

THE NAVIGATOR[®] REPORT



CLARK
CAPITAL
MANAGEMENT
GROUP INC.

FOURTH QUARTER 2001

GOOOOD RIDDANCE 2001 WELCOOOOME 2002

What a year 2001 turned out to be! The year will be remembered the same way 1941 and Pearl Harbor are remembered. September 11th has become this generation's day of infamy. This date will be imbedded in our hearts and minds forever. It is the date Americans realized that we are not immune to senseless acts of terrorism. It will be remembered as the day that we as Americans said "enough" to terrorism. There is no other country in the world that can declare war on worldwide terrorism with any hope of succeeding. The American "Will" can succeed and the American "Spirit" will succeed! As President Bush said at a recent memorial service, "We will never forget what we lost on September 11th, nor what we found."

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George W. Bush

During the past two years the S&P 500 lost 19.90% while Nasdaq lost 51.87%. In Europe, Finland lost 46.83%, Germany lost 34.71% and the U.K. lost 28.55%. In Asia, Hong Kong lost 29.68%, Singapore lost 37.33% and Japan beat the others by losing 56.51%. WOW! Places to hide have been few and far between.

Two historic events occurred during the last days of 2001 that cemented the opinion that the only good thing about 2001 is that it is over. The first was the

default of Enron, thus becoming the largest bankruptcy in U.S. history. Enron stock went from \$90 to under \$1 almost overnight. More than \$66 billion was lost by almost 60,000 investors including Enron employees whose 401k programs were wiped out. The second event involved the largest debt default in world history. This occurred when Argentina defaulted on \$132 billion in debt. While both of these events are mind shattering, what struck me the most was that one U.S. company going broke cost investors one-half as much in loss as an entire, very large, country going broke. As I said above, GOOOOD RIDDANCE 2001!

The past two years will also go down in the history books as the first years since 1973-74 that the U.S. market posted back-to-back losses and the first years since the late seventies that the European markets posted back-to-back losses.



Harry J. Clark, CFP
President, Chief Executive Officer
Clark Capital Management Group, Inc.

WHAT HAPPENED?

The U.S. economy officially entered recession in March 2001. However, the manufacturing sector entered its own recession in August 2000. Yes, the unfortunate event of September 11th exacerbated the recession and postponed the recovery, but did not cause the recession. Recession can be caused by many factors. Usually the cause can be traced to the consumer who stops spending causing the economy to go into a tailspin. This is not the case this time as the consumer has done more than their part to keep the economy going. Some say too much of everything; too much capital spending, too much inventory buildup, too much speculation, too much demand for labor, etc. caused this recession. Some say that the Federal Reserve caused the recession because of their fear that the economy was too overheated to be sustainable. Their answer was to raise interest rates on numerous occasions to slow the economy. Did they overshoot? Definitely! I believe that they misread the economy and continued raising rates even as the economy was moving into recession. Thus ended one of the longest peacetime expansions in history. You may remember a speech by Mr. Greenspan where he used the phrase "Irrational Exuberance" to describe the mood of that time. Now that he has succeeded in causing one of the most devastating bear markets in history; the largest loss in corporate profits since the depression; and a massive loss of jobs, I can't wait to hear how he characterizes the mood now. The bear market actually began in March of 2000 where the S&P 500 was 72% overvalued based on the IBES valuation model. The same IBES valuation model showed an undervaluation of 15% at the low point of the market. To compound matters, the Federal Reserve moved too slowly to lower rates when it became evident that things were going from bad to worse in the economy. This is probably because they, and most every other economist in the country, kept insisting that we were not in a recession until nine months after it began. Even though they have lowered rates eleven times they could never catch up with the rapidly deteriorating economy. The September 11th event gave them the excuse to be more aggressive in lowering rates. They have also been flooding the system with liquidity at the highest rate in Fed history. They finally panicked!

When will the economy recover? Why is the stock market moving higher if we are still in a recession? Unemployment hit a six-year high of 5.8% in December

and 2.6 million workers lost their jobs during 2001. Corporate profits are still dropping and are nonexistent in many cases. Interest rates are at the lowest levels in four decades and will still have to go lower. Is the Fed pushing on a string as the Japanese Fed has been doing for over ten years? Why do we believe that the September 21st market low point will prove to be the best buying opportunity for the next several years? Stay tuned!

