

# ANNUAL REPORT 2003



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## A MESSAGE FROM THE PRESIDENT

Thomas G. Twombly



**Thomas G. Twombly**  
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**Robert S. Phipps, III**  
*Chief Investment Officer*

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*Exec. VP, Operations*

**Glenda Summers, CFP®**  
*Sr. Advisor Associate*

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**Bryan Uecker**  
*Sr. Advisor Associate*

**J.P. O'Sullivan**  
*Research Manager*

**Leslye Kellner**  
*Marketing Manager*

We are pleased to provide you with our annual report for the year 2003, Lucien, Stirling & Gray's eleventh anniversary year.

This has been a year of substantial growth and improvement, both for the financial markets as a whole, and for Lucien, Stirling & Gray as a firm. Nationally, 2003 marked the first positive year for equity markets since 1999, bringing to an end the most protracted bear market we have seen since the early 1930's, with increases in the Dow Jones Industrial Average, the S&P 500 Index, and the NASDAQ Composite Index of 25.32%, 26.38%, and 50.01% respectively. On a more personal level, 2003 provided Lucien, Stirling & Gray with vastly improved services, a steadily increasing client base, and the highest level of managed assets we have experienced in our history as a firm.

To be sure, not all the news this year has been positive. Fears of war, and the possibility of huge geopolitical unrest cast a pall over global markets and the national psyche in the first several months of the year. Ongoing revelations of corporate greed and malfeasance have continued to leave the public feeling jittery, and a growing scandal in the brokerage and mutual fund industry

that came to light in the latter part of the year has left us all with a distinct sense that trust is not something that should be bestowed easily. Despite these concerns, we believe that there is a great deal of positive change afoot and that the business climate going forward will continue to improve. We are looking forward to the coming year with an increased sense of optimism and confidence.

*"The secret of success is constancy of purpose."  
- Benjamin Disraeli*

As a firm, we began the year with a careful examination of our client base. We analyzed existing demographic data to identify common characteristics, and to uncover any unmet needs. We also began an extensive client interview process to gain specific feedback about our services, and insight into ways in which we could improve them. In late February we began a thorough examination of our asset management procedures, with an eye towards improving, wherever possible, both the scope and quality of the services we offer. The results have been significant. In May we launched a new model portfolio – our Core Model – in response to client and associate feedback, and our overall research and management procedures have improved markedly. Much of this improvement is reflected in the results you see reported in the coming pages.

Throughout the year we have also devoted a great deal of attention to improving our communications. Email alerts are now sent to communicate the rationale behind any changes we make to model portfolios. Similar alerts are also sent to notify you of any updates to our "Outlook", which is posted on our website. Additionally, we have scheduled an on-going series of quarterly "fireside chats" which offer an opportunity to participate in more informal discussions of issues of importance to us and to you. I invite you to join us for those throughout 2004.

As we move into the new year we want to continue to ask for your advice and feedback. Our aim of becoming the most client-centered firm we can be will not be realized without your help. We appreciate your insights, and we look forward to providing you with the most valuable professional services we can offer. Thank you again for your continued trust and support.

All the best for a joyous 2004!

Thomas G. Twombly  
*President*

## MARKET COMMENTARY

*Robert S. Phipps, III*



For a year that started with very modest to even bearish investor expectations, 2003 produced some very noteworthy results. The Dow Jones Industrial's gain of 25% was the best since 1996, the 26% gain on the S&P 500 was the best since 1998 and value stocks in general posted their best calendar year gains in history. The 50% gain on the NASDAQ was the index's third best annual return in history and small cap stocks also sparkled, as illustrated by the 45% gain on the Russell 2000 Index. Of equal importance, and in sharp contrast to the past six years when, in each year, more stocks lost value than gained value, the market breadth in 2003 was very positive. In fact, 90% of the stocks on the S&P 500 were positive for the year, which represents the most positive market breadth in that index's history, and 2003 was the first period since 1997 when each of the ten S&P market sectors posted positive gains for the year.

