equity Market Indices



dollars in liabilities from their financial statements. Wall Street itself came under fire as the conflicts of interest in the investment banking industry were exposed. Clients had received biased information via street research by analysts attempting to lure in lucrative investment banking deals for their firms.

Despite all of the negative news to come out of the equity markets in 2002, there were some bright spots in the capital markets. Diversified investors were able to offset some of the losses caused by 2002's scandals. High quality fixed income, especially government and treasury securities, proved very profitable as a declining interest rate environment coupled with a distressed stock market aided returns. Also, hedge funds proved their merit as they utilized the ability to short securities in order to soften the grip of the bear markets. From an economic standpoint growth was positive for the year as the country pulled out of a recession, productivity remained high, and the Federal Reserve kept rates low in an effort to kick-start an economic recovery.

Major Market Returns

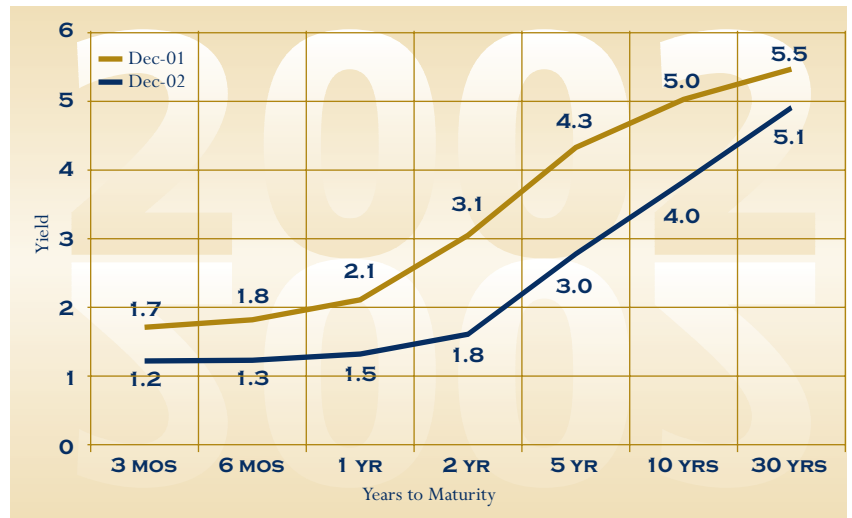
The year 2002 proved to be the year of the bond as the fixed-income market greatly outperformed the equity market. Returns for the broad market indices can be seen in *Figure One*. Three-month T-Bills were up with a return of 1.7% for the 2002 calendar year. Bonds, as measured by the Lehman Brothers Government/Credit (LB G/C) Bond Index, were up 11.0%, while foreign bonds were also up with a return of 20.9%, as measured by the Salomon Non-Dollar Government (Sal Non \$) Index. Large-cap U.S. stocks reflected by the Standard & Poor's 500 (S&P 500) Index, declined 22.1% while small-cap stocks represented by the Russell 2000 Index were also down 20.5% for the year. The international markets also struggled as the Morgan Stanley Capital International Europe Australasia and Far East (MSCI EAFE) Index descended 15.9%.

Domestic Stocks

Partially due to the attacks of September 11, 2001, along with the constant threat of terrorism, the S&P 500 dropped 11.9% in 2001. The decline proved even more severe in 2002 as the S&P 500 plunged 22.1%. Performance suffered as a result of a 17.3% decline in the third quarter along with continual profit warnings, corporate corruption and the threat of war. Despite a fourth quarter rebound of 8.4%, the performance was not nearly enough to make up for the negative measures of the second (-7.1%) and third quarter returns. The Consumer Staple sector was the best performing S&P 500 sector with a (-6.3%) return, followed by Materials (-7.7%) and Energy (-13.3%). The worst performing sectors were identical to last years' with even poorer returns; Information Technology, Telecommunication Services and Utilities, declined in value 37.6%, 35.9%, and 33.0%, respectively (*Figure Two*). The lack of performance for the second year running in the Information Technology sector was due to the lack of capital spending, leading to depressed earnings and uncertain prospects going forward. Excess capacity continued to plague the Telecommunications sector as it again underperformed. Substantial amounts of leverage eventually caught up to many companies in the Utilities sector, including Enron and Dynegy which eventually led to credit downgrades and at times even bankruptcy. The NASDAQ Composite Index, which is highly correlated with the Technology sector, had another year of dismal returns. The Composite was down 31.5% for the year, following declines of 20.9% and 39.0% in 2001 and 2000. After a year of a 2.5% positive return in 2001, the Russell 2000 Index had a negative return of 20.5% for 2002 after a rough second half of volatility and monies moving from equities to fixed-income securities.