HOW DID WE DO?

As mentioned above, the U.S. market declined during 2000-01 for the first time since 1973-74. Over the two-year period the S&P 500 declined 19.90%. Under our Classic Program (where we move assets between the index and a money market fund) we suffered about one-half of the loss or 10.75%. All of the following comparisons were recorded with our Classic Program over the two year time period and are after advisory fees. We had a loss on the Nasdaq of 29.40% compared to 51.80% on the index if you held for the two years. And on the Dow Jones Industrial Average we lost 7% while the index lost 11.80%. The Russell 2000 index of small-cap stocks lost 1.24% while we gained 17.20%. The Lipper Large Cap Growth Mutual Fund index lost 38.90% while we lost 23.50%; the Lipper Mid-Cap Mutual Fund Growth index lost 33.8% while we lost 0.50%; the Lipper Small-Cap Mutual Fund Growth index lost 19.95% while we gained 12.27%; and the Lipper Multi-Cap index lost 34.20% while we lost 11.86%. As you can see, we did much better with Small and Mid-Cap funds over the past two years. I keep referring to the past two years to cover both declining years but all of our losses came in 2001. We had built

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Alan Abelson, Barron's Financial Weekly



up such large profits in early 2000 that we were able to maintain profitability for the entire year of 2000. **While we do not like showing any loss, the losses we sustained were in all cases far less severe than experienced with any index or fund that was bought and held over the past two years.** *Because our losses are smaller, recovery is much faster.* For example, to recover from a 51.8% loss that occurred on the Nasdaq requires a gain of 107%. Recovering from the loss of 29.4% that we recorded for the Nasdaq (and was our largest loss) requires a gain of 41%. You actually have to gain 2.6 times as much to recover from a 51.8% loss as from a 29.4% loss. Another comparison is the Lipper Multi-Cap Mutual Fund Index that lost 34.2% on its own while we lost 11.86%. To recover from a 34.2% loss requires a gain of 52% while recovery from an 11.86% loss requires a gain of 13.5%. **In other words you must make 3.85 times as much to recover from the larger loss that you would experience by buying and holding over the same period than with our Classic program where we move between being invested in an index or mutual fund and a money market account.** As very succinctly stated (as usual) by Mr. Alan Abelson of Barron's Financial Weekly "The buy-and-hold mantra is a myth perpetrated by ignorance." Of course the best of all worlds is to gain while the indices are losing. Notice above that we actually had profits over the past two years on the Russell 2000 Small-Cap index, the Lipper Small-Cap Mutual Fund index and essentially were even on the Lipper Mid-Cap index. Did we do our job? Did we protect our investors from severe loss? Each one of our clients must answer that for themselves. I can say that I am never happy with any of our client accounts showing loss and all of our energy is directed toward limiting loss. As you know we have made substantial improvements (discussed in prior issues) to our models recently and we believe we will be able to greatly improve results going forward.

NOW WHAT?