**“2003 was the first period since 1997 when each of the ten S&P market sectors posted positive gains for the year.”**

As we look into the year 2004, we believe that the strong recoveries in the economy and in corporate profits will set the table for another positive year in equities. Notably, we do not anticipate a repeat of the stellar gains posted in 2003, due to our expectation that some of the market fundamentals may turn somewhat less friendly in the second half of the year. This includes our expectations for higher interest

rates and growing inflation, as well as a reduced impact from fiscal and monetary stimulus in the new year. Even so, we do believe that equities will again be among the top-performing asset classes and that there are specific investment themes that may produce above-market returns. For a detailed look back at the year 2003 and an overview of our expectations for 2004, please visit the “Market Commentary” section of our web site at [www.lsggroup.com](http://www.lsggroup.com).

## MODEL PORTFOLIO COMMENTS

**Conservative Growth Model:** At present, this portfolio is allocated with 46% in domestic stocks (predominantly value stocks), 9% in foreign stocks, 29% in traditional and convertible bonds and the remaining 16% in cash. Mid sized stocks make up the majority of the current equity allocation, but there is also a sizable allocation (28%) to large cap stocks. Over two-thirds of the portfolio's equity holdings are categorized by Morningstar as either “core” or “value” stocks.

This portfolio posted a gain of 7.2% in the last quarter of the year and 13.8% for the year as a whole. This annual return more than quadrupled the return of the portfolio's performance benchmark (the tax-adjusted inflation rate) and was achieved with 40% less volatility than that of the S&P 500. Late in the year, we introduced some international exposure into the portfolio and added three very flexible managers to the model. At this point, we are very pleased with the allocation and do not currently anticipate any changes over the foreseeable future.

**Diversified Growth Model:** This all-equity portfolio is fairly evenly allocated between value, core and growth stocks with allocation weightings of 31%, 38% and 32% respectively. The current allocation is somewhat slanted towards smaller stocks with a 37% allocation to small caps and a 38% allocation to mid caps. This over-weighting is largely due to our decision to select a small cap international fund to satisfy the portfolio's need for global diversification. Almost 15% of the portfolio is invested overseas.

The portfolio gained 11.8% in the fourth quarter and 31.4% for the year as a whole. This represents an annual out performance of 5% over the portfolio's S&P 500 performance benchmark. In the fourth quarter, we replaced the portfolio's mid cap blend position, as it was associated with one of the fund families tainted by the

current rebound in the economy and the equity markets. At present, we are very pleased with the portfolio's allocation and do not anticipate making any further changes over the foreseeable future.

**Core Growth Model:** As this portfolio operates as our core asset allocation model, we have kept this portfolio diversified across a variety of asset classes. These include a 63% allocation to domestic stocks (both growth and value-oriented), 10% to international stocks, and the remaining 27% divided between intermediate-term bonds, convertible bonds, and cash. The equity allocation emphasizes mid cap and large cap stocks.

In the fourth quarter, this portfolio gained 7.2%, which boosted its lifetime performance (since its May 31<sup>st</sup>, 2003 inception date) to 12.3%. Over the same period, the average balanced fund (one which invests in both stocks and bonds) gained 10%. We are generally very pleased with the current allocation, but are considering one change in the portfolio's bond allocation as a means of increasing the level of portfolio diversification.

**Growth Model:** This portfolio remains heavily weighted towards small cap stocks (30%) and mid cap stocks (46%) with only a modest 23% invested in large cap stocks. In total, domestic stocks currently make up about 66% of the portfolio in an allocation that emphasizes growth stocks over value stocks. International stocks make up about 18% of the portfolio and the remaining 15% is comprised of traditional bonds, convertible bonds, and cash. Over the course of 2004, we expect to add to the portfolio's allocation to domestic large cap stocks, international stocks (both developed country and emerging markets) and may even add a natural resources position.

In the fourth quarter, this portfolio posted gains of 12.6%, which boosted the portfolio's return for the full year to 36.6%. This represents an out-performance by this model, compared to its S&P 500 benchmark, for the year of over 10%. This out-performance is largely attributable to our decisions to overweight small and mid cap stocks and to introduce an international small cap position into the portfolio. Performance was also enhanced by the selection of a high yield bond position to satisfy the portfolio's required debt allocation.

