Client Bulletin
January 2005

<u>Economic & Market Update</u> – Happy New Year everyone! Here's to a year of good health and continued prosperity. With the election decided, the markets responded favorably to four more years of George W. Bush. The 4th quarter surge higher lead us to solid gains for the year with all client accounts posting positive returns. Check your portfolio performance review report for your individual results. Our international positions along with convertible preferred stocks lead the way. Large cap U.S. stock funds lagged, but as earnings growth moderates we expect money to gravitate back to these stalwarts. Bonds surprised everyone and held up well despite five interest rate increases by the Fed. Now is the time when all the prognosticators make their forecast for 2005. According to Ed Yardini, an economist formerly with Prudential Securities and now with Oak Associates, in Ohio, "2005 ends with the number 5, and since 1925 there have been eight years ending with the number 5. The average gain in the S&P 500 for these years has been 27.4%". While interesting, lets not hold our breath banking on that one.

Jeremy Grantham, a founder of Boston-based Grantham, Mayo, Van Otterloo that manages $80 billion, recently highlighted the four-year presidential election cycle. According to Grantham, we could have some tough sledding over the next two years. We have just completed years three and four, which held true to form producing nice stock market gains as Congress and the administration primed the economy in preparation for the election with tax cuts and fiscal stimulus. Years one and two of the cycle have historically been weaker for the stock market. Now is the time to avoid speculating and look at low-volatility and high quality companies. These are exactly the types of companies favored by our largest positions in the **Oakmark Fund** and **Oakmark Select Fund**. Additionally, our top global equity pick **Capital World Growth & Income Fund**, along with equity-income siblings **Capital Income Builder**, and **Income Fund of America** from the American Funds family fit the bill. We are also investigating the new **Vanguard Primecap Core Fund**. We've had good results in the past buying new funds where the management team has a proven record of success with another fund. This is the same management team that runs **Vanguard Primecap** and the **Vanguard Capital Opportunity Fund**, both of which have trounced the S&P 500 stock index. With a generally good economy, fair valuations, strong corporate balance sheets, and earnings still growing, we continue to be cautiously optimistic as long-term owners of U.S. stocks.

<u>Protecting Profits</u> – The institutional investors that dominate the trading volume with large buy and sell orders decided to cash in after the 1st of the year. We will tolerate a certain amount of price fluctuation, but we've seen hard won gains evaporate before, so for some of our more volatile holdings that had moved up in price we decided to sell to nail down gains. Recent sales include the **Ishares Goldman Sachs Semiconductor Index Fund** (IGW), **Qlogic Corp.** (QLGC), and the **Global High Income Dollar Fund** (GHI). All of these securities carry a "high beta", meaning they are more volatile than the general market. We are more apt to sell something like this, as opposed to a core stock fund from Oakmark, Vanguard, or the American Funds. With IGW, semiconductor manufacturers have continued to struggle, so we sold IGW @ $51. Qlogic is a solid company with no debt, but after the recent run-up, the price had broken down. The stock is trading at a 24 P/E (price divided by earnings per share) with earnings only expected to grow 5% this year. You like to see the P/E equal to or lower than the growth rate of earnings.

In the case of GHI, the year-end market price of $19.60 was an absurd 25% premium over the net asset value of $15.60. GHI is a closed-end emerging markets bond fund that holds mainly Latin America and Russian bonds. The monthly dividend and yield were terrific, but the share price reversed course and turned down on above average volume last week. The share price sliced through its 50-day moving average, so we sold at $18.00 to preserve capital.   Even though the fundamentals are improving for emerging markets, prices on their bonds had gotten over extended. The GHI shares originally came to market at $15 in 1993. They traded down to $9 in 1998 and hit their all-time high of $20.29 last month, so we're out at the high end. The yield spread between emerging market bonds and U.S. Treasuries is at record low levels, meaning emerging market bond prices are at record highs. We'll keep an eye on GHI for possible re-entry at a lower level.

