



Too many tragic events dominated the news during this last quarter: July began with the terrorist attacks in London and September ended with the devastation of Hurricanes Katrina and Rita. Our hearts go out to everyone affected by these disasters. Upon reflection, one has to be inspired by people's desire to push forward and rebuild – the very essence of the human spirit.

The US equity markets took these events in stride, although the aftermath of the hurricanes fueled trends that were already in place. Headlines have highlighted concerns of rising commodity prices, swelling government deficits, building inflationary pressures, and an ongoing Fed tightening campaign; yet the US market, through the 3rd quarter, has not taken up any real directional commitment. For the year through September, the S&P was up 2.8% and the Dow was -0.4%.

As investment managers, our first responsibility with respect to Katrina was to evaluate any change in risk posed to client holdings. We quickly surmised that Katrina shouldn't adversely affect the intrinsic value of our portfolio companies because it is not fundamentally an investment story. In our opinion, it will most likely result in a short-term boost to local rebuilding that will be funded by reinsurance companies and governments (taxpayers). Any company that stands to benefit from the tragedy immediately had its share price adjust to levels that long-term investors would deem imprudent. In our experience, it usually doesn't make sense to try to make serious money from a Page 1

story. These tend to be short-lived trends, with day traders chasing them.

One potential outcome is that these storms *may* induce some slowing in US commerce as a result of continuing high natural gas prices. Natural gas touches many areas of the economy - from home heating to food production. Utilities have been given cost pass-through permission because, for more than a decade, they have been pressured, induced or compelled to increase their reliance on natural gas—the clean air "wonderfuel." Natural gas is up 126% year-to-date.

The hurricanes cast a spotlight on the energy sector and exacerbated developments that we have seen brewing for years. We have emphasized this topic in past letters and continue to believe that we are still in the early stages of a bull commodity cycle for two reasons. First, commodity cycles tend to be long – usually 20 years plus. It's been since the 1970s that we had tight supplies and exploration has been underfunded for years because of low payoffs. Second, the economic development of China and India will dwarf the demand seen in OECD countries over the last half century.

For the moment, despite increased gasoline prices, overall inflation continues to be held in check by overcapacity in the technology sector (which keeps productivity high as technology keeps getting cheaper and cheaper) and by low wages paid to foreign labor. These dynamics may eventually shift, but as long as China and the US remain friendly, the trend



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will continue. The Fed is also focused on curtailing pricing pressures, as well as slowing the growth in real estate prices, as evidenced by the 11th straight rate hike last month. Ironically, Greenspan's mocking bond investors by saying that they are "desirous of losing money" (from a Nov. 19, 2004 Q&A) has had the unintended consequence of goading residential real estate speculation as investors rush to buy before mortgage rates go up.

In the current environment of relatively high asset prices and an ambitious Federal Reserve, our investment strategy remains the same: **keep risk at a minimum and identify strategic investments** that make sense in the context of our global economy.

We continue to look for stocks of domestic or multinational companies that have strong current cash flow, that are run by smart, experienced people who have stellar track records (and who are also properly incentivized), and whose resources are positioned to benefit from global trends. With respect to diversifying assets, a healthy exposure to commodity producers as well as emerging market investments makes sense as the valuations *and* fundamentals remain attractive. Our exposure to gold is still core to our clients' portfolios at present as it hedges against the poor performance of financial assets. For fixed income, we focus on actively managing portfolio duration given rising short-term rates, and plan to stick with high quality bonds as we believe the US economy has peaked.

One last word about our investment process: Our emphasis on risk leads us not only to understanding the fundamentals and valuation of companies that issue securities, but more importantly, it leads us to developing an understanding of the mass expectations implied by current stock and bond prices. From that, we can make a decision on whether an investment presents a favorable proposition or not: whether it underpriced (what we look for) or overpriced (having disproportionate downside). This is often independent of how well a company's operations are faring (a point lost on an alarmingly large number of investment professionals).

The entire Obermeyer team truly enjoys partnering with each of our clients to help them achieve their financial goals. If you are considering a change in advisory and/or investment strategy, or if you have questions about your current situation, please contact us at 970-925-8747 to set up a *no obligation* review.