

P E R S P E C T I V E

A Quarterly Review of Economic and Market Developments

Second Quarter 2003

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U.S. and International Economies

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International Equities

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Dividends and the New Tax Law



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The Benefits of Equalizing Dividends and Capital Gains

The new tax law changes the taxation of corporate dividends. Can you give us some background on this issue to help investors understand the change and how they might be affected by it?

The dividend debate began in January of 2003, when the Bush administration proposed an end to the double taxation on dividends. Since dividends have historically been taxed at both the corporate and the individual investor levels, the proposal called for dividends to be taxed only one time. The bill that was passed by Congress did not eliminate the double taxation of dividends. Instead, it leveled the playing field between dividends and capital gains at the investor level by applying a 15% tax rate to both.

A historical perspective on the relationship between dividends and taxes might be helpful here. Dividends have always been taxed at a much higher rate than capital gains. Furthermore, taxes on dividends received must be paid every year, whereas an investor only pays tax on capital gains when the underlying investment is sold. In addition, because individuals have to report dividends as a part of their gross income, the tax rate on dividends depends on the individual's income tax rate.

We believe the new tax law has two far-reaching positive implications for the stock market. First, reducing the rate at which dividends are taxed should help boost equity returns to shareholders. Second, the new tax law should remedy some of the problems caused by a tax system that was biased in favor of capital gains as opposed to dividends. At the height of the stock market bubble, when the tax rate on capital gains was much lower than the tax rate on dividends, stock-option compensated managers were under enormous pressure to boost share prices, setting the stage for many of the corporate scandals that have plagued investors in recent years. Now that the playing field between capital gains and dividends has been leveled, management should, at the very least, be unbiased between

NOTE: All index returns cited in this issue of *Perspective* represent past performance and are no indication of future results.

share price appreciation and the payment of dividends to its shareholders.

Given that we are now in a period that at best can be described as one of slow growth, will the tax changes cause companies to pay out more in dividends?

In theory, a company should determine what percentage of its return on equity needs to be reinvested in higher growth or better margin projects. The portion of earnings that is not needed to fuel growth should be returned to shareholders in the form of dividends. So, the amount that a firm pays out to its investors can be simply explained as the dollars earned minus the dollars reinvested in high growth projects. In periods of high growth, a firm's payout to investors tends to be low. In periods of lower growth, a firm's payout ratio to investors tends to be higher.

That brings us to where we are today. The booming economic environment of the late 1990s is a distant memory. While the outlook for economic growth is improving, it can still only be described as a slow growth environment at best. Given that explosive growth will be much harder to come by, theory would indicate that we should see increases in firms' dividend payouts to investors.

What other effects can this new tax provision be expected to have on corporations and investors?

First, it should bring much tighter investment discipline to how corporations spend their money. In the late 1990s, firms with too much cash on hand did not spend it wisely. Excessive capital spending and overinvestment in projects with low probabilities of success were rampant. The excess cash, which should have been paid to shareholders in dividends, instead went into bad acquisitions that did not bring higher growth, improving margins or price appreciation. With the passage of this new bill, it is reasonable to expect that corporations will bring more scrutiny and diligence to the allocation of their resources.

The second impact may be the "a bird in hand is greater than two in the bush" attitude that investors might have when considering future investments. A dividend that is received on a quarterly basis is a check that is visible to the investor on a quarterly basis. Share buybacks or unrealized price appreciation are less tangible benefits, particularly since share buybacks are often offset by options and acquisitions. Investors that have been burned from the evaporation of unrealized wealth might be more inclined to favor receiving more tangible returns on their investment.

Finally, a dividend-paying company might be a "safer" investment given that it provides a layer of financial transparency to the investing public. A firm that needs to pay out a substantial amount of money in the form of dividends might find it harder to "manufacture" earnings with various accounting tricks. In the event that the firm runs into financial troubles, a first attempt at regaining financial strength might be to suspend the dividend. This could serve as a valuable warning to investors that something is amiss.

Has there already been an increase in the dividends that firms pay out?

Anecdotal evidence suggests that this is indeed the case. Microsoft, Citigroup, Fannie Mae, Procter and Gamble, and Washington Mutual are just a few of the large cap, blue chip names that have recently increased their dividend payouts. We believe that other mature companies with large cash balances might follow suit.

