QuarterNotes

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Market Summary

Markets ended the first quarter nearly flat. For the large cap indices the Dow was off one percent and the S&P 500 rose just over one percent. The NASDAQ Composite fell by less than half a percent.

The Russell 2000 index of Small stocks, MSEAFE index of international stocks and bonds showed modest gains. (See chart)

Welcome

We want to welcome our new associate Carlos A. Carbonell to the firm. Carlos is a graduate of Northwestern University and has five year of experince in financial services. We look forward to introducing him to our clients.

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After a remarkable run-up in stock prices over the last 12 months, we are beginning to see some stock prices retreat. Among the market analysts that we follow, few predict a severe market decline, but the heady days of 25% gains are probably behind us. For the quarter, the Dow and NASDAQ lost less than a percent. Small stocks, international stocks and bonds gained.

In this issue we try to analyze some of the indicators that alert us to potential market overvaluation and how we can best position to protect against it. With our asset allocation orientation, we do not believe that we can forecast exactly when to enter or exit the markets. Instead, we recommend tactical strategies which we believe will enhance risk adjusted returns by overweighting or underweighting specific investment categories.

Interest rate movements will affect the near term economic future. Low interest rates are beneficial for several reasons. Low rates reduce borrowing costs for businesses and households. Increasing home prices and continued home mortgage refinancing have enabled the consumer to continue spending through the "recession" and into the recovery. Job growth remains low to nonexistent. But, low rates have helped boost corporate profits.

On the flip side, for fixed income investors, low rates are painful. Bonds, certificates of deposit, and money market accounts pay virtually nothing, leading investors to look elsewhere for returns.

Low interest rates can also be problematic. The government's deficit spending, combined with a low interest rate policy from the Federal Reserve, plant the seeds of inflation. With historically low rates, the Fed has very little ammunition to fight a downturn in the economy should one occur.

Eventually, interest rates will have to rise or the dollar will continue to fall. Thus far, the decline of the dollar versus other major currencies has been somewhat mitigated by foreign investors who buy and hold US bonds. But investors in other countries cannot be expected to accept negative returns on a large and increasing amount of US debt.With a record

Index	Close on 3/31/2004	YTD % Change
DJ Industrial Average	10357.7	-0.92%
S&P 500 Index	1126.21	1.29%
Nasdaq Composite	1994.22	-0.46%
Russell 2000 Index	590.31	6.00%
MSCI EAFE	1337.07	3.75%
US Bonds*	7709.02	2.86%
*Intermediate Term		

current account deficit (from more imports than exports) and a ballooning federal budget deficit, the US has a significant imbalance between savings, investment, and consumption. These imbalances will eventually need to be rectified.

Other factors influence market performance such as corporate earnings, the presidential election cycle and international events. Corporate profits have been improving and the stronger economy encourages analysts to raise forecasted estimates. Earnings surprises or disappointments tend to be reflected in short-term market movements. There are expectations about the fourth year of the presidential cycle which lead to money flowing into and out of the market. Market pundits are having a field day debating whether Republicans or Democrats are better for the markets. Let's just say that *this one's going to be close!* Whomever you favor, be sure to get out and vote!

International events and threats represent increased uncertainty, but also potential opportunity, especially if tensions are reduced and trade and international growth becomes more robust.

The question remains, however, whether stock prices can continue to rise and markets perform favorably while our longer term problems are resolved. Is a correction imminent? We don't know, but our belief is that short term movements in the market reflect momentary uncertainty. While near term volatility is expected in the stock market, we believe that the robustness, flexibility and vitality of our economic system should lead to long term gains.

Rules for Retirement Accounts Change Again.

For 2004:

- Higher salary deferrals- $13,000 ($16,000 if you are over 50), for 401(k), 403(b), and 457 plans.
- Limits for qualified retirement plans and SEP-IRAs now capped at the lower of $41,000 or 25% of income.
- Traditional and Roth IRAs remain the same: $3,000 ($3,500 if over 50 years old).

You can still contribute to an IRA even if you're participating in a 401(k) plan at work. If your adjusted gross income is less than $65,000 filing jointly, you can still deduct it. Phase out rules apply. Regardless of deductibility, you may still contribute to a Traditional IRA.