**Aggressive Growth Model:** At present, 63% of this portfolio is allocated to the foreign markets, with a particular emphasis on international small caps and emerging

country stocks (as examples, India, China, Korea, Brazil, etc.). Just over 20% is invested in domestic stocks (primarily technology companies). The remaining 18% is invested in convertible bonds and cash. In what is a bit of an anomaly, this portfolio is currently allocated with 46% in value stocks and only 39% in traditional growth stocks. While this portfolio benchmarks its performance against the NASDAQ (a technology stock-dominated index), only one-quarter of the portfolio is currently invested in technology stocks, due to our concerns over high valuations in this sector.

This portfolio posted gains of 10.7% in the fourth quarter and 52.3% for the year as a whole. This represents an out performance over the portfolio's NASDAQ performance benchmark of just over 2%. While we are very pleased with this nominal return, we are even more proud of the fact that, by diversifying this portfolio across emerging markets, international small caps, domestic small caps, natural resources and technology stocks, we were able to craft a portfolio that was able to compete with the stellar NASDAQ returns, but with notably lower than NASDAQ levels of volatility. This additional diversification also allowed us to manage this portfolio with lower than historical levels of portfolio turnover. We expect to continue investing in many of these same sectors and themes in the year 2004.

## HIGHER EDUCATION MODELS

**ORP Growth Model:** This asset class diverse portfolio is currently allocated with 51% to domestic stocks, 15% to international stocks, and the remaining 34% divided between traditional bonds, convertible bonds and cash. This portfolio is emphasizing larger stocks over smaller ones and is slanted somewhat towards growth stocks and "core" stocks. Over the near term, we expect to invest this portfolio's small remaining cash position and may build further upon the portfolio's large stock exposure.

The portfolio gained 11% during the fourth quarter and 23.8% for the year, which compares very favorably to the average balanced fund that returned 7.3% and 18.6% respectively over the same periods.

**Retirement Growth Model:** This asset allocation portfolio is currently employing a very diverse allocation strategy with 39% in domestic stocks, 32% in international stocks, and the remaining 30% divided between traditional bonds, convertible bonds and cash. It is also almost equally

allocated between management styles (32% growth, 37% value and 32% core stocks) and between market capitalizations (28% small, 39% mid, and 34% large). We expect to shift some of the equity allocation from small cap to large cap in the new year.

This portfolio gained 12% in the fourth quarter and 29% for the full year, which compares very favorably to the average balanced fund that returned 7.3% and 18.6% respectively over the same periods.

**Growth and Capital Preservation Model:** This conservative asset allocation portfolio has a 45% allocation to domestic stocks and an 8% allocation to international equities. The remaining 47% is divided between convertible bonds, traditional bonds and cash. In general, the equity portion of the allocation emphasizes larger stocks and stocks with lower than average valuations. We may further increase this portfolio's commitment to large cap stocks in the new year. We are also analyzing the need to reallocate part of the portfolio's debt allocation.

The portfolio gained 8.8% during the fourth quarter and 21.3% for the year, which compares very favorably to the average balanced fund that returned 7.3% and 18.6% respectively over the same periods.

Have a great New Year!

Robert S. Phipps III, CIO  
*And the Lucien, Stirling & Gray Asset Management Team*

