



## Your Personal Portfolio Details Inside:

- Summary of Holdings Report
- Discussion of Investment actions over the last quarter
- Investment Performance Reports for Managed Accounts
- Asset Allocation Reports for Managed Accounts
- Investment Highlights for Managed Account Holdings

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## 1st Quarter Report

April 2003

### The State of the Investment Arena

In the first quarter of 2003, high uncertainty continued to dog the global economy and securities markets. The war with Iraq also got underway in the 1<sup>st</sup> quarter. Just before and during the first week of the war, securities markets responded violently. Equity markets around the world shot higher with US equity indices rising 10% or better and some major European equity markets moving up about 18%. Then the military going got tougher and equity markets reversed lower, giving up part of that gain. Meanwhile, the big losers were oil, gold and bonds. Crude oil prices dropped about \$10, gold dropped about \$50 and high quality long bond yields rose about 50 basis points. Again, as it became apparent that the war was not going to be a one-week affair, oil, gold and bonds reversed slightly higher. These wild swings in financial and commodity markets reflect the high uncertainty about the future and the importance of military affairs in the Middle East.

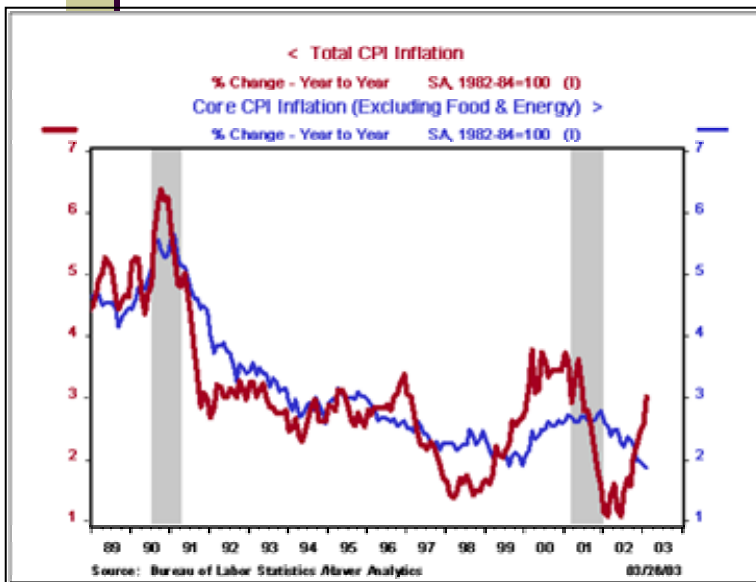
By comparison, the economic situation appears staid. The US economy remains on a sluggish growth path. Real GDP has expanded for six consecutive quarters (I'm using six because I expect the economy rose about 1-2% in the first quarter of 2003). But growth in that range is not enough to generate job growth. Corporations continue to cut costs and expand productivity at a 3-4% growth rate. So, until real GDP growth moves into high gear, I'd expect employment will continue to be flat or down.

That does not mean that we are not making progress building a foundation for faster growth later this year. Corporations have cut labor and capital costs and improved production efficiency. Workers have adjusted with lower wage demands. Corporations are working hard to clean up accounting issues on income statements and are working down debt on their balance sheets. Households are still increasing spending, but at a pace below growth in income,

so saving rates have already risen. The government sector is providing substantial stimulus. Fiscal policy is, in my opinion, continuing to provide aggressive stimulus. Tax cuts from previous tax reduction legislation continue to phase in and Congress is moving ahead with passage of additional tax cuts. Meanwhile, high-powered defense spending is up sharply. On the monetary policy front, the Federal Reserve will likely keep the fed funds rate at 1.25% for at least a good portion of this year. I think that rate is low enough to permit vigorous money supply growth and accommodate a continued rise in bank lending. It should also help prevent a substantial rebound in longer-term interest rates. The recent drop in oil prices, if it holds, will also provide substantial relief to companies and households.