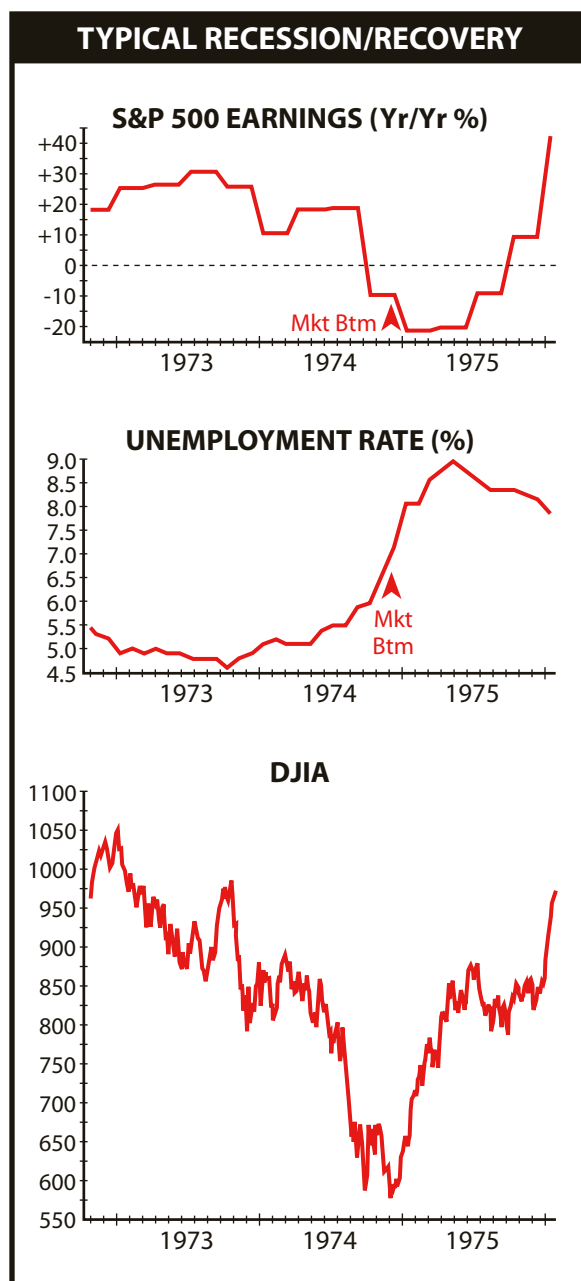
The question now becomes "What will this new year bring?" The U.S. markets made their low points on September 21st and have been moving higher ever since. Some say that a new bull market began on September 21st while others lament that this move higher is only a bear market rally with a more severe decline to follow. There are good arguments either way. The most convincing argument on the bearish side relates to valuation. The bearish camp shows that over the past 50 years no bull market has begun with the P/E multiple on the S&P 500 as high as now. Depending how you figure the P/E ratio, it was 32 at the market lows and currently stands at 47. The average P/E

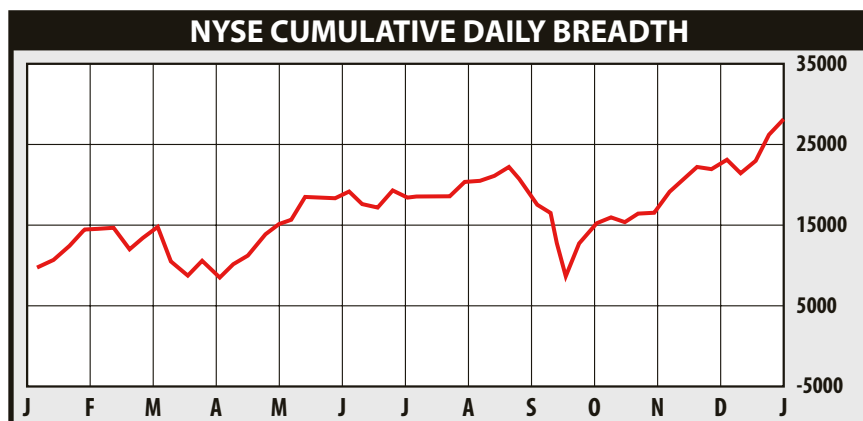
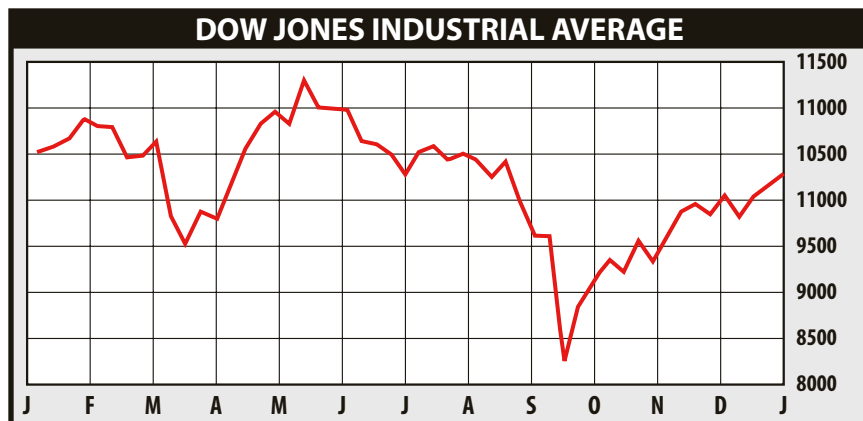
multiple at bear market bottoms (or bull market births) over the past 50 years has been 11. The highest were 16.3 at the 1960 bottom and 14.9 at the 1962 and 1967 bottoms. The bear market of 1973-74 ended on a P/E multiple of 7.5. The quandary is "will this time be different?" The chart at left, from Jim Stack at Investech, shows the 1973-74 recession and the market bottom. It looks very similar to today and is typical of most market bottoms where unemployment continues to climb, corporate earnings continue to decline, and the market advances leaving the majority behind waiting for everything to "look just right?"