### **Upcoming Events**

#### **Fireside Chats:**

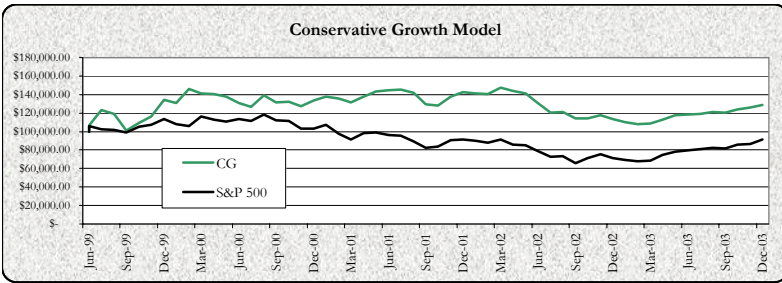
March 4, 2004

June 3, 2004

**6:30 pm - 8:00 pm**

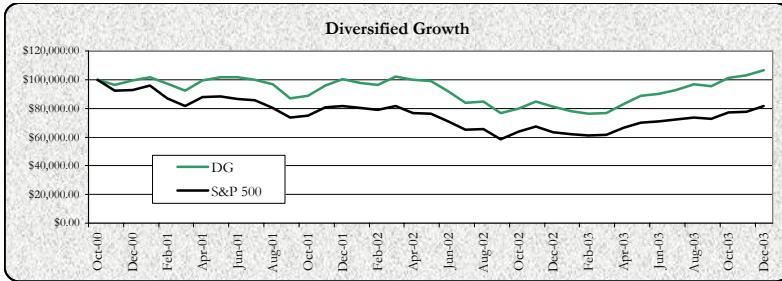
# LUCIEN, STIRLING & GRAY ADVISORY GROUP, INC

## Model Portfolio Investment Results for the Period Ending December 31st, 2003



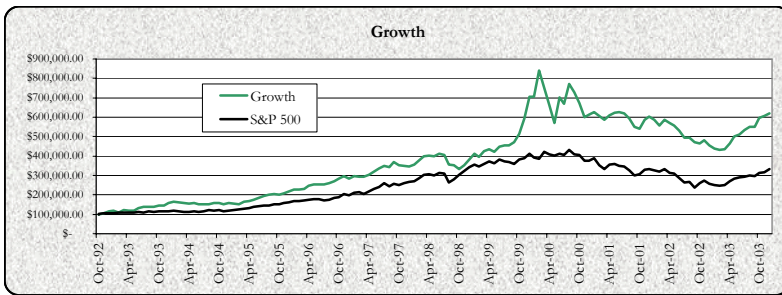
	Conservative Growth (6/3/99)	S&P 500
*1999	34.00%	13.77%
2000	-0.09%	-9.10%
2001	6.62%	-11.88%
2002	-20.55%	-22.10%
2003	13.84%	28.69%
<b>Since Inception</b>	<b>29.09%</b>	<b>-8.62%</b>

\* This model was opened on 6/3/99, and therefore only partial year results are available



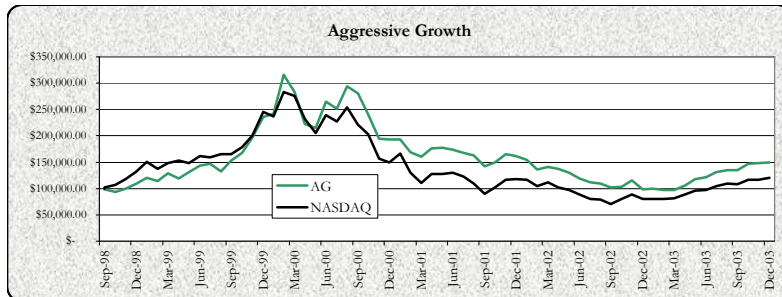
	Diversified Growth (11/1/00)	S&P 500
*2000	-0.50%	-7.43%
2001	0.80%	-11.88%
2002	-18.93%	-22.10%
2003	31.36%	28.69%
<b>Since Inception</b>	<b>6.80%</b>	<b>-18.21%</b>

\* This model was opened on 11/1/00, and therefore only partial year results are available



	Growth Model (10/18/92)	S&P 500
*1992	15.70%	5.61%
1993	37.58%	10.06%
1994	-1.55%	1.32%
1995	38.08%	37.53%
1996	31.75%	22.96%
1997	21.00%	33.35%
1998	10.44%	28.58%
1999	85.43%	21.04%
2000	-13.28%	-9.10%
2001	-1.72%	-11.88%
2002	-24.56%	-22.10%
2003	36.57%	28.69%
<b>Since Inception</b>	<b>520.53%</b>	<b>232.21%</b>

\* This model was opened on 10/18/92, and therefore only partial year results are available