On the inflation front, the news is mixed. I remain firmly in the camp that there is virtually no threat of a rise in inflation due to "too easy" monetary policy. If anything,

## The State of the Investment Arena (continued)



our concern remains centered on continued deflation. The deflation problem for goods has been masked by two factors. First, due to the rise in oil, the overall CPI inflation rate has been pushed up to 3%. But the “core” CPI, which excludes food and energy, is up only 1.8% (see chart above). And service sector (health care, education, government services, etc.) price gains totaling 3.2% more than account for the total rise. The goods compo-

nent of the CPI price index is down 1.5% and has fallen in each of the last six months.

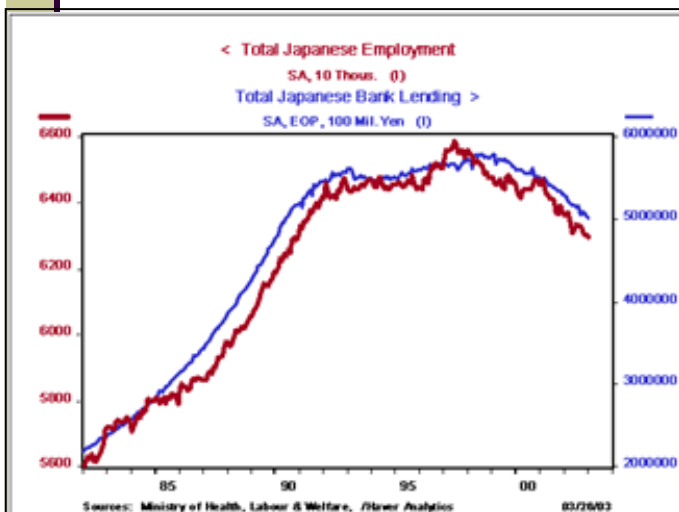
This fall in goods prices is a major problem for corporate America. Companies are cutting costs, but prices have been falling almost as much as costs. Under these circumstances it is hard to rebuild profit margins. I believe that, as the recovery proceeds and the delayed impact of an easier monetary policy takes hold, goods price deflation will end and company cost cutting will start to drop to the bottom line, pushing earnings up, perhaps swiftly.

Overseas, the news remains gloomy. In Europe, growth is very sluggish and the unemployment rate is 8.6% and rising (versus 5.8% in the US). Fiscal policy is headed the wrong direction with major economies like Germany raising taxes. Monetary policy (run by the European Central Bank – ECB) is still too tight, with their equivalent of the fed funds rate at 2.5% (versus 1.25% in the US). The combination of slow growth and too high interest rates leads me to be optimistic about European bond markets, but equity market returns are still in doubt. The news from Japan remains gloomy with severe deflation continuing unabated. Despite the rise in energy prices, the overall CPI is down 0.4% over the last twelve months (versus up 3% in the US). Continued deflation is damaging to the do-

mestic economy and keeps asset prices down. Financial reform remains stalled. Falling asset prices and a troubled banking system lead to a continued decline in Japanese lending which keeps employment falling (see chart below-left). There continue to be real risks to the outlook. The list has not changed. First, another major terrorist attack here in the U.S. cannot be ruled out. This risk will likely be with us for years to come. Second, while officially a victory, we are at war with Iraq. While a successful war should be a positive development longer-term, in the short run it creates considerable uncertainty. Third, while crude oil prices have dropped as a result of the Iraq war campaign, they are still too high and represent a considerable drag on global growth. Fourth, there continues to be potential for a financial crisis in Japan. Balance sheets of Japanese financial institutions are very weak and fiscal, regulatory and monetary policies are a mess. While I worry about and watch these risks, I really do not think they are powerful enough to completely derail a U.S. economic recovery.