U.S. Economy

Earlier this year, the financial markets were struggling with a sluggish economy, corporate malfeasance and the aftermath of the stock market bust. A vigorous fiscal policy debate asked what type of tax cuts, if any, should be adopted to stimulate the economy. But the greatest uncertainty was over the impending war with Iraq. Would the U.S. invade Iraq? Would an invasion result in the use of weapons of mass destruction, the torching of Iraq's oil fields, prolonged urban warfare, an attack on Israel, an increase in terrorism or more upheaval in the Middle East? If the U.S. won the war, would it be able to win the peace?

By the end of the second quarter, some of this uncertainty had been resolved. The U.S. invaded Iraq and toppled Saddam Hussein without triggering any of the doomsday scenarios. The swift regime change alleviated the worst of the market's fears, although it is still not clear how quickly and effectively Iraq can be secured and rebuilt, given the recent increase in guerrilla activity. And, of course, no one yet knows what

the long-term consequences of this war will be.

In late May, the fiscal policy debate was resolved by the adoption of a tax relief package that is expected to cut taxes by \$350 billion over ten years. This isn't a very large amount given the \$10 trillion size of the U.S. economy. However, the demand stimulus is front loaded, with \$57 billion in tax relief (2.2% of GDP, ann.) planned for the second half of this year and \$130 billion of tax relief (1.2% of GDP) planned for 2004.

Short-term stimulus will be provided by: 1) an across-the-board cut in marginal tax brackets (retroactive to January 1, 2003) that will result in lower withholding in the second half of the year; 2) a \$400 increase in the child tax credit; 3) marriage penalty relief and alternative minimum tax relief; and 4) an increase in depreciation benefits and a small business tax benefit for equipment purchases that should bolster capital spending.

The tax package also reduces the tax on dividends and capital gains to 15%, from 38.6% and 20%, respectively. This should narrow the after-tax cost between debt and equity, shifting the financial equation away from debt and toward saving and investments, potentially boosting long-term growth.

One drawback to the tax plan is the large number of "sunset provisions". Most of the tax cuts revert to current levels at various future dates. Historically, tax cuts that are seen as temporary are less effective than permanent cuts. However, these "sunset provisions" may be mostly political theater, placed there to give politicians the appearance of being fiscally responsible. The tax cuts are likely to be extended because it will be politically difficult to allow them to expire. If the economy responds to tax cuts, as historically has been the case, the tax cuts may be self-financing, with tax revenues growing along with the economic pie. On the other hand, if the economy remains weak, it may be hard to justify raising taxes.

Although growth prospects should be higher with these tax cuts than without them, significant risks remain, as the economy continues to struggle to sort its way through all of its post-bubble problems. The market bust has created an atmosphere of caution that may take longer than expected to overcome. Secular (long-term) pressures to rebuild savings and cut debt could undermine long-term growth. Intense global competition is likely to slow growth in employment, incomes and corporate profits. Since consumers never retrenched during this recession, we may not experience the growth in pent-up demand that typically occurs during periods of economic weakness and leads to greater spending as the economy recovers. In addition, excess capacity at home and overseas may restrain capital expenditures. Finally, if long-term growth remains sluggish, the hope of self-financing the deficit through economic expansion will evaporate, leading to the possibility that the budget deficit will grow even larger in the future. Seen in this light, the tax cuts are something of a gamble, given the Social Security and Medicare burdens looming on the horizon, unless the tax cuts grow the size of the economic pie enough in the long-term to meet these future liabilities.

Despite these risks, we believe that regime change in Iraq and the passage of the tax cuts have improved the near-term outlook for the U.S. economy. An aggressive monetary policy, lower oil prices and a weaker dollar should all support growth. With a little luck, the U.S. could end 2003 on a stronger growth path in which capital spending, global growth and inventory rebuilding will increase at levels sufficient to allow consumers to take a breather without pushing the economy back into a recession. Any recovery, however, is likely to be muted, as the near-term stimulus will be partially offset by the secular drags mentioned above.

International Economies

Based on May economic data, Continental Europe is showing few signs of recovery. The recent uptrend in the euro is not helpful, because it threatens to undermine the export sector, which has been one of the few areas of strength. However, there is room for hope. In 2004, Germany will cut its income taxes, reducing the top bracket from 48.5% to 42% and the bottom bracket from 19.9% to 15%, despite the fact that its budget deficit will likely continue to exceed the Maastricht guidelines of 3% of GDP. In addition, the European Central Bank has finally lowered interest rates in recognition of the fact that deflation poses a

greater risk than inflation. More accommodative fiscal and monetary policy, economic recovery in the U.S. and stronger equity markets should all create better prospects for European growth in the months ahead.

