



MANCHESTER CAPITAL MANAGEMENT LLC

May 16, 2003

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Market Outlook

The welcomed success in Iraq has seen a strong rally in our stock market and surprising strength in the bond market. Despite the threat of a SARS pan epidemic, nuclear proliferation in North Korea, and continued terrorist activity, the markets seem to be looking through the current global concerns and slow economic pace to better times and stronger corporate profits.

Part of the recent appreciation is due to upside surprises on the profit front. The oil and auto sectors provided most of the profit increases, but other sectors demonstrated an improvement of corporate balance sheets and cash flows. If the economy picks up speed from its recent sub 2% rate to a more normalized 3.5%, many corporations would be able to grow revenues substantially.

The bond markets have been helped by the growing recognition that deflation is a real threat that needs to be the highest priority for the Federal Reserve. Chairman Greenspan has all but promised that he will not raise interest rates for the foreseeable future. Indeed, further rate cuts might be in the cards.

Deflation (declining prices) is the opposite of inflation (rising prices), and can produce a devastating downward spiral of lower prices causing lower profits which causes layoffs that reduce purchasing power which causes lower prices, et cetera. While deflation is enabled by slow economic growth, the world is also facing two great deflationary forces. Manufacturing costs are being lowered across the globe by competition from China, with its huge labor pool willing to work at reduced rates. At the same time, technology is producing cost savings in both manufacturing and the service economy, driving productivity up, prices down, and unemployment higher.

The stock market is advancing not because there is definitive evidence of economic acceleration, but because of the confluence of several factors. The stock market's 1.75% yield becomes an increasingly attractive alternative to cash earning almost nothing,

*Stocks and bonds
are both producing
positive returns.*

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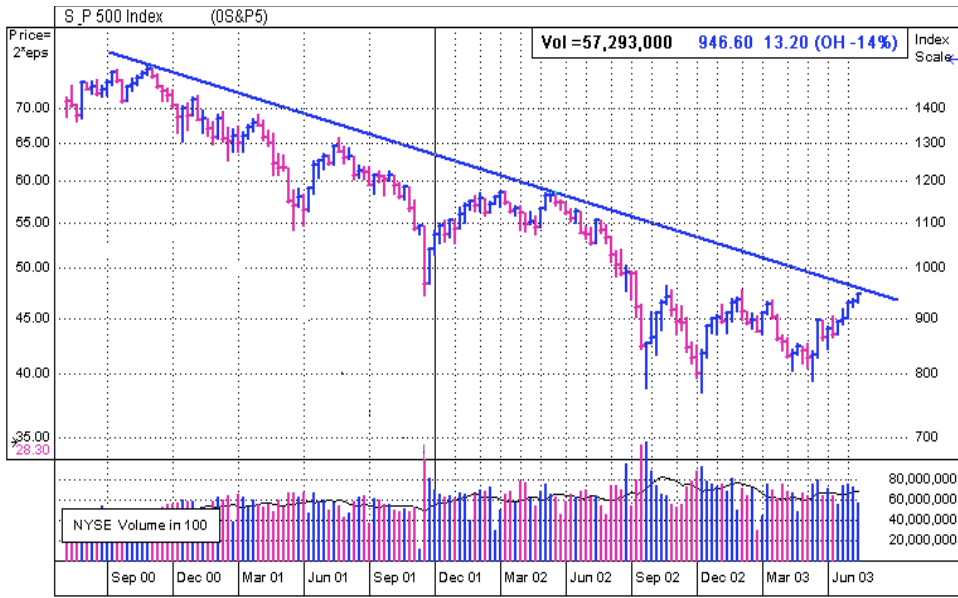
especially when investors know that the Fed is unlikely to tighten. The Bush Administration has adopted a weak dollar policy that has seen the US currency decline dramatically against foreign currencies, favoring US exports.

*Deflation
versus
inflation.*

Large government and current account deficits appear tolerable if the economy recovers. Progress in Iraq is reducing global tensions, offering the promise (if not the reality) of peace. The political strength of President Bush will probably enable a round of tax cuts, helping to stimulate the economy. Indeed, the President is looking toward an election next year and will probably do whatever is possible to enhance economic growth to please voters.

The stock market rally suggests that deflation will be controlled and the economy will recover by the end of the year. The bond market should begin to suffer if these predictions are correct, but in the meantime, it is clearly a useful hedge against deflationary forces. Stable or declining interest rates allow bonds to hold their current valuation. After a twenty-year bull run, bonds had appeared to be near a peak in value, but deflation would make them attractive again. We believe strongly in the merits of a balanced portfolio that addresses both economic outcomes—deflation or inflation.