For a second straight year, small-cap value domestic equity investing (*Figure Three*) was the choice of investors compared to growth style (-11.4% vs. -30.3%) with a spread of almost 19.0 percentage points. However, in the large-cap style of domestic

FIGURE FOUR
Year-End Comparison Yield Curve Structures

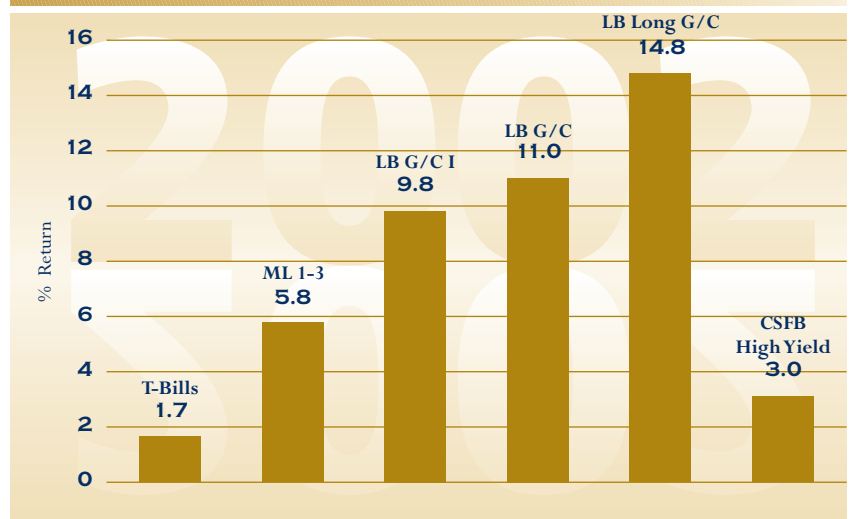


equity investing, value barely outpaced growth (-20.9% vs. -23.6%), with a 2.7 percentage point difference.

Domestic Bonds

Against the backdrop of Federal Reserve Board interest rate cuts, corporate malfeasance, and the threat of war with Iraq, investors sought the safety of the fixed-income markets. The yield curve in 2002 began and ended the year in a normal curve, with longer-term maturities showing a potential

FIGURE FIVE
2002 Performance Domestic Fixed Income Market Indices



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for higher returns, reflecting investors' bullish attitude towards the economy with help of the Federal Reserve's rate cuts. While yields declined at every maturity along the curve, the steepening effect was most apparent for intermediate-term securities (*Figure Four*).

All bond indices' year-end returns for 2002 exceeded the prior year, leaving bond investors some reason to still smile (*Figure Five*). Longer-term bonds outpaced the shorter issues as the Lehman Brothers Long Government Credit Index (LB G/C Long) rose 14.8%. The Lehman Brothers Government Credit Intermediate Index (LB G/C I) and the Lehman Brothers Government Credit Index (LB G/C) returned 9.8% and 11.0% respectively. The Merrill Lynch One-Three Year Government (ML 1-3) Index, a proxy for short maturity, high quality issues, increased 5.8% for the year, while the Credit Suisse First Boston High Yield Index (CSFB High Yield), representing the lower quality, high-yield issues, returned 3.0%. T-Bills lagged last year's return of 3.3%, but still came out positive with a 1.7% return for the year.

International Stocks and Bonds

The international markets, represented by the MSCI EAFE Index, rebounded slightly from last year's decline of 21.5%, but struggled to post a negative 15.9% for the year 2002. Issues such as steel tariffs, Middle Eastern policy, and U.S. government

regulation of business made it difficult for the European economy, which is heavily dependent on the U.S. economy. Due to this dependency, Europe failed to make strong gains despite the continued low interest rate environment. Global investors were happy to see the European Central Bank cut interest rates by a half of a point in December. Germany was Europe's worst performing market in 2002 due to lack of production and economic growth. Germany's DAX Index of 30 blue chips fell 44.0% and the Nemax 50 Index, Europe's blue chip index for large-cap equity stocks, declined 69.0% this year. The Morgan Stanley Capital International Europe Index had its worst year since 1974. Latin America still struggled with Argentina's and Brazil's depreciating currencies, as well as concerns over Brazil's ability to meet its debt obligations. Investors also questioned President elect Luiz Inacio Lula da Silva's commitment to economic reform. Argentina struggled with its currency losing 70% of its value, unemployment at almost 18%, and only making a partial payment of the \$805 million owed to The World Bank.

However, the International and Emerging Market bonds had a great year. The Salomon Non-Dollar Government Index posted a gain of 20.9% for international bonds as Emerging Markets bonds, measured by the J.P. Morgan Emerging Market Bond Index, had a positive return of 13.1% for the year 2002.

Calendar of Events



Yanni Partners provides a full range of consulting services vital to the management of various portfolios. Our ultimate goal is to offer a basis for improved investment monitoring and performance.

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