The United Kingdom is showing signs of turning the economic corner. The consumer sector appears to be improving, as the CBI Retail Survey has moved higher from a depressed level. The PMI Service Index also rose again in June to 54.5, indicating improvement in the service sector of the economy. Similarly, the PMI Output Survey (a manufacturing indicator) rose above the 50 level in June, which is consistent with economic expansion. So, the indications for the British economy are favorable, although we do not yet know whether any recovery will be more than a short bounce.

Recent data out of Japan provides a glimmer of hope for what has been dismal economic outlook. The Tankan Survey of large companies rose to -5 in second quarter of 2003. This survey has steadily improved after bottoming at -40 in first quarter of 2002. Industrial production has also experienced a stealth recovery over the last year. The equity market, a good leading indicator of economic activity, has risen sharply. Japanese stock dividends recently were yielding twice as much as bonds, creating an impetus for "yield starved" Japanese investors to move money away from bonds and back to stocks. In addition, the new Governor of the Bank of Japan (BOJ) is pursuing a more aggressive reflation policy, noticeably increasing the monetary base and adopting some unconventional policy measures (central bank purchases of stock) to provide liquidity to the economy. Finally, the Japanese economy should benefit from stronger growth in the U.S. and the Asian recovery from the SARS scare.

Unfortunately, Japan still has not addressed its bad loan problem, which is likely to continue to hamper long-term growth and creates the risk of further economic weakness. In a recent statement, Japan's Economic and Finance Minister Takenaka pressed for material bank reform, scolding the nation's banks for hiding bad loans. He stated that, "The banks' own asset value assessment is insufficient. Indeed, conditions are so bad that, at five of the fifteen largest banks, there were discrepancies of at least 50%." As a result of these capital problems, bank lending remains weak despite the BOJ's efforts to increase liquidity. Lenders are reluctant to lend to poor credit risks. Given the weak economy, higher quality borrowers don't need the money. Thus, the nascent signs of recovery could just be another of the many false dawns Japan has experienced in the last thirteen years.

Global Fixed Income

Bond yields hit new, multi-generational lows during the second quarter of 2003. The yield on ten-year U.S. Treasury bonds declined from 3.8% at the beginning of the quarter to below 3.1% in mid-June. As the Fed's June 25th meeting approached, market commentators hotly debated whether the central bank would leave interest rates unchanged (a statement of confidence that the economy was righting itself) or reduce rates by as much as 50 basis points (0.50%) in an effort to avert a "Japan-like" scenario. The Fed ultimately decided to cut interest rates by 25 basis points (0.25%), leaving room for it to reduce short rates again if necessary. Ten-year U.S. Treasury yields responded by rising 45 basis points (0.45%) during the second half of June to end the quarter below their starting point.

Although U.S. Treasury bonds posted positive returns for the second quarter of 2003, the best performance came from corporate debt – the lower the quality the better. Despite adverse publicity about Freddie Mac's management of personnel and risk, agency debt trailed Treasuries only slightly. Japan was the only major international bond market not to have positive returns for the quarter.

Locally, the California budget crisis continued to worsen. By the state's June 30 fiscal year-end, the California legislature wasn't even close to adopting a budget. The expected budget shortfall has increased from \$35 billion to \$38 billion due to weak economic conditions. In addition, the recall campaign is inhibiting Governor Davis's ability to push through a budget plan that includes increases in sales and income taxes. Yields on California's municipal bonds are higher than those of any state in the union, and the state's credit

rating is again at risk of being lowered. A quick resolution to the budget crisis will likely forestall additional credit downgrades. However, greater fiscal austerity will be required to restore the state's AA credit rating.

Looking ahead, it is possible that the 45-basis point (0.45%) increase in ten-year Treasury yields in the second half of June may represent a sea-change in the bond market. While we don't expect interest rates to rise dramatically from here, we believe the trend may be toward higher rates as economic expectations continue to improve.

Foreign Exchange

The U.S. dollar continued its slide against the world's major currencies during the second quarter. The Japanese yen was the only major currency to fall versus the dollar. New Zealand, Australia and Canada had some of the strongest performing currencies during this period. Since hitting its nadir late in 2000, the euro has rebounded sharply, returning 35% versus the dollar. In the second quarter alone, the euro gained 5.5%, bringing the single currency back to its inception level.

