Commentary - 2nd Quarter 2005

We have said many times that investing should be boring. Well, the first half of 2005 has been pretty boring in the stock markets. The Dow Jones Industrials are down approximately 3.6% for the first six months and the S&P 500 is off about 1.0%. For the second quarter the Dow lost 1.6%, with most of the loss on the last trading day of the quarter. The economy grew at a 3.8% rate in the first quarter and should be on a similar growth track in the second quarter. The stock market cannot decide if the interest rate increases by the Federal Reserve and higher oil prices are going to slow economic growth enough to hurt corporate profitability. Alan Greenspan's "conundrum" persists as long term interest rates fell during the quarter even though the Fed raised short term interest rates by fifty basis points, including June 30th's increase. We find the following table very interesting.

Table 1. Year-Over-Year Change in Financial Market Indicators

	June 30, 2004	June 30, 2005
Federal Funds Rate	1.00%	3.25%
Dow Jones Industrials Average	10,435	10,275
10 Year U.S. Treasury Yield	4.59%	3.92%
Core CPI (Ex-Food & Energy)	1.90%	2.20%

The Federal Reserve launched its program to increase interest rates at a measured pace one year ago. They have tripled short term interest rates in that time period. The stock market is almost flat over the same time period. The yield on the Ten Year U.S. Treasury fell by sixty-seven basis points while the core Consumer Price Index moved slightly higher. The Fed expected their campaign to raise interest rates would move longer term interest rates higher too. In past interest rate cycles, the Fed could depend on short term and long term interest rates moving in tandem until the economy began to slow down. We have learned not to doubt the bond market's ability to predict economic activity, so the economy is probably slowing to a 2.5% to 3.5% growth rate from last year's higher pace. The drop in long term interest rates will probably spur higher growth later this year.

Low long term interest rates are definitely supporting the strong housing market. We were worried that a housing market “bubble” was developing. If so, it would be the most widely recognized and discussed market bubble that we have read about. There are areas where speculative activity is strong, in Las Vegas, Florida, Southern California, and the coast of New England. However, most of the country is experiencing strong housing activity due to the better affordability of homes because mortgage rates are low. Until the Fed figures out how to push long term interest rates higher, the housing market should remain vibrant. The speculators may get burned, but the majority of homeowners will be able to withstand a downturn in the housing market.

Oil prices recently hit a new high, trading over $60.00 per barrel. We had people ask us if that was what caused the market sell-off in late June. Oil prices have climbed from $35 per barrel to $55 per barrel over the last year. How is another $5 per barrel going to make a big difference? Higher energy prices act like a tax on the consumer, so they will have a dampening effect on the economy. But if consumers can adjust to $2.00 per gallon gasoline, like they have done this year, then they should be able to adjust to $2.25 per gallon gasoline. We think the energy sector is still very attractive. Most energy stocks are trading at low multiples of earnings and cash flow because investors fear that oil prices will fall back to the $40 per barrel range. Our view is that oil prices will remain high until more production comes online. Exploration and production companies are making the investment to find more oil and gas but it will take time to bring new production to market. Higher prices will temper demand growth and eventually supply will catch up. So next year or the following year, energy prices should moderate. Until then, E&P companies should generate high levels of free cash flow. They can invest that cash flow into finding more reserves, paying down debt, or acquiring reserves in the market. Any of these alternatives should have a positive effect on the value of their companies. When oil companies are trading at higher multiples of earnings and cash flow we will reexamine our view.

One thing that has us concerned about future financial market performance is the reaction to China’s CNOOC bid for Unocal. Chevron agreed to acquire Unocal this spring in a deal valued at $16.5 billion. CNOOC recently offered $18.5 billion for Unocal, which owns large reserves in Southeast Asia. Chevron is fighting the breakup of their deal by taking the offensive in Washington. They want the federal government to review CNOOC's bid on a strategic value basis. Many politicians have attacked China for keeping its currency pegged to the dollar and undercutting domestic manufacturing. They view the CNOOC bid as a way for us to put pressure on China to revalue their currency. The political posturing could result in more protectionist measures. We worry that moves to block Chinese investment in private enterprises will lead to more trade disputes and restrictions on the movement of capital. Any time that capital is not allowed to freely flow to its highest potential return, there will be negative effects on financial markets. Conversely, if Chinese companies are allowed to pay top dollar for U.S. corporations, who benefits? Shareholders benefit by increasing their wealth, and the Chinese acquirers are exposed to more free market principles. Eventually the free enterprise ideals will erode Communist restrictions. Let's hope that the political solution to a market challenge is not successful.

