FRONT BARNETT ASSOCIATES LLC

INVESTMENT COUNSEL

August 28, 2002

THE OUTLOOK:
NO DOUBLE DIP - - TILTING TOWARD GROWTH

In our July 22nd client letter we emphasized our belief the U.S. economy was on track for a sustained, albeit muted, expansion. Despite the often wild mood swings of market participants which greet the release of each new piece of business data, recently published economic statistics confirm this view. With the absence of a major new corporate scandal, the enactment of the Sarbanes-Oxley Act, and further confirmation of improving business conditions, the stock market now appears to be refocusing on the fundamentals. The most salient of these are the continued economic recovery as indicated by the positively sloped bond market yield curve, and the arrival earlier this year of the inflection point in the corporate profits cycle.

Positively Sloped Yield Curve Portends Growth

The difference in yield between short-term instruments and longer-dated bonds has in the past been an extremely reliable leading indicator of future economic activity. For example, an inverted yield curve, where short-term rates exceed long-term rates, has been a precursor to slowing business conditions and declining corporate profitability. On the other hand, a positively sloped yield curve, such as we now have, has invariably signaled improving economic activity and rising corporate fortunes as shown in Exhibit I below.

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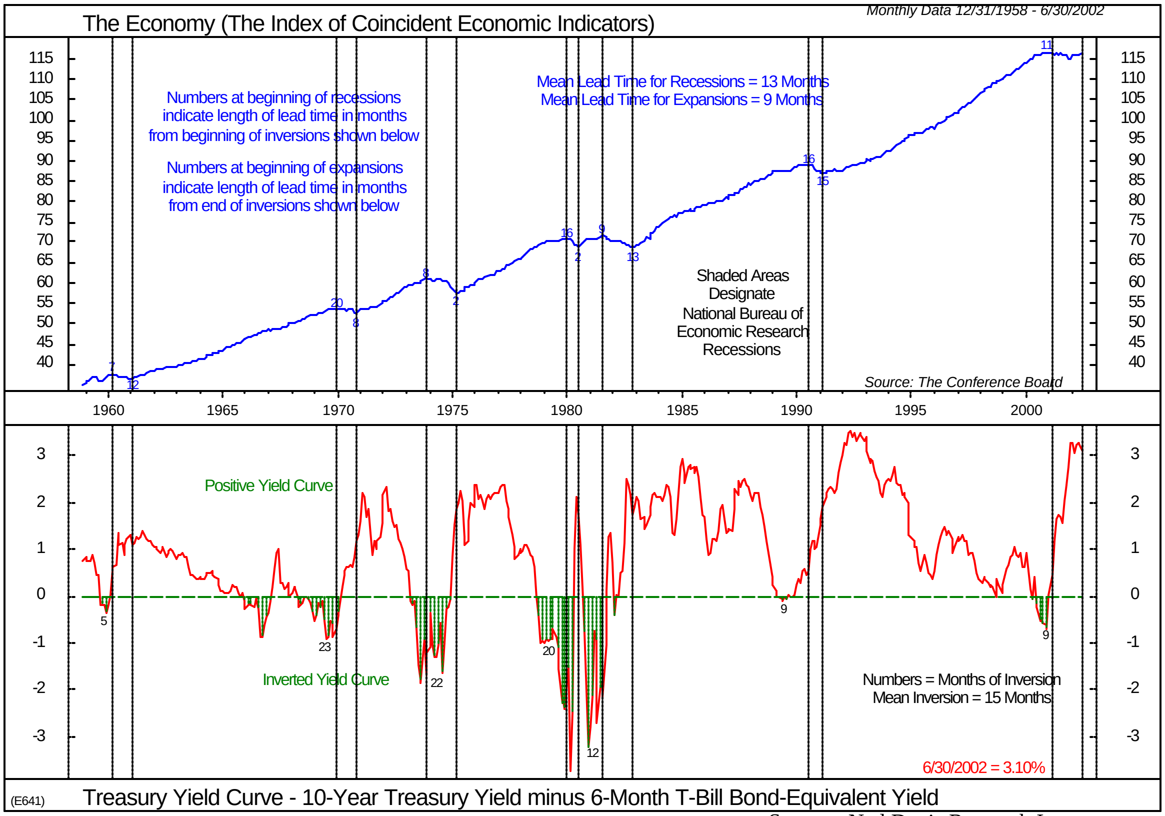
Exhibit I



Source: Ned Davis Research Inc.

An analysis of past business cycles reveals the two most recent expansions commenced about 13 and 15 months respectively following the resumption of a positively sloped yield curve. In the current cycle, the yield curve became positive in April 2001. While some forecasters question the durability of the current economic expansion, this reliable indicator points to continued recovery.