### ASSET ALLOCATION CHANGES

For the second quarter I am continuing with the changes initiated with the asset allocation modifications last quarter. It's difficult to speak in generalities here because each portfolio is managed to the specific objectives of each investor but these are

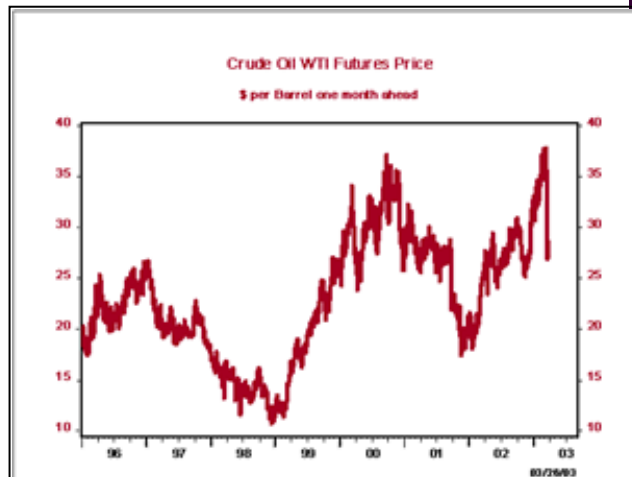


## State of the Investment Arena—Asset Allocation Changes (continued)

some general trends. I continue to increase Large Cap U.S. holdings at the expense of Small Caps. As well as to favor Growth over Value. So far these changes have served us well, as in the 1<sup>st</sup> quarter Large Caps outperformed Small Caps and Growth outperformed Value.

I have been making these changes for two reasons: First, and this gets a little technical, but I have been working on re-estimating

the optimal portfolio weights for the strategic models and my early work indicates that we can substantially reduce our expected risk and improve expected long-term return with somewhat higher weights on Large Caps. Bear in mind that the Russell 3000 Index (or any other total market index) is 90% Large Cap and only 10% Small Caps, so we have been substantially overweight, and remain over-



weight Small Caps, relative to the “market.” But we are (continued...)

## Statements Available on Account View

Today, more and more clients are online for investment information.

At Buttonwood Financial Group, LLC we believe that providing our clients with the ability to view account data anytime from any computer is just another way we can add value to our services.

With the introduction of on-

line statements, we are now able to take it one step further. Our web site now offers access to your LPL Statements and Advisory Performance Reports in addition to the existing account balance summaries and multiple account holding screens. We also offer intraday pricing on account positions, stocks and mutual fund fundamentals.

To wrap it all up, there is even access to transactional details such as dividends, reinvestments as well as checking and debit card activity. If you are not already familiar with Account View through our website, [www.LPL.com/Jon.McGraw](http://www.LPL.com/Jon.McGraw), please contact our office and we will help you get started!

## Automatic IRA Contributions

While the deadline to file taxes was April 15, there is no reason to wait until the last minute to make your IRA contribution! Avoid the last minute rush next year by setting up an automatic monthly deduction from your checking account. Not only is it sometimes easier to contribute on a monthly basis, but you can also take advantage of the inevitable

market ups and downs through “dollar cost averaging.”\* Dollar cost averaging allows you to buy more shares when prices drop and fewer shares when prices rise – ultimately lowering your average cost per share.

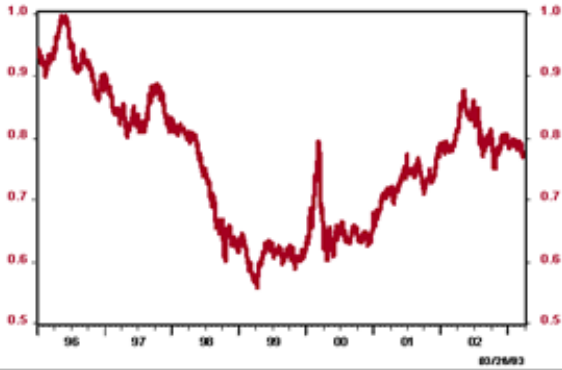
Let us know if we can assist you with your IRA contributions or with any other investment questions you may have.

