Quarter Notes
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Market Summary

For the first half of 2005, all the major market indicies had negative returns.

Year to date, the Dow is down 4.7% , the S&P 500 is down 1.7% and the Russell 2000 is off 1.8%. The international index is off 2.8%, mostly due to the recovery of the US dollar. Bonds rose slightly as the yield on the 10 year Treasury fell to 3.92%.

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Stocks Have a Tough First Half Despite Economic Growth

The first six months of 2005 gave investors very little return. Even with healthy corporate earnings growth, all major stock market indices are negative for the year. The decrease in stock prices relative to the underlying earnings growth gives us a market with its most attractive valuations since 1981. But doom and gloom forecasts assault us from all sides.

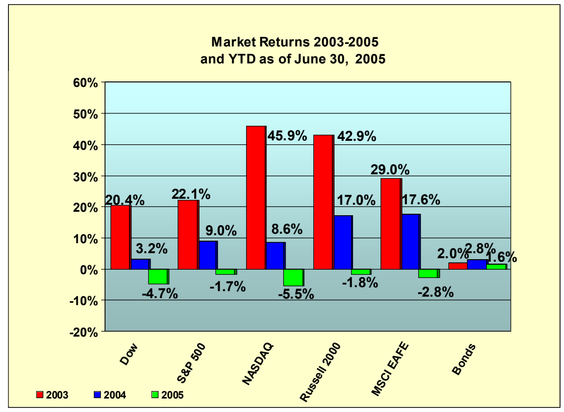
The mass media is responsible for creating most of investor discomfort. Magazines, talk radio and TV are in the business of selling advertising time. The larger the audience, the more profitable are their advertising slots. In order to attract a larger audience in financial programming, they utilize two main psychological forces: fear and greed. After a market decline, fear producing headlines are everywhere. When the market has a good streak, greed inducing pieces abound.

After markets have fallen back, investor fear increases. At these times, the financial media tend to emphasize things that investors should fear. It is, after all, what the public is interested in hearing. The problem is that after the decline, it is usually the worst possible time to sell out.

There are certainly risks which could have an impact to our financial futures. They include:

- The War
- High energy prices
- The current account deficit
- The US budget deficit
- A real estate "bubble"
- Fears of deflation or inflation
- Social Security reform
- European social and political issues

In sum, there are always things to worry about. Usually, those risks are already priced into the markets prior to the media's calling attention to them. In addition to our independent sources, we also are also exposed to the mass media. We attempt to filter out the white noise that leads to emotional, rather than rational, decisions and to act on what we believe to be in the long term best interests of our clients.



What's Going on With Interest Rates?

The Federal Reserve, on June 30th, raised interest rates by another 0.25%. to 3.25%. This is the ninth increase in a year. Fed Chairman Greenspan made it clear that the Fed isn't finished with one of its longest campaigns of interest-rate increases in a generation.

We would have thought that interest rates would increase across the board. Contrary to logic, long-term interest rates have not gone up. Since the Fed began raising short-term rates, long-term interest rates have actually *dropped.* This leaves most people wondering why. In an attempt to understand this, let's break down the forces driving the movements of short-term and long-term rates.

Short-term Rates

The Federal Reserve Board controls two major interest rates: the Federal Funds Rate and the Discount Rate. Banks are charged these rates to either borrow money from other commercial banks or to borrow directly from the Federal Reserve. These are both short-term rates (sometimes as brief as overnight).

Typically the Fed will lower rates when the economy is struggling. Their objective is to stimulate borrowing for reinvestment in businesses, as well as prop up demand by increased consumer spending. When the economy is expanding too rapidly and demand outpaces supply, inflation

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becomes a threat. One of the Fed's primary goals is to maintain price stability. It raises rates to curb excessive growth and engineer a softer landing. Therefore, whenever Chairman Greenspan talks, the financial markets dissect his words to look for signs of his inclination to raise or lower these rates.