So maybe the P/E question will not be bothersome this time but it is something to keep in the back of our minds. Do the lowest interest rates in 40 years allow for the highest P/E ratio at the start of any bull market in the past 50 years? "New Economy" or not, it is worrisome.

VERY POSITIVE SIGNS

I have discussed market breadth on many occasions as a very good indication of future market activity. It has been shown that breadth (the ratio of stocks going higher to those moving lower) actually peaked well





before the major indexes peaked and was declining for quite some time. **The opposite is occurring now. Breadth is moving strongly higher** as you can see in the chart above that comes from Barron's. Notice how breadth was steadily improving prior to the Sept. 11th event and is now moving well into new high territory. This is a very positive sign that, even though we will have corrections along the way, the underlying majority of stocks are moving higher and will pull the averages up with them.

Another extremely positive sign comes from Ned Davis Research, one of the most respected research groups in the business. He calls this "A Perfect Indicator" because it has never failed although he says that he knows there is no such thing as a perfect indicator. This indicator shows when the Industrial Production Index is going to advance or decline and hence when the general stock market will advance or decline. The indicator is based on several indices from the Institute for Supply Management. The last sell indication was given in June 2000 and obviously was right on target. The indicator gave a new signal of expanding industrial production of January 3rd which will bode well for the stock market going forward.

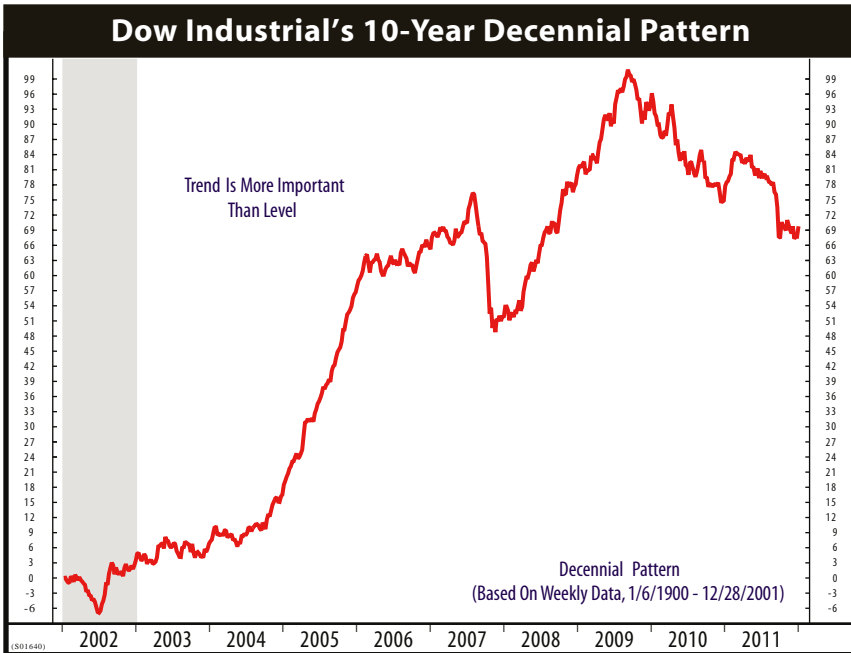
Other positive signs that the economy is coming out of the recession are; weekly unemployment claims peaked on

9/29, new vehicle sales hit bottom in September, new and existing home sales bottomed in September, building permits and housing starts bottomed in October and consumer confidence bottomed in November. All very positive signs of recovery. **Remember, economists will not tell us that the recession is over until well after it really is! In fact the lead-time to recognize the end of a recession is even longer than to acknowledge the beginning of a recession.**