Retirement Planning – For those clients still reporting earned income from wages or self-employment, now is the time to review your 2004 and 2005 tax-deductible contribution options. Plan contribution limits have increased for 2005. With the continued uncertainty surrounding the long-term prospects for the social security system, it's never been more important to maximize your contributions to other retirement savings vehicles.

Sector Watch – Energy and natural resources continue to be one of the strongest sectors in the economy. The supply / demand dynamics for petroleum are favorable. *Barron's* recently reported that production of "light-sweet" crude oil has hit capacity constraints in Saudi Arabia, the largest supplier in OPEC. U.S. oil production peaked in 1970, and now the world is nearing current capacity limits for light-sweet crude. Exploration efforts continue worldwide to uncover new supplies, but will new supplies meet the increased demand for hydrocarbons as China, India, and other emerging economies ramp up. Conservation efforts have fallen on deaf ears as more Hummer's hit the road in the U.S. Although spot oil prices have trended down off their November high of $56/barrel into the mid $40's currently, reaching capacity limits will provide price support. Energy stocks only reflect about $31 oil on a long-term basis. The Iraq war, continued unrest in the Middle East, and the possibility of a terrorist strike on a major pipeline are positive for oil prices. We continue to like the **Energy Select Sector SPDR (XLE)** for broad oil & gas exposure. XLE is an exchange-traded fund, or ETF, which is a low-cost index fund that trades on the AMEX. The fund owns the 27 energy companies from the benchmark S&P 500 stock index. XLE holdings include **Exxon Mobil Corp., ChevronTexaco Corp., ConocoPhillips**, and oil service firms **Schlumberger Ltd., Apache Corp., and Transocean Inc.**

For clients comfortable with individual stocks, we're accumulating Chevron-Texaco (CVX). At $51.75, CVX, trades at a 12 P/E, carries an A++ financial strength rating from Value Line, and pays a 3% dividend. Based in San Ramon, CA, they have major new projects moving forward in Angola, Nigeria, Kazakhstan, Australia, and the Gulf of Mexico. The dividend has been raised annually for the past 16 years, so we view it as a better hedge against inflation than Treasury inflation-protected securities (TIPS), where the principal value increases by the CPI, with a current yield of about 1%.

<u>Dividend Achievers</u> – Here are some blue chip stocks we own that qualify as long-term achievers. The companies listed, along with their current dividend yield, have increased their common stock dividend for 10 or more consecutive years. Financial services **– Citigroup**, 3.3%, generates almost $1 billion of net income monthly; **MBNA Corp**., 1.7%, new joint venture with American Express. Health care **– Johnson & Johnson**, 1.8%, announced merger with medical device maker Guidant; **Pfizer**, 2.8%, -22% in 2004 on Celebrex litigation concerns; **Stryker Corp**., 0.2%, orthopedic implant leader. Consumer staples and beverages **– Anheuser-Busch Cos**., 2%, ticker symbol BUD, enjoy! **ConAgra Foods**, 3.8%, meat & potatoes, Omaha, NE based. Energy **– Chevron-Texaco**, 3.1%, see above and **Exxon-Mobil**, 2.2% the largest publicly traded oil company. Retailing **– Lowe's Cos**., 0.3%, 140 new stores opened in 2004; **Wal-Mart Stores**, 1.0%, world's largest retailer. Telecommunications **– Alltel**, 2.6%, regional carrier acquiring Western Wireless. Conglomerates **– General Electric**, 2.4%. GE recently announced the repurchase of up to $15 billion of its common shares over the next three years and will raise its quarterly dividend by 10% to $0.22 per share, the 29th consecutive annual increase. Price appreciation goes hand in hand with dividends for total return, and with the 15% maximum federal income tax rate on dividends and long-term capital gains, any of these companies would be a great addition to a portfolio when bought at the right price.