*\*Such a plan involves continuous investment in securities regardless of fluctuation in price levels of such securities. Investors should consider their ability to continue purchasing through periods of low price levels. Such a plan does not assure a profit and does not protect against loss.*



State of Investment Arena—Asset Allocation Changes (continued)

Ratio: Russell 2000 Index to the Russell 1000 Index  
Falling line indicates Large Caps outperforming Small Caps



reducing that overweight. Second, as nervous money may re-approach the stock market, I believe that, from a tactical perspective, it is likely that Large

Caps will be more likely to outperform over the next few quarters. As shown in the chart above, through the second quarter of 2002 we experienced a substantial run of Small Cap outperformance. Since then we have experienced an irregular pattern that appears to be in a channel of Large Cap outperformance. From a fundamental perspective, often Large Caps tend to outperform as the economic recovery gains momentum, earnings start to rise and interest rates remain low. In that kind of environment I believe that earnings visibil-

ity improves and investors are able to discount earnings streams further into the future.

In terms of the Growth / Value weightings I continue to increase weights in Large Cap Growth, and reduce the weight in Small Cap Growth and Value. As shown in the chart below-right, Value experienced a huge run in outperformance over the two years ending in the second

quarter of 2002 and Growth has been coming back in an irregular fashion since then. I'd expect Growth will tend to outperform in an environment characterized by stronger economic performance and

low interest rates. Since I'd expect these conditions to develop in 2003, I'll target additional equity investment around Large Cap Growth.

While, in a long-term strategic view, there are reasons to remain committed to international investing, the traditional approach just doesn't seem to hold the allure it once did. (see chart at left) In order to continue to have some exposure to the international arena I have added positions through

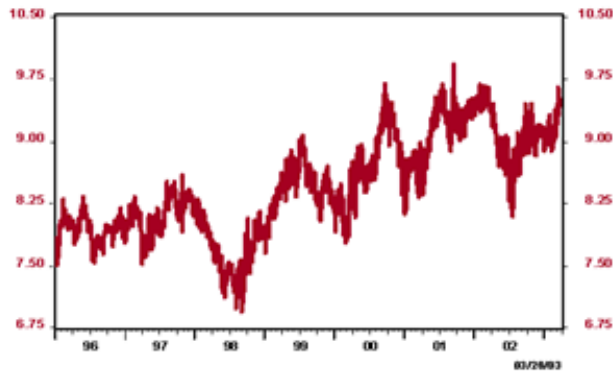
some of the more eclectic international alternatives. This is in opposition to the addition of the traditional pure international holdings. As discussed above, the thoughts for economic outlook in Europe and Japan is more pessimistic relative to the U.S. Also, the dollar exchange rate has corrected down to the point that I really do not see the dollar as overvalued as it once was.

Ratio of Russell 3000 Value To Russell 3000 Growth  
Measures Cumulative Outperformance of Value Relative to Growth



For fixed income, in comparison to a traditional allocation, I continue to be underweight in the High Quality Intermediate / Long-term Bond and overweight in High Quality Short / Intermediate Bond where it seems the risk/reward profile is better. Despite a rally in longer-term yields, the curve remains steep. Intermediates look especially attractive. Generally we are slightly underweight high quality fixed income and remain overweight High Yield in respect to where you

Ratio: Russell 3000 T.R./ Dow STOXX Europe T.R. (\$ based) Index  
Cumulative Relative Return - rising line is U.S. outperformance