Low short-term interest rates and questions about the health of the recovery have forced the U.S. dollar to depreciate to balance out our need for foreign goods. Nevertheless, improving prospects for the U.S. equity markets could prove a draw for the greenback and limit the currency's downside risk.

Domestic Equities

The U.S. stock market staged an impressive rally in the quarter ended June 30, 2003. The broad market, as measured by the S&P 500 Index, advanced 15.4%, its best gain since the fourth quarter of 1998. The tech-laden Nasdaq 100 Index rose 18.0%, the Wilshire Small Company Value Index gained 26.7%, and the Dow Jones Industrial Index increased 13.1%. The rally was fueled by relief over the end of hostilities in Iraq, a series of relatively good first quarter earnings reports and a lack of negative pre-announcements regarding second quarter earnings, all of which boosted investor confidence.

For the trailing twelve months ended June 30, 2003, only the Nasdaq 100 Index has advanced to any degree, rising 14.4%. The S&P 500 Index was up 0.3% while the Dow Jones Industrial Index and the Wilshire Small Value Index each declined -0.5%.

What is the outlook for U.S. stocks? Since confidence begets confidence, there is a good chance the rally could continue onward and upward. Currently, a lot of investor cash is still on the sidelines. Earnings reports are expected to be decent for the second quarter. Expectations for the third quarter appear to be reasonable. However, investor confidence is a fragile thing. Corporate scandals have severely damaged the trust that investors put into the markets. That, along with any hint that the improvement in the economy is less robust than anticipated, could have domestic equities giving up their gains once again.

International Equities

International stocks soared during the second quarter, as the resolution of the Iraq crisis, improved prospects for U.S. growth and a weak dollar set the stage for double-digit returns. Emerging markets continued to outperform developed markets as a whole. Indonesia, Russia and Greece advanced over 40%, while Turkey, Israel, Korea and Thailand rose over 30%. Among developed markets, only Germany posted such high returns. Emerging Europe, Continental Europe, Latin America and Emerging Asia all gained over 20%. Japan continued to be a laggard, with banking and financial shares suffering as the government bailed out the fifth largest bank. Other Asian markets were hit by SARS concerns.

While we continue to like emerging markets, we expect Asia to outperform Europe in the months ahead. Good news on the SARS front, compelling valuations and intra-regional demand growth make Asia-

excluding Japan very attractive going forward. China's development, with its concomitant appetite for raw materials, is a powerful growth driver for the entire region. Indonesia, for example, is a major beneficiary of improving commodity prices.

The Continental European economy has been hampered by weak domestic demand and the adverse impact of a strong euro on the export sector. The structural constraints imposed by the European Union have also made it difficult for Continental Europe to treat its Euro-sclerosis. The Growth and Stability Pact has limited fiscal stimulus at the country level, while the European Central Bank (ECB)'s inflation-targeting mandate has inhibited aggressive monetary easing. As mentioned earlier in this newsletter, there are signs that Continental Europe is beginning to find ways to work around these structural constraints. The ECB recently cut interest rates, and some European countries are adopting fiscal stimulus measures despite the fact that they may violate the European Union's guidelines. Europe is also likely to benefit from any U.S. economic recovery. Nevertheless, we recommend an underweight position in Germany, France and Italy at this time.

Real Estate

Those who believe in selling the winners and buying the losers might think that it is time to rebalance portfolios away from real estate and bonds and back to stocks. Over the three years ended June 30, 2003, ten-year U.S. Treasury bonds and real estate (as measured by the NCREIF National Property Index) have outperformed the S&P 500 by 69% and 56%, respectively. Yet, historically, one of the notable features of U.S. commercial real estate is the stability of its capitalization (cap) rates*. The table below shows snapshots of unlevered cap rates, earnings yields and bond interest yields at four different points in time. Note that while bond yields and stock earnings yields have come down dramatically since 1981, cap rates have remained relatively stable.

12 months ending	12/31/81	12/31/91	12/31/02	06/30/03
Bond Interest Yield (Lehman Aggregate Bond Index)	14.7%	7.9%	4.1%	3.6%
S&P 500 Earnings Yield	11.3%	5.8%	5.3%	5.1%
Real Estate Capitalization Rate (NCREIF NPI Income Yield)	8.0%	6.8%	8.4%	8.2% ¹

Sources: Ibbotson Associates. *Stocks, Bonds, Bills and Inflation: 2003 Yearbook*. and NCREIF

¹ Estimate based on 3/31/03 NCREIF NPI Income Yield.

