QuarterNotes

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What a Difference a Year Makes. Is There More for 2004?

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Thoughts for the Quarter

"Over the long-term low P/E stocks will outperform high P/E stocks."

Nobody can accurately predict short-term market movements.

Companies or markets growing at a rate of 50% per year cannot keep it up.

Famous last words, "This time is going to be different."

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There was much to celebrate on New Year's Eve 2003. What a difference a year makes. Markets had their first positive year since the turn of the century and what a year it was. All sectors of the market rose, especially the tech-heavy NASDAQ which rose by a stunning 50% finishing 2003 at 2003.

The Dow gained more than 25%. The broader market S & P 500 rose 26% while the small cap Russell 2000 jumped 45%. International stocks were helped, in part, by the weakness of the US dollar. The international index, MSEAFE, made a significant recovery with a 35% gain. The dollar has now lost nearly 40% against the Euro. With the Euro at $1.26, its highest ever versus the greenback, US exports are cheaper overseas and foreign goods and travel have become much more costly to us.

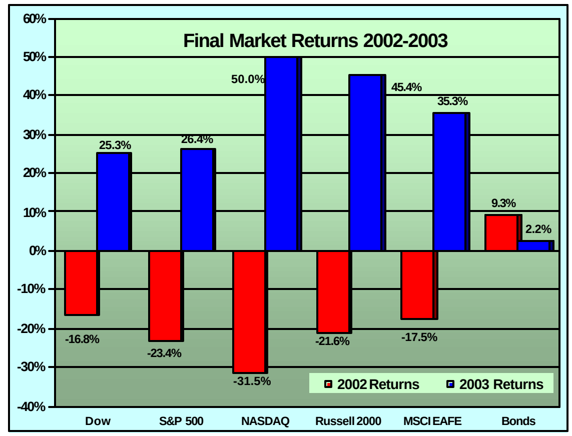
Can the party last?

It just might. According to many economists, we have truly entered into an expansionary phase, not just a large blip in a bear market run. We are buying into this generally rosy scenario. With interest rates at historic lows, a 1% Fed Funds rate since June 2003, productivity high, inflation tamed by worldwide excess capacity, and an incumbent President up for reelection before year end, the next few months look favorable indeed.

Even though personal consumption didn't fall off significantly during the "economic slowdown", business spending came to a screeching halt. Much of the consumer spending was fueled by low interest rates. This allowed many homeowners to refinance mortgages at 40 year low rates and use the funds to keep spending. With consumer debt now at record highs, individuals might now take a respite from spending. The hope is that businesses will gear up to rebuild inventories and meet expanding worldwide aggregate demand.

But, as always, there are storm clouds on the horizon. As we see it, these are the major threats:

1. Terrorism and War
2. Federal Budget Deficits
3. Trade Deficit
4. High Stock Prices Relative to Earnings



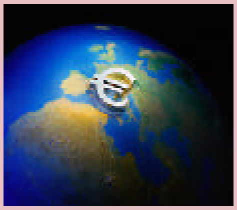
Economy is showing strong performance

Predictions of a 4% growth rate for 2004 may be too conservative. Powerful economic stimuli are at work. Low interest rates, higher than expected tax refunds as last year's tax cuts take effect, rising inventories and signs of recovery beginning overseas will all contribute to economic growth. These factors are favorable for stock prices, but the markets have already accounted for much of this information. These forces may lose some of their impact during the second half of the year.

Let's examine the risks

Anything which might impair the continuing growth would threaten this optimistic scenario. A spike in energy prices would divert purchasing power and erode growth. The effect of tax cuts on consumption could be largely behind us. The ability of business to utilize capacity anywhere in the world should tend to keep prices in check, but the flip side of the coin is that business will have very little power to raise prices. A weak dollar, however, should strengthen sales.

Stock prices, especially in the hot technology sector, are beginning to look rich. Low inflation and interest rates may, in the short term, support such prices, but any uptick in interest rates may lead to vulnerability in stocks whose prices cannot be supported by their revenues.



Changes in Florida Intangible Taxes

Legislation passed by Florida lawmakers in 2002 will make fewer portfolios subject to Florida Intangible Taxes.

Beginning January 1, 2004 individuals with assets of less than $250,000 which are subject to intangible taxes, $500,000 for filing jointly, will pay no taxes. Additionally, if the tax owed is less than $60 then no tax is due.

