



ASSET MANAGEMENT COMPANY

SECOND QUARTER 2004

A lot happened in the 2nd quarter on both the economic and geopolitical fronts. It was confirmed by the employment and retail sales numbers that the economy has continued its strong pace of growth. Furthermore, the U.S. managed to return Iraq to sovereignty despite continuing instability. Bonds were down, however, because of the fear of higher rates going forward. For the first half of the year, the S&P returned 3.4% and the Dow was down 0.9%.

One of the big factors driving returns lately was sentiment over whether the Fed will keep with its “measured pace” approach to raising interest rates. While there are many factors involved, we believe that the Fed *will* move somewhat slowly because the economy is highly sensitive to changes in rates. This stimulus should keep the economy growing at least for the near term.

In large part, the U.S. economy’s sensitivity to rates is due to a high level of debt relative to historical norms, much of which is variable rate debt. This shift was facilitated by a recent rush to adjustable rate mortgages (now 50% of the dollar volume of new mortgage originations, up from 20% a year ago)¹ leaving many consumers exposed to the upside of the interest rate cycle at a point where inflation may be building and the Fed may have to act. However, while the Fed has its critics, it *has* shown an ability to

keep the economy on a growth track through challenging times...we think that that will continue.

As always, with the challenges come opportunities. Because we think that rates are going higher, albeit slowly, we are switching many bond investments to variable rate instead of fixed rate debt to eliminate much of the interest rate risk. In addition, we continue to see good values in stocks that shouldn’t be impacted much by inflationary pressures, should they increase.

One example is our recent investment in the Chicago Mercantile Exchange (CME). Not only does the CME provide the largest global marketplace for futures contracts and other derivative instruments critical to risk management, but its market position is nearly unassailable. If one reads through CME’s value statement (available on its web site www.cme.com), it becomes clear that this is a highly focused organization dedicated to creating shareholder value. We recently took some profits in CME because we felt that the stock got a little ahead of itself, but we continue to believe that this is an investment that will provide good returns long term.

Of course, not all investments have or will work out as well. Occasionally we are blindsided by negative news, or by the reaction of other investors to anticipated news, but we do our best

¹ Morgan Stanley. June, 2004.



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to navigate these. When it does happen, we use our best judgment to continuously decide the best course of action (buy more, sell or do nothing).

In some accounts we've slightly lagged the S&P year-to-date, but we feel that this is due to many speculators' overreaction to the strong level of economic growth and their belief that the Fed will raise rates aggressively. However, with a slow-moving Fed (which we view as more likely), increasing inflation remains a distinct possibility. Therefore, to conservatively manage risk, we want to continue to hold investments that will perform well should inflation become a reality, and to avoid those that will be affected negatively.

The increased inflation pressure is seen in many sectors of the economy because of the massive amounts of liquidity provided by our government. Yet CPI, the oft-cited measure of overall inflation, will probably remain low because of measurement flaws that are too numerous to mention. This will make it easier for the Fed to rationalize an accommodative stance (raising rates slower than the actual inflation rate grows) at least for the near term.

Continuing high energy prices also remain a distinct possibility due to ramped up demand and constrained supply. A long lead-time is needed to explore and develop new oil and gas fields, and all the low hanging fruit, so to speak, has been picked. It is because of this that we

have hedged our equity portfolio with investments that should benefit from both high energy prices and inflation.

We view risk and return as two sides of a coin — one can't exist without the other. While nobody has any idea what the future holds in the short term, the best we can do is carefully form an opinion as to what will make money and know the factors that create risk. Benjamin Graham had another way of putting this when he said, "In the short term the market is a voting machine and in the long term it is a weighing machine." It weighs economic profit and that is what we look for in investments.

On a side note, we help many people manage the proceeds from business sales. I recently co-authored an article about this process and some of the common mistakes. The article was published in *Worth Magazine* and we have reprints should you wish to receive a copy. Please let us know and we'll be happy to mail you one.

If a change in strategy is needed in your portfolio either through a change in your personal finances, a change in your risk preferences, or if you are not a client and have questions about your current advisor, please contact our office at (970) 925-8747 to set up a *no obligation* review.