The engine that fuels returns for stocks is a falling E/P (earnings-to-price) or earnings yield ratio**. Starting at a high earnings yield, like 1981, provides great scope for yields to fall and stock prices to rise. Similarly, the engine for bond returns is a high yield starting point and declining yields. But for real estate, where cap rates have been remarkably stable, timing is much less important. A stable cap rate means that most of real estate's historical return has come from income rather than from capital appreciation.

Today's cap rate of around 8% for unlevered real estate implies income in the range of 5% to 6% (after deducting about 2.5% for capital expenditures). Assuming inflation is 2.5% and cap rates remain unchanged, we can forecast a ten-year return for real estate in the region of 8% per annum.

This projected return may not look all that attractive compared with 1995 to 2000, when the NCREIF Property Index, the S&P 500 and long bonds posted per annum returns of 11.9%, 21.4% and 9.1%, respectively. But recognize that today's equity earnings yield and bond yields are very low – an unfavorable starting point for both these asset classes. As a result, many investment planners expect only modest single-digit returns from stocks and bonds over the next ten years.

* Cap rates are a measure of a property's net operating income relative to its market value.

** A falling E/P ratio is the same thing as a rising P/E ratio (i.e., a P/E expansion)

In contrast, we believe the high cash yield for real estate implies (the case historically) that much of the means to satisfy future return expectations is already there. Even a rise in cap rates to 10% would only modestly affect our ten-year forecasted real estate returns. Despite its risks, real estate offers more cash yield in hand and a less adverse starting point than stocks and bonds. And so, based on this long-term historical view, we believe real estate still has a pivotal role to play in any well-designed diversified portfolio.

Market Performance

U.S. Interest Rates				
	9/30/2002	12/31/2002	3/31/2003	6/30/2003
Cash Equivalents				
90-day Treasury Bills	1.60%	1.19%	1.09%	0.84%
Federal Funds Target	1.75%	1.25%	1.25%	1.00%
Bank Prime Rate	4.75%	4.25%	4.25%	4.25%
Money Market Funds	1.51%	1.25%	1.00%	0.85%
Bonds				
Long-term U.S. Treasury	4.67%	4.78%	4.82%	4.56%
Long-term AA Municipal	4.60%	4.68%	4.78%	4.42%

Sources: Datastream International and Bloomberg L.P.

Global Bond Market Total Returns (U.S. \$) Through 6/30/2003			
	Quarter	Year-to-Date	One Year
U.S. Bonds			
Merrill Lynch 7-10 year Treasury Index	3.06%	4.13%	14.00%
Merrill Lynch 7-10 year Agency Index	3.72%	5.45%	16.13%
Merrill Lynch 5-10 year Corporate Index	5.57%	8.63%	18.26%
Lehman Bros. Municipal Bond Index	2.58%	3.81%	8.74%
International Bonds			
Salomon Smith Barney non-US\$ WBGI (World Gov't Bond Index), fully hedged	1.31%	2.65%	7.69%

Sources: Bloomberg L.P. and S&P Micropal

Global Stock Market Total Returns (U.S. \$) Through 6/30/2003			
	Quarter	Year-to-Date	One Year
U.S. Stocks			
Dow Jones Industrial Average	13.12%	9.00%	-0.49%
S&P 500	15.39%	11.75%	0.25%
NASDAQ 100	18.00%	22.21%	14.47%
Wilshire Small Value Index	26.71%	19.23%	-0.49%
International Stocks			
MSCI Japan, net dividends	11.70%	2.92%	-14.63%
MSCI Europe (includes UK), net dividends	22.01%	10.77%	-5.22%
MSCI EAFE (Europe, Australia, Far East), net dividends	19.27%	9.47%	-6.46%

Sources: Bloomberg L.P., Wilshire Associates and S&P Micropal

Real Estate Total Returns (U.S. \$) Through 6/30/2003*			
	Quarter*	Year-to-Date	One Year
NCREIF Property Index	1.88%	3.80%	7.42%

*Return for latest quarter is an estimate.

Source: NCREIF (The National Council of Real Estate Investment Fiduciaries)

Past performance is no indication of future results.

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