Risks to our forecast

The year 2003 could bring surprises that would prevent our forecast from being realized. For example, there could be a prolonged war with Iraq, increased terrorist activity, a resignation by Fed Chairman Greenspan or weaker than expected economy, dollar or housing markets. Any of these events might hurt investor confidence as well as the stock and bond markets. There is also a possibility of positive surprises, such as stronger than expected corporate earnings, which might speed the stock market's recovery.

Value of asset allocation

Over the coming decade, we anticipate returns from financial assets will be well below those investors enjoyed from 1982 to 2000. Moreover, it's unlikely that large cap stocks will regain the dominant role they played in the 1980s and 1990s. Rather, we expect that market leadership will rotate among asset classes and their subclasses.

Accordingly, our first recommendation is that investors hold broadly diversified portfolios of many different types of assets. Thus, they would be positioned to benefit from any of these assets rising in value. Also, a fall in value by one asset class might be offset by a rise in another, making for a smoother pattern of investment returns over the long term.

Secondly, we believe adjustments will be required in asset allocation among asset classes from time to time to help augment total return. Third, we believe fundamental research, going back to basics, will be critical to enhance portfolio returns in future years. Company-specific developments will become more important because good companies with sound fundamentals will be less susceptible to the overall volatility of the stock market.

Conclusion

Notwithstanding only moderate improvements, we anticipate 2003 will be the best year for the economy and equity investors so far in the new millennium. Bond investors will find the year more challenging, yet with pockets of strength.

Please call your advisor to learn how you can benefit from this information.

Harvey Hirschhorn is Columbia Management Group's Head of Active Asset Allocation and Investment Strategy.

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Perspective on Investments

January 2003

Overview

We believe that better economic growth and an improved environment for corporate profits will pave the way for gains in stock prices that should result in equities outperforming fixed income, except perhaps for high yield bonds, in 2003.

In our opinion:

- The consumer will continue to spend, although at a slower pace
- Capital spending will improve by mid-2003
- US stocks will outperform other asset classes, including foreign stocks, in 2003
- We will remain in the disinflationary environment that began in 1980

Better economic growth

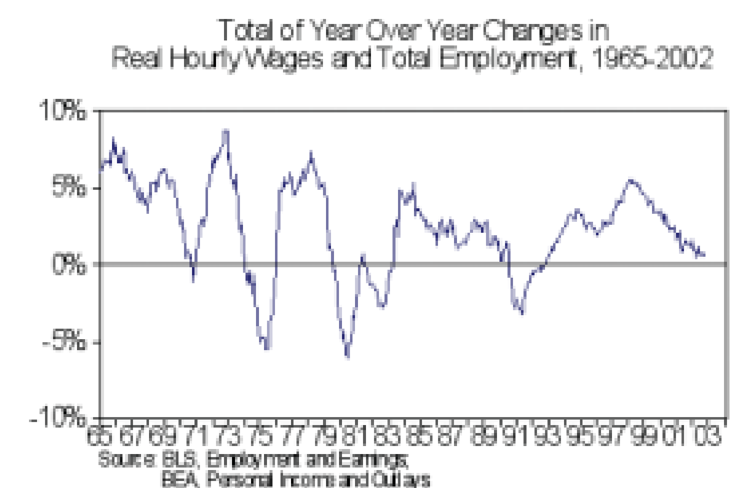
During 2003, the U.S. economy will, in our opinion, continue to grow at an annualized rate of 2.5% to 3.25% with support from capital spending, stimulative monetary and fiscal policies, and the consumer.

Consumers have shown resilience by spending throughout the recession and the subsequent recovery. Some pundits fear consumers will run out of steam. We disagree. We believe consumers will continue to spend, albeit at a somewhat slower pace, thanks to wage gains of 3% over the next year, rising employment, and high debt loads made sustainable by low interest rates and carrying costs.

An improved savings rate over the past year has provided additional enhancement to consumers' balance sheets.

Fundamentally, consumers have been supported by the fact that average growth in employment and real wages remained positive despite slipping over the past two years (see Exhibit 1). Historically, in contrast, during prior recessions employment

Exhibit 1



and real wages turned sharply negative. These developments in employment and real wages have supported, and should continue to underlie, further moderate gains in consumer spending.

Capital spending is coming back in certain areas after weakness that precipitated 2001's recession. Capital spending, which refers to spending on physical assets such as property, plant or equipment, declined because of the drop in corporate profitability, higher costs of financing due to lower stock prices and higher bond quality spreads, and overcapacity in many sectors. However, although spending on telecommunications and technology will continue to lag, spending elsewhere should pick up, funded by better corporate profits, sharp productivity gains, higher stock prices and reduced bond quality spreads.

Current monetary and fiscal policies reinforce and support the expectations of moderate spending by consumers and an improvement in corporate capital spending. The Federal Reserve brought the federal funds rate down to the low level of 1.25% in November 2002. If the economy falters, it could cut short-term rates further or it could resort to other methods of pumping liquidity into the economy, such as cutting reserve requirements for banks or outright purchases of government bonds.