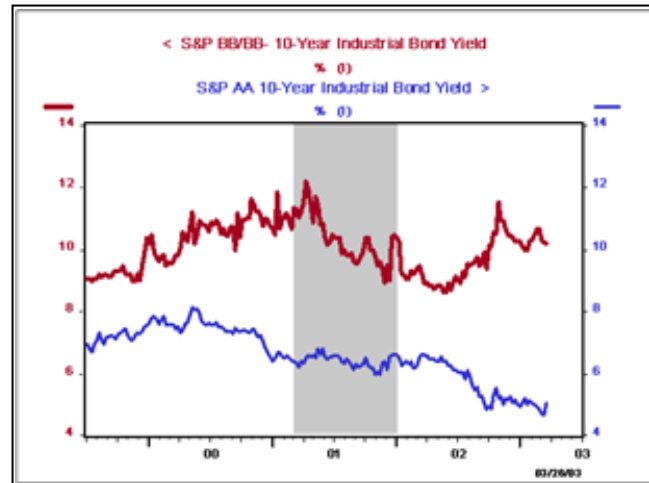


## The State of the Investment Arena—Asset Allocation Changes (continued)

would see more traditional allocations. Spreads have finally started to tighten back in and High Yield returns were excellent in the first quarter, but remain historically wide, leaving possible room for additional spread tightening. Finally, in the first quarter I added a modest increase in exposure to Foreign Bonds for lower volatility portfolios. This will continue into the second quarter. As discussed above, foreign bond yields, especially in Europe, continue to look attractive relative to U.S. High Quality Bond yields. Germany, for example (see charts at right), now has government bond yields higher than the U.S. and with ECB easing still, in my opinion likely, and real European growth slumping, duration risk also looks lower in Europe than in the U.S. In conclusion, in this period of high uncertainty associated with the war in Iraq, wide swings in oil prices, sub par global growth, continued goods price deflation and the associated sluggish rebound in corporate earnings, I think it still very prudent to maintain well

diversified portfolios. That said, most of our managed investment portfolios are moving towards higher volatility asset classes (Growth) that would benefit from a reduction in risk, higher growth and stronger earnings. While the US economy is still only growing slowly, it is growing and has been for six quarters. I believe that US monetary policy, with the fed funds rate at 1.25% and money and bank loans growing, is providing necessary stimulus. The phase in of already enacted tax cuts plus the new tax cut plan moving through Congress will provide additional stimulus. Defense spending is rising sharply. Corporations have made major strides in cutting costs and hopefully the accounting and corporate governance scandals are largely behind us. Under these circumstances I remain optimistic that US equity markets can once again deliver positive returns.

As always, I appreciate and encourage your feedback and input as we all move together through history!



Past performance is no guarantee of future results. Indices are unmanaged and cannot be invested into directly. The Russell 1000 Index consists of the 1,000 largest securities in the Russell 3000 Index, which represents approximately 90% of the total market capitalization of the Russell 3000 Index. The Russell 2000 Small Stock Index is an unmanaged index generally representative of the 2000 smallest companies in the Russell 3000 Index, which represents approximately 10% of the total market capitalization of the Russell 3000 Index. Russell 2000 Index measures the performance of the Russell 2000 companies with lower price-to-book ratios and lower forecasted growth values. The Russell 1000 and Russell 2000 Growth and Value Indices are companies in each index that are split into two groups based on price-to-book ratio to create growth and value indices. The Russell 1000 and 2000 Value indices contain companies with lower price-to-book ratios, while the Russell 1000 and 2000 Growth indices contain those with higher ratios. The Dow-Jones Europe Stock (STOXX) Index is a cap weighted broad market index of companies in Europe.

***The uncertain times we live in and the volatility of the stock market have given all of us concerns for the future. We are concerned about losing money and, at the same time, afraid of missing a market rebound.***

*Just a  
Reminder!*

*Please let us  
know if your  
investment  
objectives or  
financial  
situation ever  
change!*

## Keep the Perspective... Short-Term Fears vs. Long-Term Goals

To borrow a line, “It was the best of times; it was the worst of times.” The uncertain times we live in and the volatility of the stock market have given all of us concerns for the future. We are concerned about losing money and, at the same time, afraid of missing a market rebound.

For the past three years, during market declines, we have emphasized the importance of focusing on your long-term goals. With each decline in the market, that focus becomes increasingly important. During 1998 and 1999, the best-performing asset class was generally considered to be large-cap growth stocks and everybody wanted to be invested in large growth companies. We know that “past performance is no guarantee of future results,” but money poured into these stocks as investors chased the returns of those two years. In 2000, large-cap growth stocks ranked near the bottom as the worst – performing asset class and it remained toward the bottom in 2001 and 2002.

