Quarter Notes

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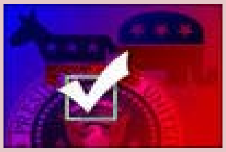

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Market Summary

The Dow remained in negative territory for the year dropping another 3.4% in the third quarter. The S&P 500 lost 2.3% this quarter, but has a quarter point gain for the year. The NASDAQ is off 5% year to date.

The Russell 2000 index of smaller companies posted a small gain. It is now up 2.9% for the year.

(See chart)

Bonds Have Outperformed Stocks

Bonds have now outperformed stocks for the seven years ended August 31, 2004. The Lehman Brothers Aggregate Bond Index gained 7.1% for the period. Even with the go-go stock markets of the late 1990s, the S&P 500 gained only 4.5%.

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Markets Still Weak with Some Hopeful Economic Signs

Returns for equity and bond investors have been hard to come by in the last few months. Performance of financial assets has been plagued by uncertainties: the war in Iraq, deficits both trade and fiscal, the rise in oil prices, increases in interest rates and the outcome of the election.

But despite these problems, there is some good news. Interest rates are still low, inflation is stable and the dollar is trading in a narrow range. While earnings are growing at a decelerating rate, profits are still growing. The Fed's latest survey finds that US households and corporations have record high net worth and are sitting on substantial cash positions.

What does this mean for our investors? For bonds, interest rates will continue their slow climb. We expect short term rates will rise more than long term. The yield curve has already flattened surprisingly with long term rates actually falling back to rates of a year ago. Without an increase in inflationary expectations, this is likely to continue.

For stocks, after the current earnings season and the election have passed, we expect that investors will begin to recognize and reward earnings growth and profitability.

Index	Close on 09/30/2004	YTD % Change
DJ Industrial Average	10080.27	-3.57%
S&P 500 Index	1114.58	0.24%
Nasdaq Composite	1986.84	-5.32%
Russell 2000 Index	572.94	2.88%
MSCI EAFE	1318.03	2.27%
US Bonds*	7703.35	2.78%
*Intermediate Term		

Will Social Security be there for our children?

Social Security may be the ultimate "Ponzi Scheme". The dollars withheld from our paychecks today are supporting payments made to retired workers. That works only so long as there are sufficient workers paying into the system to cover the cost of benefits. Our younger clients frequently tell us "We are not counting on Social Security being there when we retire." They may be right.

Is the Social Security Trust Fund running out of money? We first need to acknowledge that there is no trust fund. Today the payroll taxes from three workers support one retiree. The surplus of S.S. taxes is supposed to be invested by the government, but in fact, trust fund surpluses are funding deficit spending. Supposedly, in some government filing cabinet in Washington, there are reams of IOUs signed by Uncle Sam.

How do we fix it? The Social Security Board of Trustees' 2003 report concluded that the system will begin running a deficit by 2018. Michael Tanner, the director of the Project on Social Security at the Cato Institute explained ". . . the 2018 cash shortfall will be approximately $16 billion or roughly the equivalent of the current budgets for Head Start and the WIC (Women, Infants and Children) nutritional program. Two years later, Social Security's shortfalls will nearly exceed those two programs, plus the Departments of Education, Commerce, Interior, and the Environmental Protection Agency. By 2030 or so, you can throw in the Departments of Energy, Housing and Urban Development, and Veterans Affairs. And the biggest deficits would still be to come."

As a nation, we are having fewer babies, living longer and want to retire earlier. In 1950, there were 16 workers paying in benefits for each retiree drawing benefits. Today there are 3.3 and by 2030, there will be only 2. Some data suggest that immigration may delay the crisis, but the problem still persists.

There are few options for reform:

- Pay in more (raise taxes, increase immigration, delay full retirement age)
- Pay out less (decrease benefits, postpone retirement)
- Increase the rate of return on Social Security "investments" (privatization)

There are two major problems with privatization. How do we fund the interim when younger workers pull money out of the system to establish private accounts? And, can we afford to shift the investment risk to so many unsophisticated investors?

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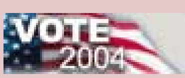
Social Security Statistics

- Social Security faces an unfunded liability of more than $26 trillion.
- 46 million Americans receive Social Security benefits.
- Nearly 80% of Americans pay more in Social Security Taxes than income taxes.
- Social Security payroll tax has grown from just 2% in 1949 to 12.4% today.
- For every two year cycle that we wait to reform Social Security, the cost will increase by $320 billion.
- By 2030 there will be 70 million Americans of retirement age- twice as many as today.

Source Social Security Administration



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The New York Times' Paul Krugman, on Aug. 13, suggested that privatization was scrapped in President Bush's first term because nobody figured out where Social Security benefits for older generations will come from if younger workers siphon their payments into private accounts. The Ponzi Scheme would collapse.

We only have to look back to 2000 and the years following to see what a mess many workers made in their 401(K) plans. Private accounts could be a windfall for brokers and insurance salesmen, but will they be in the best long-term interest of retirees?

Means testing benefits, based on wealth or earnings, is one other option, but that totally changes the character of Social Security where workers pay into the system to fund their own retirement.

Unless we fix Social Security, the benefits promised to future generations won't be there. Unless there is a broad bipartisan coalition, nothing will happen. Perhaps the recent success of the bipartisan 9/11 Commission gives us hope that there can be a consensus in the next term. But it's no wonder that Social Security is called the "third rail" of politics; touch it and you will get fried.

Are REIT Values In Line?

After a significant sell off in April and May, the NAREIT index recouped its losses and ended August 2004 at higher levels than its previous peak reached April 2. After a spectacular run up over the past several years, the question is: Is this asset class overvalued and should we therefore be tactically under weighting REITs in our portfolios?

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Indications of over valuation:

Over valuation arguments highlight weak tenant demand and lackluster cash flow growth. Rising interest rates increase cost of debt and decrease attractiveness of REITs compared to competing investments. "Hot money", which entered the asset class after several years of excellent performance, could cause selling pressure. In addition, tax reform in 2003 lowered rates on qualified corporate dividends to 15%. But REIT dividends do not qualify for the 15% tax rate because 95% of REIT income is passed through to investors and REITs don't pay taxes at the corporate level.

The NAREIT index was trading at a premium over net asset value of 9.1% as of 8/31/04 and, although some premium is probably warranted due to the increased liquidity that REITs provide, this premium may be viewed as excessive.

Case for fair valuation:

Even though growth in cash flows have been slow, REITs tend to lag the overall economy. It is expected that there will be 3.7% growth in 2004 over 2003 levels. Rising interest rates are usually signs of a growing economy which should strengthen demand for space and increase rents. The dividend yield of the NAREIT index was 5.1% as of 8/31/04. Since payout ratios and debt coverage ratios are in good shape, these dividends appear secure. Offsetting the "hot money" risk is the observation that pension funds are increasing their allocation to REITs. Pensions now allocate on average 5% to real estate as an asset class.

Until there is a clearer answer to the question of tactically under or over weighting REITs, we will be maintaining normal investment policy targets as we rebalance portfolios.

Historical perspective of out-performance of REITs as an assets class versus broader stock markets.(Graph Below)