GOING FORWARD

The "Buy of a Lifetime" phrase was coined by Mr. Harry S. Dent of the Dent Foundation shortly after September 21st. Mr. Dent is a "Demographic Economist" because he bases his forecasts on spending habits of the population as they move through their lifecycles. This is possible because we all spend as we age, get married, raise a family, experience college education costs, prepare for retirement etc. in very predictable patterns, which Mr. Dent has identified. A member of our board of directors remembers a speech given by Mr. Dent in early 1990 in Rome. In that speech he predicted that the Dow Jones would reach 10,000 or higher by the year 2000. At that time the Dow Jones was at 2,500. It might make you feel pretty good to know that Mr. Dent has a target for the Dow in 2009 of 35,000. Just as the audience in Rome in 1990 was incredulous that the Dow would reach 10,000 by 2000, I am sure that you are also incredulous at this moment too! From 2,600 in 1990 to 11,000 (where it was) in 2000 is an internal rate of return of 16%. From 10,000 today to 35,000 in 2009 is an internal rate of return of 16.9%. Seems possible doesn't it! Of course it will not be a straight line affair. There will be ups and downs, scary moments and rewarding moments, and, as always, greed and fear.

The chart on the next page could have come from the Dent Foundation but did not. It comes from Ned Davis Research. It shows the Dow Jones 10 year Decennial Pattern. This chart is the result of what has happened each decade since 1900 and is based on weekly data. Notice the caveat on the chart that "Trend is More Important Than Level." Now as you are looking at this chart, let me tell you what Mr. Dent is predicting for this time period based solely on his research into demographics and cycles of the economy.



chart, doesn't it? He goes on to say that a major bear market will than take hold and last into 2020-22. The message here is that we must take advantage of the next eight years because based on demographic trends and cycles of the economy, it will be a long time before we have a friendly market environment after 2009-2010. Below is the Dent Foundation Dow Channel showing the eventual level of 35,000.

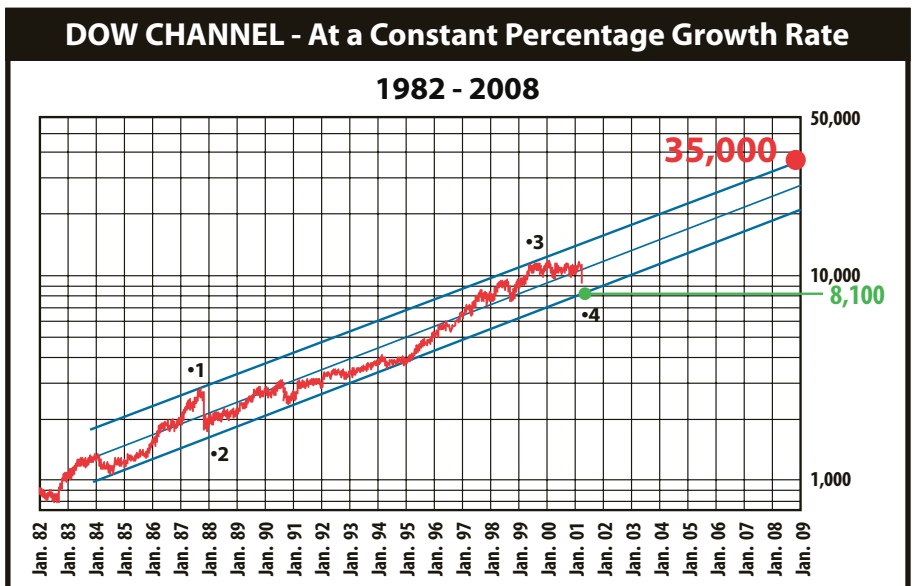
WHAT COULD GO WRONG

We always ask ourselves what could happen to derail the economic recovery and abort the new bull market. The answers are the usual things such as consumer confidence, inflation and a mistake by the Fed. Lets take a look at each one.

Mr. Dent expects the market to move higher into Spring of this year and then to have a severe correction. He says that correction will provide the "Second Best Buy of a Lifetime." I believe that the correction will be very scary, all the bears will be saying "I told you so" and the uninformed will again sell out at the wrong time and give up. As an aside to this look ahead, I must say that there were several clients of the firm that insisted on going to cash when we got stuck in the market after the Sept. 11th event. All the reasoning in the world would not convince some people to stay put and stay invested for the inevitable rebound. Well! Rebound the market has and now that the horse has gone and the barn door has closed, so to speak, they want to know when to get back invested. A difficult question. Please know that there will always be very scary events that will try your patience. I firmly believe that we will avoid serious loss when the inevitable corrections occur thus enhancing performance. A steadily improving market and economy should ensue through 2003-04 as we prepare for the next election cycle. Mr. Dent then predicts a stiff correction beginning between May and October of 2006. The chart from Ned Davis shows that correction beginning a little later in early 2007. Mr. Dent says "Two moderate cycles hit in 2010 alone with strong downward demographic trends after mid-2009. Hence we feel it is extremely likely that we will see a top by late-2009 and a strong downturn in 2010." Sounds a lot like the picture of the

