Client Bulletin
July 2004

<u>Economic & Market Update</u> – Following a strong first quarter, the second quarter produced a mixed bag of results. Stocks retreated from April to mid-May then rebounded through June to close mostly higher. Bonds and many of our higher quality fixed-income securities declined as interest rate jitters rattled prices. The Fed finally moved on June 29th and increased the Fed Funds rate by ¼% to 1 ¼%, up from a 46 year low. Mortgage rates have increased approximately 1% and the real estate party is starting to level off. The economy is expanding with positive numbers continuing to be reported in many areas. One chink in the armor appeared when the June employment report came in light, prompting analysts to speculate that business spending and hiring may be cooling, and the Fed may not be in such a hurry to raise rates in the future. Prior to this report the interest-rate futures market was forecasting a steady rise in short rates, to 2.25% by the end of 2004. Those expectations have since dropped and bond prices have rallied back. The Fed has stated that they will pursue a "measured" approach toward interest rate policy. We continue to suggest that most clients hold a balanced portfolio with allocations to both equities for long-term growth and fixed-income securities for stability and income.

How will higher interest rates affect stock prices? Historically the market's reaction to Fed rate increases may surprise you. A study by the *ISI economic-research group* shows that during the past five cycles in 1983, 1986, 1994, 1997, and 1999 when the Fed raised rates, the S&P 500 Index gained an average of 14.9% nine months after the first hike. A strengthening economy that prompts the Fed to contemplate raising rates is favorable for corporate profits. Rising rates alone do not make, or break, a stock market. More important to the stock market's fortunes is growing profits, which are the ultimate driver of higher prices in the long run.

Last quarter, S&P 500 earnings soared 27%, so some moderation is expected. Our value managers are having a difficult time finding attractively priced stocks versus a year ago. We could easily drift into the Presidential election traversing a trading range with no meaningful movement up or down. However, based on historical precedent, this stage of the election cycle could be good for stock prices. A study by *Ned Davis Research* reports that during the June – December period of all election years since 1900, the stock market has risen 81% of time and posted an average gain of 10.68%. That may be a stretch this year with the on-going tensions in Iraq, stubbornly high oil prices, bullish investor sentiment, and heavy IPO activity. But the stock market loves to climb a wall of worry, so we may be pleasantly surprised.

<u>Stock Funds</u> – The majority of our domestic funds were up in the second quarter and year-to-date. Our current favorites include **Vanguard Capital Opportunity**, **Primecap**, and **Health-Care**, the **Oakmark Fund**, **TCW Galileo Value Opportunity**, along with **First Eagle Overseas** (which we buy without the load), and the **Dodge and Cox**

International Stock Fund. Top-notch stock pickers manage all of these funds with an eye towards bargains. Most of these funds also have below-average expense ratios.

<u>Equities</u> – Over the past year we have acquired shares in **Allied Capital Corporation** (ALD - $23.88) for several clients. We were attracted by their operating history dating back to the 1960's offering the ability to tap into private equity and mezzanine debt investments in middle market companies. Based in Washington D.C., Allied is the largest business development company in the U.S. Their valuation is reasonable and they have increased their 9% dividend each year for the past nine years. The stock price was hit hard last quarter following a negative press report regarding the 2003 transfer of $9 million in bad debt from a subsidiary to the parent company. If the parent chooses to write off the loan, *Value Line* estimates it may be impact earnings by as much as $0.07/share. On June 24th the SEC notified Allied of an informal investigation into this matter. Allied has adamantly denied any wrongdoing and as the SEC stated in its letter, this investigation "should not be construed as an indication by the Commission or its staff that any violation of law has occurred." We are continuing to hold our shares, but will monitor the situation closely for on-going developments.

Have you heard of Radio-frequency identification, or RFID? RFID tracks goods from every stage of production to consumers' shopping carts through a wireless tracking system, based on a tag containing a semiconductor chip with an electronic product code. RFID looks to drive gains in productivity by cutting labor costs, shrinking inventories and reducing out-of-stock items. It will eventually replace the bar codes used today to track inventory. This technology will continue to gain traction as Wal-Mart Stores and the U.S. Department of Defense have mandated that their top 100 suppliers become RFID compliant by January, 2005. There are many small emerging players but we like blue chip **International Business Machines**, (IBM - $83.89) which provides software and integration services in this area.