Currently, the Lehman Brothers Aggregate Bond Index – including U.S. government, corporate and mortgage-backed securities – ranks as the top-performing asset class.\* Investors searching for safety, income and less volatility are shifting more of their portfolio to fixed income. A change in interest rates can cause a decline in bond yields, just as we have seen in the equity markets, with similar losses of investment principal.

There is a whole field of study called behavioral finance – that examines investment behavior. Some of the research helps explain why investors make the decisions they do. People usually act on fear and greed. Greed causes them to chase returns of last year’s best-performing sector. And fear causes them to sell at a loss when the markets turn downward.

The fear of losing money comes in two forms: fear of action and fear of inaction. Investors fear that if they don’t do anything, they will lose money. Others fear that

if they do try to do something, they will lose money.

Staying in the market for the long-term is still the most important factor in working toward your financial goals. Although people continue to try to out-guess the markets using various market timing strategies, the penalties for guessing wrong can be severe.

A good asset mix – that is, a combination of stocks and bonds or that have distinct characteristics and may react differently under the same market conditions – can help smooth the ups and downs. It doesn’t eliminate the volatility, but it can help offset the declines in any one asset class.

Assess your risk, assess your time, assess your income needs and allocate your portfolio based on financial objectives, not emotions.

\*The Lehman Brothers Aggregate Bond Index is an unmanaged index which cannot be invested into directly.

## Is Long Term Care Important?

I am sure at some point in time, you have asked yourself the question, “Should I get a long-term care insurance policy or should I take my chances and go without? If you haven’t asked yourself this question yet, now’s the time.

Here are some questions to think about when making your decision.

Do you want to risk giving a nursing home the money that you have worked hard to accumulate your whole life?

Do you want to pass your estate on to your heirs or risk giving it to a nursing home?

If you have to go to a nursing home, do you want to have the choice of where you

go or do you want to leave that choice up to the state in which you reside?

If you have to go into a facility, do you want to have a choice of a private space or do you want to have to share that space with someone else?

Last, but not least, ***how important is it to you to know that you will not***

## Is Long Term Care Important? (continued)

### *have to depend on your children to take care of you?*

If you do have to go to a long-term care facility, the costs can be devastating. According to the American Council of Life Insurance, the average cost of a long-term care stay is \$45,000 per

year. The average stay in a nursing home is 3.1 years, according to a 1998 study by the American Health Care Association. That means your stay may cost you \$138,750. The costs are also rising on average by 5% to 7% per year. That means in 2013, people will be paying \$90,435 per year for a long-term care stay if it continues

to increase by 7% year after year. What would that do to you financially?

If you have questions or would like to learn more about how Long Term Care may be able to protect your assets – and your choices– I would be glad to review options that may be right for you.

***How important is it to you to know that you will not have to depend on your children to take care of you?***

## Catch Me If You Can!

On an average day, you probably write a check, use a credit card, make a cell phone call, throw out unopened junk mail or apply for a credit card. If you are like me, you don't give these activities a second thought. But someone else may. Simply by obtaining your personal information, such as your name, address, phone number, bank and credit card account numbers; and social security number, someone could falsely claim to be you.

We are starting to hear more and more about a new kind of crook, so-called "identity thieves." In a recently-released movie, "Catch Me if You Can," Leonardo DiCaprio plays an adventuresome, creative teenager who managed to defraud banks out of millions of dollars by impersonating an airline pilot, a lawyer and a doctor, just to name a few professionals. The story was based on the

exploits of a re-life con man back in the 1960s.

Our modern day crooks are at least as creative and they have switched from holding up banks to using our good credit to run up enormous debt. An identity thief does this by obtaining your personal information and opening credit card accounts in your name. People whose identities have been stolen can spend months or years – and thousands of dollars – cleaning up their good name and credit record. In the meantime, victims may be refused loans or even arrested for crimes they did not commit.