Only after-tax dollars can be contributed to a Roth, but withdrawals are tax-free after age 59 ½. Contributions are phased out over $150,000 for joint filers. If your income qualifies, it usually makes sense to contribute to a Roth if you are planning to keep the IRA more than 5 years.

When are these contributions due? Qualified plans must have been in place by the end of 2003, along with the salary deferrals. Traditional and Roth IRAs still allow for 2003 contributions up until April 15th 2004. That deadline includes SEP-IRAs as well.

So, how do we proceed? Over the past few months our focus has been to:

☐ Underweight aggressive US equities, focus on more conservative US equity mutual funds and bank some of the profits of the past year;

☐ Slightly overweight and diversify international equities and include international small cap equities and emerging market equities;

☐ Shorten the maturities on domestic bond positions and maintain, where possible, an exposure to inflation protected bonds (TIPS). Introduce a more flexible fixed income approach using more global bond positions;

☐ Use alternative investments such as commodities, merger arbitrage positions, hedge funds, and funds that have the ability to "short" equity or bond investments;

We continue to evaluate other asset types to attempt to diversify risks while providing favorable returns.

Stock and Bond Alternatives

Considering Hedge Fund Investments

With the uncertainty over the direction of traditional stock and bond markets, we feel this is a good time to discuss the alternative investments also referred to as hedge funds.

Well, what exactly is a hedge fund? No single definition exists, but part of the definition could begin within the name itself – a hedge. The funds are pooled investment vehicles that may allow the manager to place trades so as to make money both when stocks go up and when stocks go down. In technical, terms the manager can be on both the long and short sides of the market to protect, or hedge, against adverse price movements. The objective is to achieve an absolute (positive) return by hedging certain positions, regardless of which direction the market is moving. Generally, most hedge funds fall into one of four broad categories: Relative Value/ Arbitrage, Long/Short Equity, Global Macro, and Event Driven.

Unlike traditional mutual funds, hedge funds have the ability to manage money using long and short positions in equities, commodities and currencies, but also include derivatives such as futures, options, swaps, and leverage. It sounds scary, and certainly hedge funds are not risk-free investments, but the benefits may actually result in less volatility than traditional investments of stocks and bonds.

The goal for hedge funds is to produce equity-like returns of 8-10%, with minimal correlation to the equity or bond markets. Volatility is reduced because of its ability to use short positions and derivatives, which offset sharp price changes and smooth out performance. That means we expect a positive return whether the stock market and bond markets are up or down. Some mutual funds have the ability to use hedge fund-like strategies and we have been using them in select portfolios over the last year or so.

As asset allocators, we think that the best way to invest in hedge funds is through a diversified fund of hedge funds. Individual hedge fund managers tend to specialize in one specific strategy and focus 100% of their efforts on that strategy. For example, a manager who seeks to profit from merger arbitrage will only research and take positions relating to company merger events and arbitrage opportunities. The manager has neither the expertise nor the interest to seek out opportunities in an unrelated area such as the managed futures markets. A fund of hedge funds combines the benefits of 20 to 50 different managers by investing in a variety of hedge funds to achieve safer diversification. As a result, your investment is spread across the various hedge fund categories, exposing your portfolio to long/short equity strategies, managed futures, mergers and arbitrage, distressed/special situations, and so on. For the same reason you want to have different mutual fund managers to prevent concentrating all eggs in one basket, you also want to have different hedge fund managers.

If hedge funds are so great, why isn't everybody using them? Hedge funds are not for everybody. Traditional funds have high net worth requirements and high investment minimums which exclude most investors. Also complicated taxation, limited liquidity, higher fees, and lack of transparency, dissuade many qualified investors. Net worth requirements start at $1 million and higher for certain funds. Initial investment minimums also can start at $25,000, but can be as high as $1 million or more. Liquidity is usually offered quarterly after the first year, but is not guaranteed. However, for the right investor, hedge funds may enhance a well balanced portfolio by reducing volatility, yet consistently providing steady returns. *(See Graph Below)*