Charting the Bear Market



The US stock market, as represented by the following logarithmic chart of the S&P 500, has had a remarkable run since just before the onset of the Iraqi war. The market is up nearly 20% from its most recent low and up 8% year-to-date. As you can see, the market has made similar rallies but has yet to break its 3-year bear market resistance level. The market is still down over 35% from its all-time high set on March 24th, 2000.

The Value of Independent Research

A record \$1.4 billion settlement was reached last week between regulators and ten of America's largest financial service firms. These fines and penalties are meant as punishment for years of self-dealing and conflicts of interest. Among the violations, regulators found consistent patterns of large brokerage firms distorting their "objective advice" to investors to generate investment banking business. The settlement is an important step in the process of restoring integrity to US financial markets, already undermined by corporate fraud and deception.

*Record settlement
reached with
Investment Banks.*

While the \$1.4 billion fine is the largest ever and the new regulations meant to address the problems are numerous, the real value of this settlement is in making investors aware of the problem. Investment professionals have known of these deceptive practices for years, but the general investing public has had a mistaken faith in the independence and honesty of those firms. Exposing problems with "street" research will hopefully force the design of safeguards into the investment process and prevent abuses.

Below are a few of the abuses for which firms are being penalized:

- Credit Suisse First Boston (CSFB) and Salomon Smith Barney (SSB) engaged in "spinning" of Initial Public Offerings (IPOs). These firms would take advantage of access to IPOs in great demand by allocating them to executives and related parties who were then encouraged to do business with their investment banking departments.
- CSFB, Merrill Lynch and SSB issued fraudulent research reports. Bear Stearns, CSFB, Goldman Sachs, Lehman Brothers, Merrill Lynch, Piper Jaffray, SSB and UBS Warburg issued reports that were not based on principles of fair dealing and did not provide a sound basis for evaluating facts, contained exaggerated claims and contained opinions for which there was no reasonable basis.
- UBS Warburg and Piper Jaffray received payments for research without disclosing such payments. These two firms as well as Bear Stearns, JP Morgan and Morgan Stanley made undisclosed payments for research, called "research guarantees." In essence, these firms would pay other firms to write favorable reports to support their investment banking business.

*Independence is
Manchester
Capital's
hallmark.*

Unfortunately, it doesn't look like the culture at these ten brokerage firms will change any time soon. Morgan Stanley's CEO Philip Purcell publicly commented on the day of the settlement that these charges shouldn't raise any concerns for their retail investors. Just two days later, Bear Stearns used an "independent" analyst to promote an IPO that they were underwriting – a clear violation of the settlement.

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Since inception, MCM's hallmark has been our independence. We earnestly reaffirm our commitment to work on your behalf alone. We have no investment banking business, no brokerage commissions, and no conflicts of interest that would cause us to place any interests above yours. For us, there is simply no other way to fulfill the trust you have put in us.

*MCM subscribes to
completely
independent
research.*

In our commitment to independence, we subscribe to research from two venerable firms – Callan Associates and Argus Research. Callan is one of American's largest independent consultants, and avoids conflicts of interest as they advise many of the world's large pension funds. They provide objective review of money managers, asset allocation designs, capital market projections, and other data necessary to provide superior investment counsel.

Argus, in nearly 70 years, has never had relationships with nor received compensation from companies that they do or do not recommend. They provide us with excellent research on individual companies and portfolio construction suitable for our clients. In a recent review by Investors, Inc. of the buy and sell recommendations of 63 firms, Argus was rated number 11. Many of the firms named in the settlement – SSB, Merrill Lynch, Goldman Sachs, JP Morgan, etc. - comprised the bottom of the list.

Fiduciary responsibility to the client should be the first priority of any firm. The only way to align the interests of the firm with those of the client is to have compensation transparent and based on the value added to the client. We are encouraged to see reform in the securities industry and welcome increased awareness of corporate responsibility. In these changing times, we will work diligently to protect and grow the assets of our client partners.

Inside MCM

MCM Welcomes New Portfolio Manager



Vito Gioiello, CFA recently joined the staff of Manchester Capital as a Portfolio Manager and head of the Montecito, California office. Mr. Gioiello's responsibilities include investment analysis and research, asset allocation, and investment plan design and implementation. Before joining Manchester Capital, he served as Vice President of Northern Trust Bank in Santa Barbara. He currently serves on the Board of Directors and as Treasurer of The Music and Arts Conservatory of Santa Barbara and is on the Board of Speaking of Stories. With an undergraduate degree in finance from California State University, Long Beach, he also holds an MBA from the University of Southern California and is a member of the Institute of Chartered Financial Analysts.