Quarter Notes
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Market Summary

Effectively the Dow ended the second quarter almost exactly where it began the year posting a year to date loss of 0.18%. During the same time the S&P 500 gained 2.6% and the NASDAQ just over 2.2%.

Only the Russell 2000 index of smaller companies posted a better gain, growing slightly over 6.2%, and nearly all of that was in the first quarter.

(See chart)

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Markets Inch Forward Without Much Conviction

The markets can't seem to decide on a direction. Stock prices moved in a narrow range for the second quarter. Year to date 2004 has provided meager returns on most financial assets. The exception has been commodities, which have experienced a significant rise in prices over the past couple of years. With oil and gasoline affecting all costs, the War in Iraq and unrest in the Middle East continue to weigh on the markets.

Index	Close on 6/30/2004	YTD % Change
DJ Industrial Average	10435.48	-0.18%
S&P 500 Index	1140.84	2.60%
Nasdaq Composite	2047.79	2.22%
Russell 2000 Index	591.52	6.21%
MSCI EAFE	1327.98	3.04%
US Bonds*	7533.68	0.52%
*Intermediate Term		

The Federal Reserve has just raised short-term rates by ¼ of one percent. This was the first of what is expected to be a series of interest rate hikes intended to keep inflation in check. Higher rates will remove some of the economic stimulus that has precipitated the recent recovery. How far and how fast will the Fed move? This question about interest rates fuels concern from both stock and bond investors. Our forecast is for three-quarters of a percent hike by the end of the year. Will this be just enough to curb budding inflationary pressure or will the Fed choke off the renewed economic recovery? It is a delicate balance.

Although higher interest rates may affect corporate profitability, higher rates may not hold back deferred, but needed, capital expenditures. Further, severe cost cutting, out-sourcing and improving sales have contributed to robust profits. Companies rich with cash may be able to fund investment without substantial borrowing.

We believe that inflation is going to pick up to close to 3%, the long term historical average. Also interest rates will have to rise to a level where they no longer produce negative real returns. If the Fed's moves are right, they may be able to bring the economy in for a soft landing. We do not see runaway inflation, requiring the Fed to raise interest rates quickly or severely.

Although the U.S. economy is showing solid growth, there are anti-inflation forces also at work. The two major forces are:

Global competition: Lower costs and cheap labor in developing countries put pressure on the developed countries to stay competitive. Although world wide capacity utilization has picked up, it is still well below average.

U.S. Consumer Spending: There is still a sizable unemployed or underemployed portion of the U.S. workforce which supresses wage increases. Addionally, tax refunds have been spent and many homes have already been refinanced. These have led to record debt levels which may curb consumer spending going forward.

What are the risks we face? If the modest tightening of monetary policy in the form of higher interest rates doesn't work to slow down the inflation, the Fed will have to get more aggressive. This would happen at the same time that the economy is losing the stimulative effect of massive tax cuts, a weak dollar, and booming Chinese economy. *(see article next page)*. Also, we have a record current account deficit caused by significantly more imports than exports of both goods and capital. Even though a weak dollar has given rise to record foreign investment in the U.S., we continue to buy more abroad than foreigners are investing here.

The uncertainty is reflected in financial markets as volatility.The uncertainty today is nothing new; there is always uncertainty. While long term we expect the markets to reflect fair value, investor sentiment can force under (or over) valuations for sustained periods of time. Our response to this is to be patient and maintain a diversified investment policy. Specifically, where appropriate, we have tactically shortened bond durations, reduced exposure to TIPS, cut REIT exposure and allowed international allocation to continue to be overweighted in many portfolios.

Interest Rates are Rising Can We Still Make Money on Bonds?

An inverse bond fund borrows bonds, sells them, and then buys them back (at lower prices as interest rates rise). This is known as "selling short" or "shorting"(in effect selling high and buying low). It is a tactical investment which can be useful when interest rates are low. In an environment where the economy is reviving and it appears interest rates will begin to climb, an inverse bond fund can help offset some of the interest rate risk.

In that environment, a bond fund that "shorts" long term bonds should provide a positive return. However, if short term rates rise, but long term rates don't, the "shorting" of intermediate or longer term bonds will not produce any significant positive returns. Like all other investments, it is not a "slam-dunk".

A Critical Look at Risk

In all investing, there is a trade-off between risk and return. In order to make some money, risk is an unavoidable component. The key to smart investing is to maximize the compensation you receive for the risks that you take. Often oversimplified, we have been programmed to believe that the riskier investments yield the potential for higher returns. However, by taking a closer look, we see that risk comes in many different discrete forms which investors often overlook. Let's examine some of the risks that investors often forget.

Market risk: the risk normally associated with stocks, but which could also describe real estate, hard assets or other asset types. Market risks are caused by fluctuations in the business cycle, economic conditions, and investor sentiment. This particular risk is unavoidable, and reflected to some degree in all assets.

Security risk: the risk that is unique to an individual investment which can cause it to perform in an unanticipated way.

Interest rate risk: the risk that the value of an investment can change because of a change in interest rates. Existing bonds decrease in value when new bonds offer to pay higher rates of interest. Rising interest rates can dampen stock prices by affecting the future profits of leveraged companies.

Credit or Financial Risk: the risk that a company will become insolvent causing a default on their financial obligations.

Purchasing Power or Inflation Risk: the risk that investments will not provide a sufficient rate of return over and above the inflation rate, so that purchasing power is reduced.

Currency Risk: the risk that the return from a foreign investment once translated back into dollars, will be worth less than if retained in the original currency.

We spend a considerable amount of time assessing the risk tolerance of our clients. It is crucial to invest within your comfort zone both for peace of mind and to limit the emotional response which can cause an investor to sell or buy investments at precisely the wrong time. The point we are trying to make here is that it often it is not a choice between more risk and less risk, but rather a choice between more of one type of risk and less of another. For example, a lower market risk from a lower equity exposure might actually be a trade-off for a higher purchasing power risk.

Tips on TIPS

We have been using Treasury Inflation Protected Securities, more commonly know as TIPS, as a refuge for our bond dollars when interest rates were at their bottom. TIPS have the advantage of paying a fixed interest rate, although comparatively low, plus the face value is indexed to inflation. So investors holding TIPS to maturity should always have a real rate of return over the underlying rate of inflation.

Because there are two significant variables at work; interest rates and inflation, TIPS have to be judged with both factors in mind. They have to be evaluated on a relative basis against Treasuries and on absolute terms according to their real yields.

On a long term basis, we expect TIPS will continue to be useful for investors as a hedge against inflation. However, in an environment where interest rates are rising and inflation is not rising proportionally, there is an expansion of real interest rates. This scenario could make TIPS less attractive relative to other short term bonds.

As interest rates have begun to rise, other bonds are starting to look more attractive and TIPS aren't the bargain they used to be. But for diversified portfolios which require a bond allocation, TIPS still have a place.

China Boom

Over the last year, the Chinese economy has been growing at the rate of 9.1% versus 3.2% for the U.S., and that is in the midst of a significant U.S. economic recovery. Needless to say, China has been on a tear, so much so that the Chinese government is trying to slow down the growth in their economy to keep it from overheating.

What has brought about China's growth? The Chinese have instituted new policies reforming land rights and taxation. These reforms are allowing millions of Chinese households to become owners of property. This, in turn, is increasing production, facilitating a major wealth transfer and providing a stimulus throughout China's economy.

Whether China is overheated or not, one fact remains, over the coming decades Chinese incomes will rise significantly. That, coupled with China's huge population, will have substantial investment implications and opportunities.