Can you completely prevent identity theft from occurring? Probably not, but you can minimize your risk by better managing your personal information. The Federal Trade Commission (FTC), working with other government agencies and organizations, has pro-

duced a booklet to help guard against and recover from identity theft.

One of the best ways to catch identity theft is to regularly check your credit record. Order your credit report from each of the three major credit bureaus each year and make sure all the information is correct. Also, follow up with creditors if your bills do not arrive on time. A missing credit card bill could mean an identity thief has taken over your credit card account and changed your billing address to cover his tracks.

If you've been a victim of identity theft, call the FTC's Identity Theft Hotline toll-free at 1-877-438-4338. They will advise you on how to deal with the credit-related problems that could result. For further information, visit the ID theft website at [www.consumer.gov/idtheft](http://www.consumer.gov/idtheft).

***Our modern day crooks are at least as creative and they have switched from holding up banks to using our good credit to run up enormous debt.***

***People whose identities have been stolen can spend months or years – and thousands of dollars – cleaning up their good name and credit record.***

**1st Quarter Report  
April 2003**

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Buttonwood Financial Group, LLC

**At Buttonwood Financial Group, LLC our goal is to be  
viewed as the best in the minds of our  
clients at guiding them towards financial security.  
We will guide our clients in making the right decisions  
for their financial future through  
education, communication, and service  
which exceeds their expectations.**

## **Surprise! You're Too Young to Retire...**

In a recent survey, 80% of American workers either incorrectly guessed or didn't know their eligibility age for full Social Security retirement benefits. Do you know yours?

Thanks to legislation passed in 1983, those born after 1960 won't be eligible to receive full Social Security benefits until age 67. Those born before 1960 can begin to receive full benefits somewhere between the ages of 65 and 67, depending on their birth year. If this information is new to you, it may be time to take a fresh look at your retirement savings strategy and Social Security distribution plans.

Determining the right strategy for drawing on Social Security requires careful planning and a healthy dose of number crunching - taking into account your individual life expectancy, your "full retirement age" (as defined by the Social Security Administration), the anticipated value of your assets at the time of retirement and what type of return you can expect from your portfolio. As you review your options, you may want to keep the following considerations in mind.

- If you want to retire early, you can begin to receive Social Security benefits at age 62, but doing so will reduce your monthly benefit by as much as 30%. You can also delay taking benefit payments until age 70 if you want to receive a larger benefit later in life. For example, a person who could expect to receive \$1,000 a month from Social Security at full retirement age (66) could choose to (a) begin taking benefit payments at age 62 and receive a reduced benefit of \$750 a month, (b) begin taking benefit payments at age 66 and receive \$1,000 a month or (c) begin taking benefit payments at age 70 and receive an increased benefit of \$1,320 a month.

- All Social Security distribution options are designed to provide you with roughly the same amount in overall benefits, so choosing the best option for you means analyzing your unique needs and financial situation.

- Your full retirement age depends on your birth year. For help in determining the year in which you can begin to receive full Social Security retirement benefits, visit the

Social Security Administration's Web site at [www.ssa.gov/retirement](http://www.ssa.gov/retirement).

- Delaying Social Security benefit payments means you will have to rely on your savings to fund the early years of your retirement. This could shrink your portfolio and reduce the returns you can expect in later years. On the other hand, if you claim benefits early and unexpectedly outlast your savings, you may end up living on a reduced Social Security benefit for the rest of your life.

- If you plan to continue working, you no longer need to wait until age 70 to receive full Social Security benefits. You can begin receiving benefits as soon as you reach your full retirement age.

Although many of the laws governing Social Security distributions were enacted 20 years ago, they remain a mystery to most retirement-minded investors. Whatever your retirement plans entail, you may want to be sure they take into account all facets of the prevailing legislation.