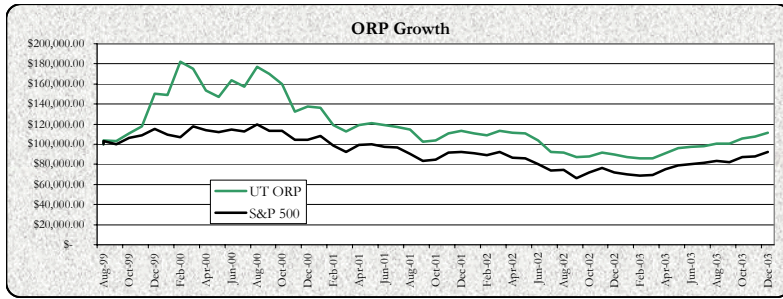


	Aggressive Growth (9/8/98)	NASDAQ
*1998	9.92%	32.00%
1999	123.49%	85.59%
2000	-18.05%	-39.29%
2001	-16.34%	-21.05%
2002	-39.46%	-31.51%
2003	52.25%	48.71%
<b>Since Inception</b>	<b>49.31%</b>	<b>19.71%</b>

\* This model was opened on 9/8/98, and therefore only partial year results are available

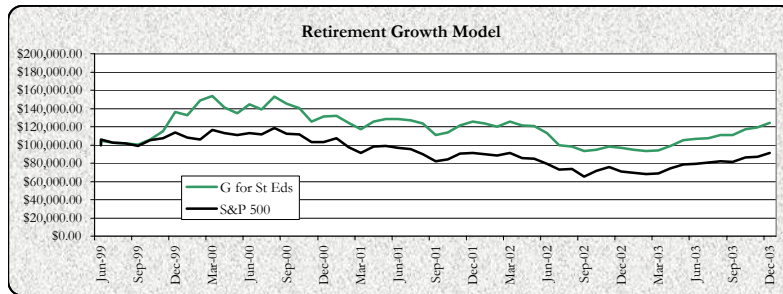
# LUCIEN, STIRLING & GRAY ADVISORY GROUP, INC

## Model Portfolio Investment Results for the Period Ending December 31st, 2003



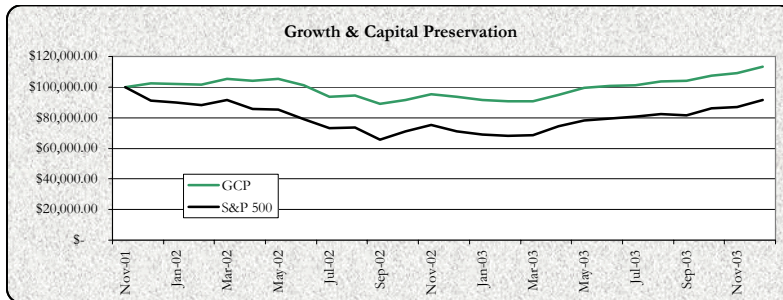
	ORP (8/10/99)	S&P 500
*1999	50.60%	15.13%
2000	-8.69%	-9.10%
2001	-17.51%	-11.88%
2002	-20.75%	-22.10%
2003	23.80%	28.69%
<b>Since Inception</b>	<b>11.27%</b>	<b>-7.53%</b>

\* This model was opened on 8/10/99, and therefore only partial year results are available



	Retirement Growth Model (6/3/99)	S&P 500
*1999	35.90%	13.77%
2000	-3.17%	-9.10%
2001	-4.76%	-11.88%
2002	-23.00%	-22.10%
2003	28.97%	28.69%
<b>Since Inception</b>	<b>24.44%</b>	<b>-8.62%</b>

\* This model was opened on 6/3/99, and therefore only partial year results are available



	Growth & Capital Preservation	S&P 500
2001	2.50%	0.88%
2002	-8.80%	-22.10%
2003	21.26%	28.69%
<b>Since Inception</b>	<b>13.33%</b>	<b>1.14%</b>

\* This model was opened on 11/30/2001, and therefore only partial year results are available

Past Performance is no guarantee of future results. It is not possible to invest directly in indices. Statistics for indices include reinvestment of dividends. Model results are net of management fees.

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