

QUARTERLY REPORT

Third Quarter 2004

A sluggish year in the investment markets continued into the third quarter. Common stocks lost ground in the quarter with the S&P 500 down 1.9%, the Dow Jones Industrials off 2.9% and the NASDAQ Composite declining by a larger 7.4%. After the first nine months of 2004 the S&P 500 clung to a small 1.5% gain while the Dow Jones Industrials and the NASDAQ Composite were shackled with losses of 2.1% and 4.2% respectively.

The fixed income markets, which were slightly negative through the first half of the year, had a good quarter. The widely watched Lehman Brothers Intermediate Government Bond Index rose by 2.3% in the quarter to move the index's slight mid-year negative into the plus column at 2.1% for the first nine months.

Risk-free cash equivalents, while increasing in yield in response to the Federal Reserve Board's tightening activities, still provided a meager return. Ninety-day U.S. Treasury Bills provided a cumulative return of just 0.9% for the year's first three quarters.

In an environment in which no major asset category is rising appreciably, more and more investors are turning their attention to yield. We've been asked by a number of clients whether we could increase the yield on their portfolios. The question is typically accompanied by mention of one or another of the currently popular high-yield investment options. Invariably, my answer has been "Yes, but there's a tradeoff." While that tradeoff varies with each option to improve portfolio yield, there is *always* a tradeoff. The question in each instance is whether the improved yield is worth the tradeoff. Let me look at a few of the more popular approaches to improving yield and comment on the related tradeoffs.

In the bond arena, traditional methods of increasing yield involve either extending maturities or moving lower on the quality scale. We believe that the odds favor rising rather than falling interest rates in the months and quarters ahead. Rising rates would make long bonds the worst bonds to own. Since the early 1980's, investors have been blessed with largely declining interest rates, which have rewarded long bonds. Holders benefited from high coupons plus price increases as rates moved lower. Conversely, for more than four decades preceding the great bond market rally that began in the early 1980's, rising rates severely penalized bondholders, especially holders of long maturity bonds. Specifically, from the end of 1940 to the end of 1981, long U.S. Government bonds earned an average annual total return of just 2.2%. By contrast, risk-free short U.S. Treasury Bills produced a much higher 3.6% average annual return. Taking the obvious path of increasing yields by owning long bonds proved counterproductive for more than four consecutive decades. Unless a serious recession is approaching, which could keep yields low, we anticipate that rising interest rates will again create an environment in which, despite lower coupons, short fixed income securities will outperform their longer cousins.

We also hesitate to buy lower quality bonds. Because bond market confidence is currently so high, there is a relatively small spread between the yield on treasury issues and that of lower quality, but still investment grade bonds. If rates rise, we would expect that spread to grow and the lower quality issues to perform especially poorly.

At the extreme end of the bond quality spectrum reside high yield or “junk” bonds which have performed extremely well over the past two years. The advantage that these below investment grade bonds may have had two years ago, however, appears to have been fully realized. They appear far more vulnerable to any bond market correction than better quality paper. Historically, high yield bond price moves tend to be more closely related to stock market movements than to those of the bond market. Given our continuing cautious stance on equities, we do not believe that the potential reward in high yield bonds equals the risk of loss. In an era of extremely high debt burdens, we prefer to remain on the high quality end of the securities spectrum.

In the current environment of historically low dividend yields on common stocks, some investors have begun to explore the market sectors that provide relatively higher yield, like utilities or real estate investment trusts (REITs). The fact that both categories have been strong performers recently has added to their attractiveness. Let me look at each of these separately.

Utilities in the Dow Jones Utility Index are currently yielding 1.2% per year more than the thirty stocks in the Dow Jones Industrial Average. More often than not utility prices move in the same direction as those of industrials but on average a bit less aggressively. Over the long term, the total return on utilities has lagged the total return on industrials. While utility declines have also typically been more moderate, that has not always been true. For example, from high to low, the Dow Jones Utility Index declined by 60% in 2001-2002. An extra one or two percent in yield is small compensation if stocks are vulnerable to further decline in the year or two ahead, which we think likely.

Both mortgage and equity REITs have provided excellent returns through most of the tough markets of the past few years, attracting many new investors. Unfortunately, new investors can't buy past results. They have to buy tomorrow's results. It has almost always been dangerous to buy any asset after strong multi-year advances. Real estate has obviously benefited from the Federal Reserve's efforts to provide huge amounts of liquidity to the U.S. economy. Much of that liquidity has found a home in real estate. It will be far more difficult, however, for the Fed to keep the monetary spigots wide open in the years ahead. When REITs have corrected in the past, they have fallen hard. Weak periods have included 1973-74, 1987-90 and 1998-99, with declines having ranged from 21% to 65%. In our view, following their sustained recent rise, REITs are a risky bet over the next few years.

Some investors have chosen to improve their returns by purchasing guaranteed investment contracts. The current issue of *Barron's* shows the present returns on three, five and seven year contracts to be 3.3%, 4.0% and 4.4% respectively. These are in turn better than the yields on equivalent length Treasury securities by 70, 80 and 90 basis points. These are not especially attractive yields if interest rates are to move higher, and the yield advantage over more liquid securities is minimal. We would not be willing to sacrifice liquidity and the opportunity to make alternate decisions in a potentially changed environment for such a meager return.

Less than a year ago Warren Buffett was asked why he did not act to increase the yield on his Berkshire Hathaway portfolio. While he said it would be easy to increase that yield by a billion dollars a year, he believed such an action would be counterproductive. He disliked the prospects in both stocks and domestic bonds. He opined that junk bonds were no longer worth the risk. He counseled that occasionally there were times, such as the present, when the best advice he could offer was patience. We concur.

We believe that staying in short-term fixed income securities for now will prove more prudent than buying higher coupon longer-term notes or bonds, which would decline in price if interest rates rise. We continue to buy individual equities when they meet our valuation criteria. We anticipate being able to add far more substantial equity positions at lower prices in the months or quarters ahead. In the interim we might periodically add equity to the portfolio, in the form of exchange-traded funds that mimic the movement of the Standard & Poors 500 Stock Index, if market prices decline significantly enough over the short term. In anticipation of a temporary stock market rise, such a position would serve to increase our equity exposure if we had not yet added appreciably to our individual equity holdings.

Let me discuss a somewhat unusual investment situation that arose two weeks ago. Most of our portfolios held some Marsh & McLennan stock. On October 14, Eliot Spitzer, Attorney General of the State of New York, announced that he was bringing suit against Marsh & McLennan for what he characterized as a series of practices that unfairly damaged the company's clients. Spitzer's earlier actions against miscreants in the investment industry took a toll on the stocks of companies he prosecuted. As we watched Spitzer announce on television his intentions with regard to Marsh & McLennan and heard the aggressiveness of his rhetoric, we acted immediately to sell our entire Marsh & McLennan position at about 40½, despite the fact that it was already trading down about \$3 that day. (We normally attempt to sell on intermittent bounces.) Our reasoning was that the negative impact was unknowable but that it could be severe. We also surmised that a cloud could hang over the company for a long time. There was simply no way to know. As it turned out quick action saved money. The stock closed below 35 that day and below 23 a few days later. It has since bounced a bit to about 28. There are advantages to having an investment management team able to make decisions on the spot without waiting for the approval of an investment committee.

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