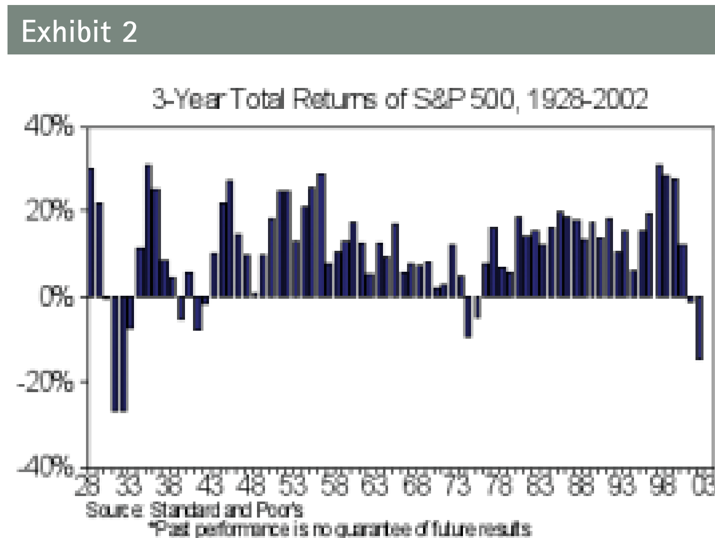
On the fiscal side, Republican control of the U.S. Congress is supporting President Bush's push for tax cuts to further stimulate the economy. The elimination of the double taxation of dividends is the largest component of his January 7 proposal. If this passes Congress, it would result in higher after-tax returns for stock investors. Our valuation models suggest this could boost the upside potential of the stock market by an additional 12% over the following year.

However, it takes time to iron out differences among politicians, so a tax relief bill would probably reach a vote no earlier than the third quarter of 2003. Given the rising federal budget deficit, any tax cuts would be moderate. Moreover, the strapped budgets of many states are forcing them to raise taxes and fees or to reduce spending. These state actions would offset some of the federal stimulus.

Improved environment for stocks

We believe stocks are likely to deliver moderately positive returns for 2003 after three consecutive years of negative returns, one of the worst records in the past 75 years (see Exhibit 2). The stock market, as measured by the Standard & Poor's 500, hit an interim low in July and pierced that low in early October. Since then, the stock market has firmed due to prospects of continued economic recovery, further reductions in short-term interest rates, and the fact that external risks, such as war with Iraq and corporate accounting irregularities, have been discounted to a large extent.

Exhibit 2



The economic growth we anticipate in 2003 should underwrite faster growth of corporate profits. Moreover, the past year's corporate governance controversies are spurring companies to reform their accounting practices and to report earnings that merit greater credibility. We expect profits to grow around a double-digit rate that would, with bolstering from low interest rates and low inflation, support further moderate gains in equity prices. Nonetheless, we anticipate continued volatility in the stock market. Individual security performance should be driven more by the fundamentals of sales and profits than by external disruptions or shocks such as those that have rocked the stock market over the 15 months.

Bad deflation vs. good disinflation

The low rate of inflation has excited concern that the U.S. may experience a debilitating deflation, in other words, the kind of drop in the general level of prices that has sapped the Japanese economy. A bad deflation reflects poor monetary and fiscal policies, protectionism on international trade, failure to address bad debt problems, and self-reinforcing economic erosion. These conditions do not exist in the U.S.

Instead, since 1980 the U.S. has experienced a good disinflation - a reduction in the rate at which prices rise, supported by productivity gains that pressure prices downward and by noninflationary monetary and fiscal policies. This positive environment is likely to persist in the U.S. with continued movement on fiscal stimulus through tax relief and with the Fed willing to provide liquidity to the system to maintain a thrust on economic activity.

Outlook for 2003

In 2003, stock market growth is likely to be led first by large capitalization stocks, though leadership should rotate as the year unfolds. Size and liquidity mean that large cap companies are likely to benefit first from investors redeploying the considerable funds sitting on the sidelines. Also, the disparity in valuations between large cap versus mid cap and small cap stocks has been largely eliminated by the underperformance of large caps from 2000 into early 2002. As shown by Exhibit 3, the price/earnings (P/E) gap between growth and value has sharply narrowed over the past three years. In addition, P/Es by market capitalization within growth and value have converged in 2002.

Exhibit 3
Price-Earnings (P/E) multiples by Equity Asset Class, 1999-2003

	1999 P/E	2000 P/E	2001 P/E	2002 P/E	2003 P/E
Large Cap Growth	41.77	33.69	31.20	22.77	20.04
Mid Cap Growth	34.14	32.19	29.86	22.96	18.37
Small Cap Growth	31.17	26.01	26.94	21.96	17.17
Large Cap Value	20.95	18.26	21.71	16.42	14.32
Mid Cap Value	16.17	16.29	19.49	17.61	14.16
Small Cap Value	19.69	17.31	23.90	17.97	14.43

Source: Baseline Estimates

International stocks are likely to lag U.S. stocks just as international economies are lagging the U.S. economy. Monetary and fiscal policy options in Japan and Europe are more constrained than in the U.S. Japan is confronted with massive fiscal deficits and interest rates near zero, whereas Europe is operating within strict guidelines on fiscal and inflation targets.

U.S. Treasury bonds are also poised to lag U.S. stocks. Three consecutive years of bond market outperformance driven by a weak economy and modest inflation have driven up bond prices, which move in the opposite direction of interest rates. With interest rates at multi-decade lows, there isn't much room for bond prices to rise, particularly given our expectation of economic recovery. Within the fixed income category, corporate and high yield bonds as well as mortgage- and asset-backed securities are likely to outperform Treasuries in 2003 as the economy improves, relieving investor fears about companies failing to pay their debts.