An Inflection Point in the Corporate Profits Cycle

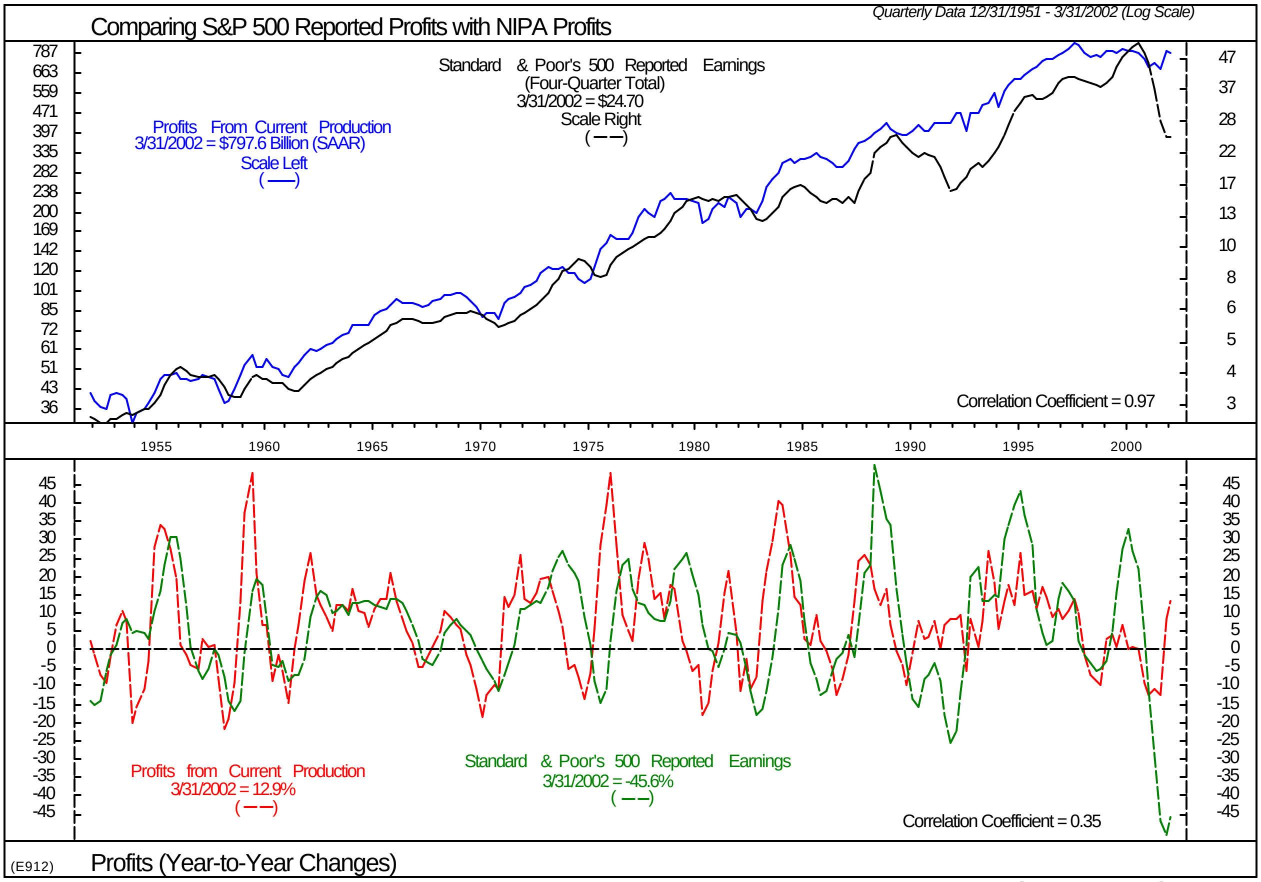
Corporate activity in the past 18 months has been focused on cutting costs to rationalize business structures following the enormous over-expansion of the late 1990's. Evidence is now mounting that this process, which has to date constrained economic activity, is beginning to abate. Weekly initial unemployment claims, after peaking at 527,000 in September 2001, have recently been in the neighborhood of 385,000. Temporary help agencies are now experiencing modest growth and overtime is increasing. Taken together, these factors suggest that corporate executives now feel their businesses are appropriately sized to generate adequate profitability at current levels of demand. Further, because of improved operating leverage, small improvements in demand and volumes should lead to even larger gains in profits, especially for those companies likely to grow more rapidly than the economy as a whole.

There are numerous other underpinnings to improving corporate profitability including:

- Non-farm productivity, or output per man-hour, has been very robust, averaging 4.8% growth in the first half of this year;
- Unit labor costs are declining, consistent with typical post-recession behavior;
- The massive inventory liquidation of the past 18 months shows early signs of reversal, which paves the way for increases in future production;
- The weaker dollar is helping U.S. exporters regain their competitive position in world markets, and;
- Low interest rates and improving job prospects are supporting consumer spending following a bit of a slowdown in the last quarter.

A review of corporate profits as reported by the government in its National Income and Profit Accounts, as shown in Exhibit II below, suggests that a recovery is already underway.

Exhibit II



Source: Ned Davis Research Inc.

