Commentary - 3rd Quarter 2005

The stock market performed surprisingly well in the third quarter, considering the hurdles it faced. The hurricanes and sharply higher energy prices could have caused an alarming decline in stock valuations. However, the stock market gained 3.6% in the July through September period. The economy had strong positive momentum going into the hurricane season, as employment strengthened, boosting personal incomes. When the devastation of Hurricane Katrina became apparent in early September, the energy markets vaulted higher and the bond market rallied, bringing down interest rates. The market's immediate reaction was that the economy could fall into a recession because of the high energy prices and the disruption of Gulf Coast area activity. The bond market presumed that the Federal Reserve would halt their drive to raise interest rates until the damage to the economy could be estimated. That assumption turned out to be wrong as the Fed was more concerned about the inflationary effects of higher energy prices. We think the Fed was correct in that decision. A natural disaster like Hurricane Katrina (and Hurricane Rita) can cause a temporary disruption in economic activity, but the destruction can be overcome as long as the country has the resources to rebuild. We have seen this type of scenario before with some of the terrible hurricanes of the 1990s, the California earthquakes, and September 11th. Economic activity is interrupted for a short time period, but once the country gathers its resources and responds, future economic activity is stronger that it would have been without the disruption. In essence the country is depleting its savings (insurance reserves) to rebuild its capital stock. This is the same principle behind fiscal stimulus when the government borrows to finance spending. The consequence of this type of behavior can be inflation. The storms reduced the production or supply-side, of the economy by destroying buildings, oil rigs, homes, etc. It takes time to rebuild that productive capacity. In the meantime, demand is stronger than it would have been because of the governmental transfer payments and insurance payments. The supply/demand imbalances result in higher prices. (Some alarmists call this price-gouging.) Energy prices spiked higher because of reduced supply. Prices move higher in order to find a balance between supply and demand. High energy prices are already causing demand to weaken and conservation is being

discussed again. If the Fed were to keep interest rates down and not react to the spike in prices, they would be supporting demand in the face of restricted supply and reinforce the inflationary pressures. Since the Fed kept to their measured pace of interest rate increases, the economy will adjust to higher energy prices and regain momentum.

We think that high energy prices are not just a symptom of a strong economy and short supply of fuels. Commodity prices in general are higher, and that is a reflection of too many dollars in the monetary system. Gold hit $475 per ounce recently, a level not seen in twenty years. We think that high commodity prices are a signal that the Fed is still too easy on monetary policy. There may be a burst of inflation coming through the pipeline because the Fed has moved too slowly in raising interest rates. The Fed has been cautious in raising rates because the American consumer is highly leveraged and the Fed does not want to be seen as causing a recession at the same time that Alan Greenspan will be leaving the position of Fed Chairman. In reality, the Fed has encouraged the consumer to take on leverage by reducing the volatility of interest rates and financial markets over the term of Greenspan's tenure by always providing liquidity to the financial markets every time there is some kind of crisis. Greenspan learned during the stock market crash of 1987 that the best way to fight a financial crisis is by fueling the financial markets with liquidity. So he has used the same trick every time since. How else can you explain the drop in the U.S. savings rate, the speculation in housing, the tech stock bubble, and the high debt rates of the average American? Greenspan has tried to protect us from our tendencies towards greed by reducing risk, i.e. guarding against market sell-offs and volatility. Conversely, he has encouraged the consumer to take on more risk than is appropriate.

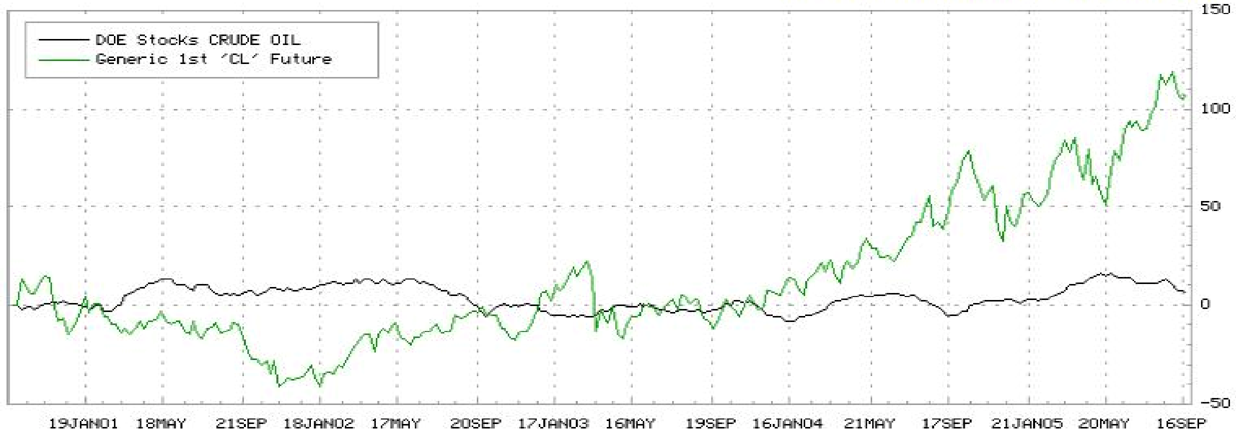
We think high oil prices are being caused more by speculators and traders than surging demand. The graph on the next page shows that crude oil inventories have increased 6.63% over the last five years, while oil prices have climbed 108.14%%. Just like the tech stock bubble, easy money is feeding the frenzy.