Here is a look at how our various asset class strategies performed during the second quarter:

Blue Chip Stocks: Our Blue Chip Strategy fell slightly during the second quarter. The composite lost 1.59% compared to the S&P 500 index gaining 1.37%. For the first half of 2005, the Blue Chips are down 3.62% versus negative 0.78% for the S&P 500. Surprisingly, the biggest gainer in the portfolio during the second quarter was General Motors. After hitting a multi-year low in April, GM rebounded after investor Kirk Kerkorian announced a tender offer for up to 9.0% of GM's common stock at $31.00 per share. Subsequently, GM offered employee discounts on all their vehicles to any buyer, which boosted sales, and revealed that they are in discussions with their employee unions over health care cost issues. IBM led the decliners in the portfolio, falling 18% after announcing disappointing earnings for the quarter. Our investment opinion on the Blue Chips remains positive since they are trading at much more reasonable valuations compared to the previous eight years. Once the Federal Reserve pauses in their drive to raise interest rates, the stock market can move higher and large cap stocks can lead the way.

Small Cap Stocks: Our Small Cap Value Strategy gained 6.75% during the second quarter versus a 4.00% gain for the Russell 2000 Index. For the first half of 2005, the strategy is virtually unchanged compared to a 1.8% decrease in the Russell 2000. Komag lead our rising stocks with a gain of 45%. We sold our position in Komag at the end of May since it reached our price target and had appreciated over 130% since our purchase last summer. Metro One Communications declined 39% during the quarter as they lost more business. However, one of their largest holders is moving for a management shakeup and new business strategy. Energy Transfer continues to be one of our most successful long term holdings as it recently hit another all time high. We anticipate more gains with Energy Transfer as they increase their payout over the next year. Hopefully, our patience with American Pacific will be rewarded in the second half of 2005 as the space shuttle program restarts with the scheduled July launch. We are watching a few candidates to add to the small cap portfolio and expect to reinvest the Komag proceeds during the next quarter.

Convertible Securities/High Yield: The Convertible Securities Strategy gained 2.73% in the second quarter for a year to date gain of 3.27%. This compares to the Merrill Lynch Convertible Index rising 0.95% for the quarter and the Merrill High Yield Index gaining 2.69% for the quarter. Year-to-date the Merrill indices are down 4.37% and up 1.22% respectively. Our position in Texas Industries convertible preferred appreciated almost 21% in the second quarter as the company announced stronger than expected earnings and raised guidance for the year. The publicly traded master limited partnerships held in taxable accounts exhibited strong gains as long term interest rates declined and energy demand was strong. We added UTStarcom bonds to our portfolio in April after the company filed their 2004 annual report with the SEC, alleviating a technical default on their bonds. Subsequently, their earnings report was viewed pessimistically and their stock price fell substantially, taking their bond value down too. We own a three year maturity bond and the company has more cash than long term debt and is profitable, so we are comfortable with the credit quality. We are in the process of converting our Callon convertible preferred position into the company's common stock. The company finally announced they were calling the issue, so we cannot earn our 6.5% yield anymore, but we like the common stock valuation and see significant upside potential. Whereas six months ago it was extremely difficult to find attractive values in the convertible market, it is much easier now. After GM and Ford were downgraded many convertible arbitrage hedge funds experienced losses, with some going out of business. As they faced investor redemptions, they had to sell positions to raise liquidity. This process caused yield spreads and risk premiums to widen dramatically. Some of our recent purchases should boost our strategy's returns down the road.

Intermediate Bonds: The Intermediate Bond Portfolio Strategy gained 1.16% in the second quarter versus a 2.56% increase in the Citigroup 1-10 Year Government/Corporate Index. For the first half of the year, the Strategy is up 0.34% versus 1.65% for the Citigroup Index. The Intermediate Tax Exempt Bond Strategy rose 1.60% during the quarter versus 2.02% for the Merrill 3-7 Year Insured Bond Index. For the year, the Strategy is up 1.27% versus 0.89% for the Index. We are positioned defensively, expecting rising interest rates. We are faced with the same conundrum as Alan Greenspan. Short term interest rates have increased 2.25% over the last twelve months and long term interest rates have fallen. We were also hurt by our exposure to GM bonds in the first quarter, but that position recovered some in the second quarter. The most plausible explanation for the fall in long term interest rates is the weakness in the economies of our developed trading partners. European and Japanese growth rates are very weak. With China and Southeast Asia as the other main drivers of global growth, the U.S. is the safest place to invest long term capital with an attractive return. Until our European and Japanese economic growth accelerate, we will remain the refuge for global capital flows and our trade deficit will swell.