<u>Bonds 101</u> – Bonds help us sleep well at night. Their prices typically move opposite of stocks and they provide regular income. A bond is a promise to repay a loan, and as long as the borrower is creditworthy, we receive regular interest and a return of principal upon maturity. Bonds accrue interest daily and pay it out semi-annually based on the coupon interest rate stated on the bond. Bonds are issued at par, or a price of 100.00 for a $1,000 bond. After issue, the price will move to either a discount (below par) or a premium (above par). The price will move back towards par value when the bond nears maturity. Shorter maturity bonds carry the lowest interest rates but are the safest regarding potential principal erosion if market interest rates turn higher. Longer maturity bonds offer higher interest rates as an inducement to tie up our money for a longer period of time. But, the longer maturity means your bond value will be subject to more price fluctuation over the life of the bond. U.S. Treasury obligations with a one-year maturity currently yield 2.86%, five-year maturity – 3.73%, and ten-year maturity - 4.28%. These are super safe benchmark rates for short and longer-term bonds that we use to evaluate other alternatives.

We believe in owning both no-load bond mutual funds and individual bonds. The funds provide more diversification, a monthly dividend, and no fees in or out. Our favorite bond fund family continues to be Metropolitan West, based in Los Angeles. Lead by Tad Rivelle, these bond aficionados learned the trade at PIMCO in Newport Beach. Although PIMCO gets more press, Met West has quietly amassed $14 billion of assets. As we've discussed in the past, the problem with bond funds is that they carry no set maturity date when we know our principal will be returned. This is not a concern in a flat to declining interest rate environment as bond fund share prices behave themselves. However, in an increasing interest rate environment, many bond fund share prices will decline. To combat this risk, we have positioned ourselves in short-term funds – the **Met West Ultra-Short Bond Fund** and the **Met West Strategic Income Fund**. Although the yields are low, in the 3 – 3.5% range, safety of principal is high. The **Met West High Yield Bond Fund** with a 7%+ yield has done well for us. High yield, or “junk bonds” have prospered as yield starved investors bid up prices to multi-year highs. Corporations have taken heed and issued a record $800 billion of new corporate debt in 2004.

The **Pro Funds Rising Rate Opportunity Fund** continued to languish in the fourth quarter as higher short-term rates refused to spook the longer-end of the yield curve. This fund is meant to serve as a hedge against all our other fixed-income positions, as the share price is designed to rise if the 30-year Treasury yield increases. The fact that long rates have not moved up in tandem with short rates is puzzling. Uncle Sam continues to spend more than it takes in and America continues to run a trade deficit, but the Asian central banks keep buying up our long-dated Treasury paper. This fact along with the fear that high oil prices will restrain economic growth and inflation have served to keep longer-term yields depressed. How long will foreigners continue to subsidize us if the dollar resumes its decline?

With individual bonds, we continue to purchase high quality tax-free municipals and U.S. government agency debt. We review daily lists of bond offerings (IPO’s and secondary market issues) from Schwab Institutional and independent bond specialists looking for attractively priced issues.

Other Fixed-Income – Preferred securities have been an excellent companion to bonds for us in this low yield environment. The preferreds we own have dividend yields in the 6-8% range. Many issues have now traded up above their $25/share par value and are not suitable for additional purchases. We continue to monitor this area waiting for opportunities to arise.

Income Taxes – For clients with taxable brokerage accounts, we will be mailing your realized gain/loss report prior to January 31. Our report will provide original trade date and cost basis information to be used with the Schwab 1099. These two documents will give you everything necessary to report sales that occurred in your account during 2004. As always, we suggest you defer filing your Form 1040 until early March, as Schwab has been known to issue a corrected 1099.

Money Market Fund – Last quarter Schwab Institutional introduced a new sweep money market fund. This fund is the interest-bearing cash receptacle that is associated with every account at Schwab. Client accounts with a minimum balance of $100,000 were upgraded from the **Schwab Money Fund** to the **Schwab Advisor Cash Reserves**. With the lower expense structure, the new sweep fund has a yield advantage of approximately 0.10%. Every little bit helps.

We are grateful to have you as a client and appreciate the opportunity to meet your financial service needs. Please feel free to let us know if there is anything we can do to help improve your experience.

Scott Walker

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