Consumer confidence ties directly to consumer spending which ties directly to Economic recovery. True, this recession was not consumer driven but industrial spending driven. But if the consumer pulls in their horns it will not be good. So far consumer confidence is rising after bottoming in November and in one Conference Board measure has risen from the lowest level in forty years to a neutral reading. I worry how headlines such as "Consumer Debt Surges," "Ford Cutting 35,000 Jobs," and "Kmart Bankruptcy Imminent," affects consumer psyche.

Inflation has been dead for quite some time even though Mr. Greenspan and the Fed kept fighting the wrong battle for years later. This fight is the primary reason



why we are in the fix we presently find ourselves in today. The problem here is if the Fed perceives that inflation is even remotely possible they could prematurely raise interest rates and choke off the recovery. The fact is that there is little or no inflation. The Economic Cycle Research Institute publishes a Future Inflation Gauge that is one of the most reliable inflation forecasting models available. It is forecasting extremely low inflation and is still trending lower. Ned Davis Research, mentioned here often, also has an inflation model that is near record lows. It is inconceivable to me how the Fed could misinterpret the present inflationary picture and let's hope they do not.

CONCLUSION

We believe that we are positioned properly to take advantage of further market strength as it becomes evident that the economy is getting stronger. A possible target for the Dow sometime by late winter or early spring would be the 11,000 area and for the Nasdaq our target is 2,400 to 2,500. These are both substantial gains from today's levels of about 10,000 and 2,000 respectively. However, it should not matter which way the market moves. We are confident that we can avail our clients to the upside and protect them from serious loss if a downtrend occurs.

As many of you are aware, we are one of the very select Investment Advisors in the country to be able to receive the Harry S. Dent Foundations recommendations for our Dent programs. If you are interested in the Dent philosophy and would like to read Harry's latest book, please contact us by e-mail at Navigator@CCMG.com, call at 800-766-2264, or ask your local advisor.

CCMG also publishes a weekly update that is e-mailed to all of our advisors. We are making this available to those clients who feel they need contact on a regular basis and feel the need to stay in touch with the market. Please request this at the above e-mail address.

We have developed a new risk tolerance profile and at the beginning of the year it is a good idea to review your prior risk levels and allocations. If you would like to prepare a new risk tolerance profile, please contact your local advisor so he/she may assist you or e-mail/call the office to have one sent to you.

The enclosed statement shows all transactions for the year for help in preparing your taxes. We will be forwarding

any tax information received from mutual funds or custodians as soon as received. We will not be preparing tax statements but you may request one if you desire by e-mail/phone.

Let us all have a happy, healthy, and prosperous year in 2002. We live in the best country in the world and only we, each of us, can make it better.



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All CCMG performance figures in this Report are net of fees and expenses. Past performance is not a guarantee of comparable results in the future. The cited data have been prepared utilizing a methodology consistent with industry standards.

*CCMG accounts are managed through the use of tactical and strategic asset allocation methods and utilize the buy and sell indications produced by these methods to determine when clients should be invested in equity securities. When a buy signal is generated clients' accounts are invested in equity securities, and, conversely, when a sell signal is generated their accounts' equity positions are liquidated and invested in money market accounts and other cash equivalents. The performance data cited above reflects the effects such buy and sell signals would have had on an investment in the market indices and mutual funds discussed for the time periods indicated for all CCMG clients invested in the Navigator Classic Program. The buy and sell signals used in such information are actual signals generated by CCMG's methods during the periods portrayed. Client accounts may or may not have been invested in the referenced indices or funds during the periods portrayed. The cited performance data assumes the reinvestment of all dividends and capital gains distributions, and reflects the deduction of the maximum management fee charged by CCMG for the referenced program and actual mutual fund expenses. Historical performance is available upon request.

Photos by: Don Pearce Photographer