

State of Affairs

In the second quarter we witnessed record money flows into most domestic asset classes. Helping the cause were a quick fall of the Iraqi government, a generous tax reform package and signals from the Federal Reserve Bank that it intends to keep credit cheap and vigorously defend us from deflation. The S&P 500 returned 11.8% for the first half of the year, and the Dow returned 7.7%. While we like to see positive returns, we are aware that the market and the economy continue to face heady challenges despite our government's best efforts to mitigate them.

The Fed's loose credit policy may be akin to having a bloody mary to cure a hangover. It may work for a while, but it's likely only to delay some sort of slowdown. Similarly, by punishing those who would like to hold cash with negative real returns, the Fed is effectively forcing investment that isn't necessarily needed in the economy at this time, and in the interim risks a flight of foreign capital back abroad where better returns are perceived. As you probably know, many assets purchased in the late 90s continue to be underutilized, not because of tepid demand, but because of overcapacity/overinvestment.

Currently, the short-term case for a return to a bull market is indeed compelling. The financial press is celebrating the recent run up and the investment industry is loudly calling for terrific returns in stocks going forward. Some important elements in stocks' favor are regulatory reform, liquidity (and the

aforementioned disincentive to hold cash), improving profitability and an impressive potential macroeconomic growth backdrop. There are three notable exceptions however – high valuations, low capacity utilization and continuing pressure on profitability from rising insurance, energy and pension costs.

Caveats and Solutions

Among other things, low interest rates have put pressure on the insurance industry to raise premiums, and some carriers even find they can't cover certain risks profitably. In addition, crude oil prices remain high despite the Iraq campaign and there continues to be a supply shortfall in natural gas, which should keep energy prices high. Separately, and more importantly perhaps, many companies also face rising pension costs. Having assumed an 8% - 10% return on their plan assets (even though the actual returns have been significantly less), many firms have booked pension income, which is allowed under U.S. Generally Accepted Accounting Principals. However, this income stream may disappear for many because these high returns assumptions are aggressive for balanced portfolios in this low interest rate environment.

Certain companies have greater exposure to these factors than others, but in general it is tough to pass through higher costs with price increases when many consumers are maxed out on their personal debt, and when foreign competition is intensifying. As investors, there are strategies to profit from these

dynamics, but we aren't expecting domestic corporate profits to grow 50% over the next year, which is what the stock market appears to be pricing. To respond, we have identified some compelling values and for certain accounts have made investments in preferred stocks and some convertible preferreds where there is a consistent stream of cash delivered to the client, but where the downside is somewhat limited. For these investments, we are also cautious as to the type of issuer and structure so that we can effectively manage risk.

While the recent stock rally is encouraging, we continue to believe that, as Warren Buffett says, "it is optimism that is the enemy of the rational buyer." In other words, over the long run, it is better to take a skeptical approach to investments rather than buying stocks because Wall Streeters say that we should (which they always say). As Paul Krugman (a noted economist) said in the June 20, 2003 New York Times, "Investors seem to be buying stocks because they are rising - which is pretty much the definition of a bubble." Hence, we remain cautious in our investments.

The Current Strategy and Resource Allocation

Overriding the meaning of all these forces upon the investment landscape, Obermeyer Asset Management's most important objective, which is to provide our clients with a positive investment outcome regardless of the direction of the economy or the securities markets. We prefer not to make directional bets because the future is truly unknowable, but instead to continue to make investments with a strong value orientation, and in issues that should provide positive returns over time. To enhance this effort, we also invest with managers that have a sensible investment approach, and who

provide a needed level of expertise in certain styles or asset classes.

To improve our effort, Obermeyer just added to its analytical capability through a subscription to Bloomberg — a proprietary financial news service that provides extensive information on both foreign and domestic securities and commodities. In addition, we routinely attend investment conferences that present relevant information on industry trends and market conditions. Our hope is that we can apply this knowledge to reduce our customers' risk and/or increase the return potential.

Odds and Ends

Worth mentioning is an important customer service that we provide for our customers — proxy voting. We are pleased that the SEC passed a regulation that improves the integrity of our capital market system by requiring mutual funds and investment advisers to disclose their proxy voting policy and to keep their voting records for public access. The result should be better checks and balances on corporate governors by making fiduciaries more accountable for their actions.

We are also pleased to have recently celebrated our 5th anniversary. The firm has made many positive strides, but is continually seeking ways to improve. My staff and I are committed to giving our clients both the highest level of service and to helping them achieve their financial objectives with a customized investment strategy. If you suspect that the investment advice you are receiving may be below the quality you expect, or perhaps conflicted in some way, please feel free to meet with us for a *no-obligation* review, or to contact our office at (800) 337-0933 or (970) 925-8747 with questions.