Another emerging technology is Voice-over-Internet Protocol, or VOIP. The chairman of the FCC has heralded it as promising "the most important shift in the entire history of modern communications since the invention of the telephone." Consumers must have broadband cable or DSL Internet access service to use VOIP. There are regulatory issues still to be decided, but the cost savings and convenience are driving demand. With VOIP, you can pick a phone number from any area code you like and still get the calls at home. From a Web page, you can route your calls so they ring not only at home, but also on your cell phone or at work. Voice quality on an Internet call, in most cases, now equals that of calls placed via the old circuit-switch network. In May of this year IBM unveiled an alliance with **Cisco Systems** (CSCO - $22.36) aimed at selling integrated technology and hardware systems to companies seeking to use the Internet as a hub for voice, video and data communications. **Cox Communications**, (COX - $28.30) along with other cable companies stand to benefit from VOIP, while bell companies like **Verizon** (VZ - $35.44) will face new challenges.

<u>Fixed-Income</u> – The benchmark 10-year U.S. Treasury rate ended the quarter at 4.59%. One-year T-bills are quoted at 2.1%. We blend together different asset classes to add value in the fixed-income arena. Individual bonds, preferred securities, bond funds, and real estate investment trusts are the four main categories on the fixed-income side of the ledger for us. Last quarter, we shortened the maturities of our domestic bond funds, since shorter-term bonds maturing over the next few years will hold their value better than bonds maturing in 20-30 years if interest rates continue higher.

Thornburg Mortgage, Inc. (TMA - $27.65) is a new holding for us with a unique business model. The company lends to mainly wealthy individuals who have the best credit. These high credit quality loans have kept delinquencies to .02% of the portfolio. They make only adjustable-rate mortgages primarily on single-family homes, and keep every mortgage they make. Mortgages are offered over the Internet, in print advertising, by direct mail, and through financial planners. The firm has no branches and no expensive overhead. Higher interest rates may boost demand for adjustable rate loans. The Santa Fe, NM company has $22.4 billion in assets. The firm is structured as a real estate investment trust, so no tax is paid at the corporate level. The dividend yield is 9.4% based on the recent share price. Check out www.thornburgmortgage.com for additional information.

Another new fixed-income alternative is **Kinder Morgan Energy Partners, LP**, (KMP - $43.03) the largest independent owner/operator of products pipelines in the country, transporting more than two million barrels a day of gasoline, jet fuel, diesel fuel and natural gas liquids through more than 10,000 miles of pipelines. The company also owns the most prolific source of carbon dioxide in the world and is the largest CO2 marketer and transporter in the U.S. CO2 is used for enhanced oil recovery projects, an area experiencing growing demand. Structured as a master limited partnership, this holding provides a 6.75% tax-advantaged dividend yield, and the company has a history of increasing the dividend greater than the rate of inflation.

Where appropriate we moved back into emerging market bonds with the purchase of the **Global High Income Dollar Fund** (GHI - $15.77). Latin American and Russian paper are large holdings that allow this closed-end fund to pay a monthly dividend with a 10% yield. We have targeted a 2 ½% portfolio allocation for this holding to limit risk. Since our purchase, the shares have moved from a discount to a premium versus the net asset value. For safe money, the **Metropolitan West Ultra-Short Bond Fund** is a new holding that a shown excellent principal stability with a 3.2% yield. For larger accounts, holding a laddered portfolio of individual bonds provides a valuable diversification benefit, steady income, and a promise to return principal at maturity. With the unstable geopolitical situation and on-going threat of terrorism, holding securities with reliable interest or dividends provides a safe harbor and cushion against stock market volatility.

Annuities – A recent report by the Securities and Exchange Commission and NASD has found that the variable annuity business is plagued by abusive sales tactics and urges consumers to be cautious. Annuities are investment contracts issued by insurance companies. They come in two varieties, fixed and variable. Fixed annuities offer a stable principal feature and a fixed interest rate. Fixed annuity interest rates have been low, so variable annuities with investments in stock and bond funds have been more enticing.

The problem is that variable annuities have higher costs than mutual funds and those costs are not always fully disclosed to consumers. In addition, many annuities carry surrender penalties for withdrawals in excess of 10% of the account value. The NASD (National Assoc. of Securities Dealers) is the brokerage industry's self-regulatory organization and has proposed a sweeping set of new rules governing the sale of variable annuities. Although we do not recommend annuities, we have helped clients upgrade existing annuities to the Schwab Annuity that pays no commissions, has no surrender penalty, and carries reasonable fees.

Cost Savings – Responding to competitive pressures in the marketplace, Schwab Institutional has announced a further commission reduction for our clients. Effective June 15, commissions for equity trades were reduced to 1 ½ cents per share, with a $19.95 minimum charge per trade. For clients with household account totals over $1 million, the minimum charge per trade will be $9.95.

As always we appreciate the opportunity to serve your financial advisory and investment management needs. Feel free to contact us with any additional questions you may have.

Scott Walker
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