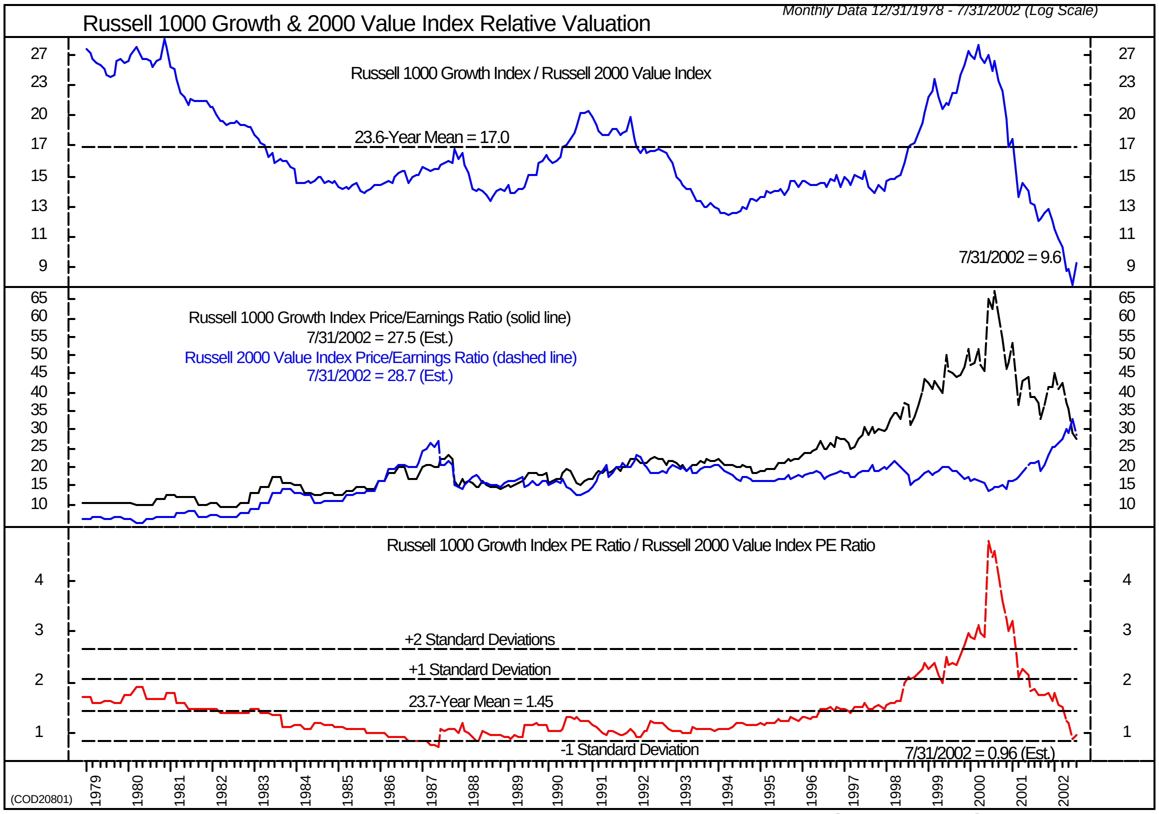
Market Sector Valuation Disparity

While many investors remain focused on the general stock market's sharp decline from late March through July 23rd and its subsequent rebound, we have noted a potentially important shift in investor preferences *within* the equity market itself. Whereas the past 2½ years have been marked by the dominance of small cap versus large cap stocks and the outperformance of value relative to growth shares, returns since mid-year show early signs of a shift in leadership toward large cap growth. In fact, since the end of June large cap growth shares, as measured by the S&P Barra Growth Index, have declined by only 1%, as compared with a fall of over 12% for the Russell 2000 Value Index, a good proxy for small cap value shares.

Indeed, over the past few years, the performance difference between major classes of equities has been staggering. Small cap value equities have returned approximately 15% since the overall market peak in March 2000, while large cap growth stocks have declined approximately 50%, resulting in a differential of 65 percentage points. This market action reversed a similarly extreme period of large cap growth stock dominance in the prior two years when large cap growth stocks outperformed small cap value shares by a margin of 80 percentage points. Style shifts, which formerly took years to play out, are now occurring over shorter periods of time and with a greater magnitude of return differential.

As a result of the significant underperformance of growth shares over the past two years, they are now priced at a lower price/earnings ratio than small cap value stocks -- an unusual circumstance not likely to persist. Exhibit III below clearly demonstrates large cap growth shares have typically sold at a premium price/earnings ratio to small cap value stocks. The current valuation relationship between these two asset classes is, in our view, in the process of reversing.

Exhibit III



Source: Ned Davis Research Inc.

Tilting Toward Growth

Our proprietary Economic Model points to a continued business expansion, and the above-noted yield curve analysis confirms this viewpoint. Corporate efforts to wring efficiencies out of operations, in tandem with the forecast economic recovery, will lead to improved profitability. This outlook has important implications for portfolio strategy. The profits of growth companies are more sensitive to rising volumes than are those of more mature businesses. Therefore, growth shares have typically outperformed value shares during an economic rebound. We have, therefore, gradually tilted equity portfolios under our supervision toward growth shares so they are well positioned to benefit from this emerging stock market dynamic.

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