Figure 1. Crude Oil Inventories and the Price of Oil

Range 9/29/00 - 9/23/05 Period W Weekly 260 Wk. Period

	Securities	Crncy	Prc Appr	Total Ret	Difference	Annual Eq
1	DOESCRUD Index		6.63 %	6.63 %*	-101.51 %	1.30 %
2	CL1 Comdty		108.14 %	108.14 %*		15.84 %
3						

(* = No dividends or coupons)



We think the stock market can generate more gains in the fourth quarter as the economy recovers from hurricane season and the 2006 outlook brightens. Corporations have repaired their balance sheets over the last few years and mergers and acquisitions activity is picking up. The low income consumer may struggle with higher energy prices, but the average consumer will benefit from wage gains and will spend those gains as usual. Here's a look at the sectors we cover:

Blue Chip Stocks: Our large cap stock strategy gained 3.88% in the third quarter while the S&P 500 Index rose 3.60%. Year-to-date, the Blue Chips are up 0.12% versus a 2.79% increase for the S&P. The biggest gainer in the portfolio was Hewlett Packard up 24.62%, followed by Caterpillar up 23.86%, and McDonald's up 20.68%. The laggards included Merck, down 10.55%, and Pfizer, down 8.79%. The drug stocks are being weighed down by product liability lawsuits but they have the cash generating ability to survive. They remind us of the beaten down tobacco stocks of the late 1990s. Since they are generating excess cash flow we expect the Blue Chips to continue increasing their dividends and buying back shares. The dividend yield on the portfolio is currently over 2.5%. The Blue Chips are better able to compete in a rising interest rate environment than their smaller competitors and also should benefit from a strengthening global economy.

Small Cap Stocks: Our Small Cap Value Strategy gained 1.05% in the third quarter while the Russell 2000 Index was up 4.40%. For the first nine months of the year, the Small Cap portfolio rose 0.12% versus a gain of 2.49% for the Russell 2000. We experienced more turnover in the portfolio than usual. As we mentioned in our last letter, we sold Komag in the second quarter. We reinvested the proceeds into Talk America Holdings and Sierra Pacific Resources. Talk America is a competitive local exchange carrier, or an aggressive small competitor to the Baby Bells. Sierra Pacific is the regulated utility that serves most of Nevada, including the fast growing Las Vegas area. They were negatively impacted by the Enron fiasco, but have turned their operations around over the last eighteen months. We sold two of our underperforming positions, IDT Corporation and Bell Industries. We recently added Hawaiian Holdings, the regional airline that serves the Hawaiian Islands. Hawaiian Holdings exited from bankruptcy in June, 2005 with a strong balance sheet and some of the strongest operating ratios in the industry. High fuel prices and increased competition have depressed their share price since they began trading, but if fuel prices moderate or they are able to increase fares, their upside potential is impressive. (Research summaries on our new positions are included for clients that have small cap holdings.) Our biggest gainer in the portfolio during the third quarter was Spinnaker Exploration, up 82%. Spinnaker is being acquired by Norsk-Hydro, a Norwegian energy company, at $65.50 per share. The worst performer in the portfolio was our long-time holding American Pacific Corporation, down 26%. American Pacific is the sole supplier of solid rocket fuel to NASA and the Department of Defense. Their biggest program is supplying the space shuttle. Due to delays in the shuttle program, their sales could be depressed for a longer time period than we anticipated. The company also announced a major acquisition during the quarter that will double their size. They purchased the specialty pharmaceutical chemicals operations of GenCorp, a company they made a successful purchase from last year. Unfortunately they have not announced any terms of the deal besides the purchase price, so investors have no idea what kind of multiple they paid for cash flows and earnings. This uncertainty is clearly weighing on the stock price. We expect to hear details of the transaction as soon as it closes, which should be this month.

Convertible Securities/High Yield: Our Convertible Securities High Yield Strategy gained 3.68% for the quarter, bringing its year-to-date gain to 7.08%. The Merrill Lynch Converti-

bles Index rose 3.71% in the third quarter, but is still down for the year 0.82%. The Merrill High Yield Index was up 0.91% for the quarter and 2.14% for the year. We exited our positions in Calpine convertible preferred and Checkpoint Systems common stock this quarter for nice gains. We had converted Checkpoint bonds into common last year, expecting the stock to perform well. It finally met our expectations in August. We added some new positions this quarter including Gateway convertible bonds, Standard Motor Products convertible bonds, and a Lucent Technology convertible preferred. Whereas we were lucky to find 5% yields earlier this year, we are now finding yields ranging from 7.5% to 10%. The high yield sector is much more reasonably valued than it was in the first quarter of this year. We expect our IOS (Ikon Office Solutions) bonds will be called this quarter and have identified some suitable replacements.

Intermediate Bonds: The Intermediate Bond Portfolio fell 0.10% in the third quarter versus the Citigroup 1-10 Year Government Corporate Index's decline of 0.51%. For the first nine months of the year, the Intermediate Bond Portfolio is up 0.25% versus 1.13% for the Citigroup Index. The Intermediate Tax Exempt Bond Portfolio fell 0.06% for the quarter and is up 1.20% for the year versus a decline of 0.10% for the Merrill 3-7 Year Insured Bond Index in the quarter and gain of 0.79% for the year. We have patiently waited for interest rates to go up this year. Short term rates have moved higher with every Fed tightening of 25 basis points, but long term rates have not moved up in sympathy until recently. We think as the market perceives the Fed is closer to pausing in its campaign to raise rates, long term rates will rise and the yield curve will steepen. The Fed may want to raise the Fed Funds rate to 4.00% or 4.50% from its current 3.75%, and then announce that they have reached a neutral bias. When that occurs, long term bond investors may decide it is time to seek protection in short term maturities. We think inflationary pressures and global economic strength will continue to put upward pressure on interest rates over the next few months.