Businesses will pay no tax on the first $250,000 of assets .

ADV Annual Offer

Each year the SEC requires that we notify clients when we are updating our ADV Part ii. If you would like a copy of the updated form please call the office we will be happy to send one out to you.

Statement Bundling

Schwab can "household" mailings and monthly statements to the same address with the same tax ID. You can further reduce your mailings, by signing a form to have all statements to the same address mailed in a single package.

Call us to obtain this form.

Other than increased threats of terrorism and war, the greatest risk to our extended recovery comes from the gaping trade deficit. Morgan Stanley's Stephen Roach notes, "America's current-account deficit is a by-product of two of the world economy's most unsustainable trends- a saving-short, overly indebted US that is living well beyond its means, and the inability or unwillingness of the rest of the world to stimulate [their own] domestic demand." Last year our foreign trade deficit was $491 Billion, much worse than the $418 Billion of the prior year. These economic tensions have weakened the dollar by nearly 40% against the Euro. Roach concludes, "The bill for speculative excess and global imbalances has yet to be paid. Peering into 2005, that's the biggest risk of all."

What do we do with our portfolios given this Scenario?

1. **Be Alert to Unrealistic Valuations:** Lighten up on funds which hold stocks with stratospheric price to earnings ratios in favor of more stable earners.
2. **Maintain Low Duration Bond Portfolios:** This will limit the pain of rising interest rates expected in the future.
3. **Take Advantage of the New Tax Laws:** Portfolios of dividend paying stocks will reward investors. If capital gains are hard to come by, dividends will provide a large component of portfolio growth in a low interest environment. In the growth versus value tug of war, value may once again have the edge.
4. **Introduce Tactical Diversification:** Diversify even within existing assets classes. For example, our fixed income allocation now includes TIPS (Treasury Inflation Protected Securities), some emerging market bonds and global hi-yield bonds. We want many factors at work to produce absolute returns even when domestic positions are not expected to add much value. We have also been overweighting international stocks and have added some emerging market stock exposure.
5. **Manage Expectations:** We need to assist our clients to have realistic expectations. Investors who expect a repeat of 25% returns are likely to be sorely disappointed.

(Continued next column)

Our goals for 2004 are to focus on fundamentals and emphasize management teams who value companies with strong balance sheets, excellent franchises and growing cash flows.

The Mutual Funds Scandal

Mutual funds have received some ugly press as Eliot Spitzer, New York's Attorney General, exposed the misdeeds of several prominent mutual fund firms. This was not just a case of a couple of bad apples. Firms that have been cited include Bank of America, Bank One, Putnam, Janus, Alliance, and Strong. Typically only one fund from each of these institutions has been accused of participating in questionable or illegal practices. However, together these fund families account for over 15% of all mutual fund assets. The cases are not fully resolved, but each of the companies have made changes to their executive suites and have either admitted wrong doing or have had regulatory actions taken against them.

There were three main issues:

1. Market timing: This is the quick in/out trading to take advantage of minor temporary discrepancies in pricing. Although a legal strategy, most mutual fund prospectuses say they discourage timers. The problem occurs when they disallow timing for some investors and allow it for others.

2. Late trades: When the market closes at 4 P.M. prices of mutual funds are set for the day. Some funds allowed certain large clients to buy in after closing prices were set, thereby giving them an inappropriate advantage over other investors. This is clearly illegal.

3. Breakpoints: These do not pertain to our clients because they relate only to commission compensated brokers. (We use only no-load funds.) Retail brokers were accused of not giving their clients appropriate commission discounts for large fund purchases or steering them into B shares when not appropriate to size of the purchase. Additionally, some firms paid higher commissions to brokers to sell their own branded mutual funds.

We have faith that the many funds in our clients' portfolios are both ethically run and well managed. Funds still represent a cost efficient tool for creating well-diversified investment portfolios. They allow for liquidity while providing exposure to asset types that require managers with expertise in specific areas. They provide opportunities to invest in areas which would be too risky without the diversification mutual funds provide.

We believe that our mutual fund due diligence identifies managers who are primarily concerned with preserving and enhancing the wealth of our clients.

We wish you a Happy Healthy and Prosperous New Year.