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Investment Outlook Third Quarter 2004

Dullsville may not be the actual name of a town in the United States but it is a great name to characterize the financial markets this year. All major stock and bond market indices are near break-even, trading volume has been tepid, and volatility has been near the lowest levels since the mid-1990s. The S&P 500 stock index has meandered within a narrow trading range between 1163 and 1076 over the past six months or less than 7% from bottom to top. This type of environment has been rare over the past twenty five years according to a recent Credit Suisse First Boston report indicating there have been only four periods in which the index was range-bound for longer. This trading pattern is indicative of an economy and financial market climate in transition. After surging to the strongest economic growth in two decades during last year's second half, economic activity has recently showed signs of cooling to a more sustainable rate. Similarly, corporate earnings, having surged to their highest level as a percentage of GDP since the end of World War II, are now beginning to slow. In addition, the economy is shifting from being driven by short term influences (fiscal and monetary stimulus) to long term drivers (employment and income growth).

The biggest events in the second quarter occurred at the end of the quarter when the Federal Reserve Bank announced a much anticipated increase in the Fed Funds rate by 25 basis points and sovereignty was returned to the Iraqi people. As we look ahead to the implications these and other events will have on the economy and financial markets, it may be instructive to put in context the positive and negative influences currently affecting the markets. Much attention has surrounded the strengthening economy and rising pressures on energy prices, inflation and interest rates. The Fed has signaled in its message released at the conclusion of the last two meetings that they were prepared to raise rates at a measured pace consistent with the pace of economic activity and the demand for capital. In our view, the most serious inflation pressures are most likely transitory in nature and will probably abate within several quarters. With the rate of economic activity beginning to ease in the US and China and interest rates beginning to rise, the threat of escalating inflation will likely ease in the upcoming quarters. Another key economic driver for the US economy has been the housing market. With interest rates rising, a legitimate question is how serious the housing market will be hurt? The answer is still not entirely clear, but we are not in the camp that suggests there is a serious housing bubble within the US. Housing prices within the US have not outpaced those in other developed countries during the past decade and our demographic composition will likely soften any price or sales declines. On the other hand, geopolitical risk continues to weigh on investor psyches and is expected to remain as a cloud perhaps for a number of decades, similar to the way the Cold War affected our society for 3 decades.

Consumer and business confidence remains solidly positive, retail sales have moderated but continue robust and household net worth has rebounded to record levels after declining for three years. With employment and household income trends rising rapidly, virtually all evidence points to an economy that is now on a sustainable and normal growth path. As the markets adjust to moderating economic

trends, sector rotation is a typical part of the adjustment process. We expect this process to continue throughout the summer months and new market leadership to reveal itself as we head toward year-end. Historically, at this stage of a market cycle, more consistent growth sectors such as consumer staples, healthcare, media, and business services typically perform relatively well. The focus of our equity research has been tuned to these areas for the last few months and we expect new investments to come largely from these sectors. We are still hesitant to invest in intermediate or long-term bonds in the current environment as we continue to expect market interest rates to rise to more attractive levels sometime in the next twelve months. In the interim, we plan to maintain our policy of allowing bond maturities to sit in short-term fixed income instruments.

We have fielded a number of client inquiries concerning the potential impact of the November elections. In order to address this important issue, we intend to dedicate the rest of this quarter's outlook to the upcoming elections. Neither President Bush nor Senator Kerry has held a decisive lead in the 2004 presidential election polls at any point since Kerry became the Democratic frontrunner. Kerry's selection of fellow Senator John Edwards as running mate and the upcoming Democratic convention could push the polls in his direction, due in large part to the increased attention the pair will get in the media. However, if history is any guide, the "bump" in public opinion shouldn't last long. The momentum likely will fade after the Democratic convention, which takes place July 26-29 in Boston, if not before.. There are two distinct questions related to the Edwards selection: First, whether he significantly increases Kerry's chances of being elected, and second, whether his presence in a Kerry Administration would affect policy to any great degree. Edwards may provide a marginal benefit to the Kerry campaign in certain states, and could perform well in debates and public appearances. If elected, he may have a small impact on policy, but in many areas his positions are indistinguishable from Kerry's.

Kerry's choice of Edwards has been perceived negatively by investors for companies in the pharmaceutical, managed care, property/casualty insurance and student loan industries, among others. In addition, in boosting enthusiasm among southern Democratic voters through the Edwards choice, Kerry may also help prevent losses among 5 open Democratically-held Senate seats (in Edward's birth state of South Carolina and home state of North Carolina, as well as in Georgia, Florida and Louisiana). With competitive races already emerging for GOP-held open seats in Colorado and Oklahoma (on top of seriously-at-risk seats in Arkansas and Illinois), the possibility of Democrats retaking Senate control has climbed. Based upon expectations of a tight Presidential election and rising odds of Democrats retaking Senate control, the investment community has red flags on industry sectors favored by Bush policies including autos, retail, credit cards, brokers, energy, tobacco, IT outsourcers, and defense. In reality, the electorate doesn't seriously focus on elections until two months prior to Election Day. Any poll results published prior to mid-September should be analyzed with caution. With this in mind, we will re-address this important topic with updated data in our next letter. In the mean-time, please accept our best wishes for an enjoyable summer.