

LM CAPITAL GROUP, LLC

Investment process:
**Global macroeconomic /
Fundamental**

Total firm assets:
\$1.38 billion

3RD QUARTER, 2003

CORE PLUS FIXED INCOME STRATEGY

ATTRACTIVE ALTERNATIVE IN A VOLATILE MARKET

BY MACK CHRISTIAN

LM Capital Group has long been an advocate for the core plus strategy in a fixed income portfolio when the client's investment mandate allows. With Fed Funds at a 45 year low, where does the fixed income manager go to get total return in a low interest rate environment? The answer is the opportunistic or "plus" portion of the core plus portfolio.

US Treasuries, agencies, corporates and mortgages underperformed the benchmarks in the second quarter while high yield and emerging market debt outperformed the benchmarks. When the general consensus of fixed income portfolio managers is to capture the coupon and protect the principal, the logical methodology to execute this strategy is to sell the low coupons (Treasuries, agencies, corporate and mortgages) and purchase the high coupons (emerging markets and high yield). With the Fed Funds at 1% and very unlikely to tighten in the next 6 months, portfolio managers must create total return in the form of coupon yield because the likelihood of principal appreciation is low. The effect of this portfolio positioning is reflected in the performance (or lack of) in the various fixed income sectors.

Applying this logic to an economic scenario that is neither deflationary nor inflationary, we have a high probability that interest rates will stay in a broad trading range for the next 12 months. The high yield and emerging markets debt sectors should continue to outperform the other sectors of the debt market in that timeframe. Unless inflation exceeds 3% on an annualized basis, we would expect these sectors to benefit from an improved economic environment as their credit worthiness becomes stronger due to increased business activity.

If in the near term we see slow economic growth without generating inflationary pressures, the domestic fixed income market will be in a low-yield environment with little likelihood for monetary tightening for some time. With a 30% weighting of high yield emerging markets and non-dollar securities, the portfolio could add yield and improve total return in an otherwise flat, low interest rate environment. In our opinion the strategy to add incremental yield to a domestic investment-grade portfolio should remain favorable for the next 6 to 12 months and receive serious consideration by all portfolio managers.

EMERGING MARKETS ECONOMIC COMMENTARY

LUIS MAIZEL

The June - July period was very difficult for the emerging market debt asset class as it followed the lead of declining US Treasury prices.

As domestic rates increased there was a severe outflow from emerging debt funds, the first such move in over a year. Shorter maturity instruments held their value comparatively well, with strong emerging market corporate issues dropping less than sovereigns.

As bonds continued to mature and new issuance approached a standstill, the supply-demand equation was impacted; this helped hold values in spite of the negative environment. The only major new issue to come to the market was a Brady bond substitute by Venezuela that was oversubscribed in spite of being upsized to \$2 billion.

Mexico continues to exhibit a large difference between its macro and its micro economies. The big picture shows a country with contained inflation, a strong currency and very high foreign reserves, all positive signs. At the micro level, unemployment is increasing, growth in GDP has been repeatedly revised downward, and the country is losing competitiveness because of a lack of investment in equipment and technology which enhance productivity.

Brazil continues to set the example of a leftist government leaning towards the centre of the political spectrum to reassure foreign investors and stabilize the economy. But Brazil still suffers a long term endemic problem with its expensive pension system, a worrisome dollarization of its internal debt and a continuing concern with its social imbalance.

Argentina is definitely improving from the very low levels it reached a year ago and the entire asset class is awaiting a proposed plan to restructure the foreign debt in the last week of September. Venezuela is doing well based on the very high price of oil but the lack of trust in President Chavez precludes foreign investors from fully committing to the country in spite of the placement success we previously mentioned. There was a major issuance of new debt denominated in Euros but the trend was halted as the dollar started to recover some of its lost value as US interest rates climbed in US Dollar denominated instruments.

I expect a slight reversal in US rates and an above average improvement in emerging market sovereigns with increased issuance in the fourth quarter as funds again see a return to positive inflows.

After the FOMC's May announcement regarding deflation concerns, which was quickly followed by additional comments from Chairman Greenspan indicating that deflation was the Fed's primary concern, the Fed lowered rates at the late June meeting by only 25 basis points as opposed to the 50 basis point rate cut expected by market participants. As a result, bond prices began to fall and were further undercut when Chairman Greenspan downplayed the risks of deflation. At this point the economic data began to show more strength and the forecast government budget deficits were raised significantly. Finally, trading dynamics sourced from the MBS market exaggerated the downward move in US Treasury prices.

Our proprietary Trend Identification Score had recently shifted to a slightly bullish indication in the second quarter. The domestic portfolios' average duration had been adjusted to five to ten percent long versus the benchmark index. These changes had a heavy negative impact in July. As we enter August, the Trend Identification Score has returned to a neutral position and we liquidated various US Treasury Strip positions, reducing the portfolios' average duration.

Our cautiously bullish outlook for interest rates has proven too optimistic, yet the fundamental outlook does not yet confirm a continued upward trend in interest rates. Since the FOMC continues to see the risk of deflation as greater than renewed inflation, we believe that interest rates will trend in a sideways range from their currently high levels. Additionally, the steepness of the yield curve argues for attractive returns over the next 12 months should yields remain somewhat steady.

Last quarter we saw no fundamental indicators that could lend support to a sustained upward trend in interest rates until we were well into 2004 at the earliest. And our global fundamental analysis had suggested that longer-term rates could continue their decline in the immediate future as deflationary fears influenced market sentiment. These outlooks were overly bullish in hindsight but we continue to question the sustainability of any projected economic recovery based upon current data, or the resurgence of inflation. Therefore, we believe that any further upside movement in interest rates appears unwarranted for the remainder of 2003. Nonetheless, until the economic and inflation scenarios become clearer, we plan to maintain average portfolio durations close to their relative benchmarks for the immediate future.

CALPERS INCREASES ACCOUNT ASSETS BY \$50 MILLION

San Diego, CA, July 2, 2003--The California Public Employees' Retirement System (CalPERS) awarded LM Capital Group an additional \$50 million to be managed in the firm's Opportunistic Core Fixed-Income strategy. CalPERS has been a client of LM Capital since April, 2002, and is also a shareholder in the firm along with Strategic Investment Group Ventures (SIGV) of Arlington, Va. The extra funds complete CalPERS's original asset allocation agreement with LM Capital, and brings CalPERS' account total to more than \$167 million.

NEW TELEPHONE NUMBER EFFECTIVE IMMEDIATELY

The telephone number for LM Capital Group has changed. **The new number is 619-814-1401.** All other contact information for the firm remains the same. Please update your records so that we can keep in touch!

PORTFOLIO CHARACTERISTICS (AS OF JUNE 30, 2003)

	LM Short Term	LM Intermediate	LM Core	LM Opp. Core	LM Emerging Market
Duration	2.12 yrs	3.84 yrs	4.15 yrs	3.18 yrs	2.28 yrs
Yield to maturity	1.74%	2.84%	3.23%	3.71%	8.96%
Average coupon	3.54%	5.08%	5.40%	6.07%	9.32%
Average maturity	2.30 yrs	4.45 yrs	5.49 yrs	4.16 yrs	3.51 yrs
Average quality	AA1	AA3	AA2	A3	BB3

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