Because the banks' cost of money is set by the Fed, movements in the Fed funds rates are closely tied to movements in the retail interest rates. Consumer spending is directly affected by these rates because they impact rates charged by credit cards, home-equity loans, auto loans, etc. The conclusion is that movements of short-term rates are primarily due to government manipulation based on the state of the economy.

Long-term Rates

Long-term rates are not closely linked to the manipulation which affects short-term rates. Typically measured by the 10 year U.S. Treasury note yield, long-term rate movements are primarily driven by market demand and issuance (availability). A normal yield curve (or upward sloping) illustrates that lenders receive higher rates for longer maturities. Buyers of bonds receive higher interest payments in exchange for the risk by tying up their money for a longer period. Today, long-term rates are still higher than short-term rates, but not by much. The difference between interest earned on two year and ten year notes is less than 0.30%, making if difficult to justify locking up your money for eight years longer.

So what are the forces keeping long-term rates low?

Foreign Demand: Our previous newsletters have discussed the trade and fiscal deficits. Foreign countries selling goods to the U.S. are financing our spending in order to keep demand high. They are funding our deficits by purchasing more US Treasuries which is keeping the long-term yields down.

Flight to Quality: With France and Holland rejecting the European Constitution, global investors have less faith in a unified Europe, and worry about the long-term effects on the Euro. The result has been a rally in the value of the US dollar, as more investors seek safety by redirecting money to the US. Part of that money also gets invested in bonds adding to demand.

Inflation: Despite oil at record prices, overall inflationary pressure has been small. When forecasts anticipate long-term inflation, investors will demand higher rates to compensate them for their loss of purchasing power. Therefore, unless we see a sustained inflationary trend, there will be little pressure for long rates to increase.

Stock Markets: The fourth market force affecting bond yields is related to the equity markets. Forecasts for U.S. GDP is expected to slow to 3.25%, down from 4% in 2004. As bonds compete with equities for investor's capital, the slowdown in equity returns reduces pressure on the bond yields to stay competitive and yields will likely remain low.

Strategies for Flat Markets

When markets are going nowhere, indexing or passive investing will produce few positive returns. We have to rely on the belief that some companies will perform better than the indices. Outstanding managers, through excellent research, will be able to identify companies that have the potential to outperform .

The first two quarters of 2005, are looking a lot like 2004. Last year we saw outsized growth in the fourth quarter. So how are we managing in this environment? First, we remain diversified. We don't expect all the asset classes to move in unison. We have tried to identify certain asset classes which have low correlations to US stocks and bonds. We added commodities and international real estate positions and carved out a specific tactical allocation in portfolios for assets and strategies which don't fit neatly into one of the traditional assets classes. We are on the lookout for areas where assets may not be appropriately valued.

In flat markets, dividends become a more important source of investment return. Changes in IRS Code, taxing both dividends and long term capital gains at 15%, have made it advantageous to put income producing stocks in taxable portfolios. Looking for income from bonds has become more difficult. At this point there seems to be no pressure on long term rates to rise and yield on the 10 year Treasury is hovering just below 4%. Our fixed income holdings now include a more diversified basket of bond strategies.

We remain internationally diversified. We have supplemented our developed markets portfolios by adding small cap international, emerging markets and Pacific rim funds.

We are disciplined in rebalancing. We are aggressive in taking gains where portfolios have become unbalanced and repositioning assets where we see greater possibilities for growth. For taxable portfolios, we are strategically harvesting losses which can be used to offset future capital gains.

Housing Bubble?

The median national home price has risen by nearly 15% over the past year. These statistics don't tell the whole story. In hot markets like Miami, housing prices jumped 21% last year and 85% in the last 4 years according to Merrill Lynch.

Is a housing bubble destined to be the tech bubble of current decade? Probably not. Housing behaves differently than stocks. People have to have places to live. Although there may not be a melt down, future returns may be negligible. It may take some time for value to catch up to unrealistic price levels.

Highly leveraged, speculative real estate activity is soaring. The debt structure and creative financing is also cause for concern. Speculative real estate is being bought with "zero" down payment , interest only loans, and negative amortization loans. Even a modest pull back in values could cause defaults which could end up effecting our financial institutions.