April 22, 2004

ONE YEAR LATER

Executive Summary

The Economy -- Since the start of the war with Iraq, the U.S. economy has improved significantly, aided by tax cuts and low interest rates. The biggest disappointment has been the meager creation of new jobs. Higher than average economic growth of 4%-4.5% is forecast for 2004, along with better growth in employment and rising interest rates.

The Financial Markets -- Stock prices rallied sharply over the past year due to a rebound in corporate earnings and improved investor confidence. Short-term interest rates have declined in the past year, but intermediate and long-term rates have started to climb. A study of past periods of Federal Reserve tightening reveals that on average, stocks are not adversely affected until after the Fed has increased interest rates for the third time. However, certain interest-rate sensitive sectors may face a headwind in 2004.

Politics -- At the current time, it appears that President Bush and John Kerry are neck and neck in the polls. Historically, there is no significant correlation between stock market returns and the party in the White House. Kerry's themes include a rollback of tax cuts for the wealthy, expanded health benefits for the poor and elderly, lower drug prices, energy independence, penalties for outsourcing jobs, and broader world support in Iraq. Control of the Senate and House and budgetary and political realities will most likely constrain the agenda regardless of who wins the election.

Investment Strategy -- We continue to believe that equities represent better value at current prices than bonds. However, due to an expected deceleration of earnings growth and current relative valuations, we plan to gradually become more defensive in our portfolios by increasing commitments to companies in the consumer staples, healthcare, and energy sectors and to reduce commitments in the information technology, cyclical and interest-sensitive sectors.

First Anniversary of the Iraqi War

It has been a little over a year since U.S.-led coalition forces stormed into Iraq and toppled Saddam Hussein's regime. We thought it might be useful to review what has changed in the past year in order to help put the current financial market environment into perspective. The beginning of the war also coincided with the stock market lows during 2003. The Standard & Poor's 500 Average recorded its lowest closing price on March 11, 2003, just days before the coalition forces entered Iraq on March 20, 2003. We have organized our review into three basic categories: the economy, financial markets, and politics.

The Economy

It is clear that the U.S. economy has improved significantly over the past year. Growth in real Gross Domestic Product (GDP) has accelerated from a 1.4% annual rate in the fourth quarter of 2002 to a 4.1% annual rate in the fourth quarter of 2003. Other economic statistics are presented in Exhibit A. Aided by tax cuts and the lowest interest rates in 45 years, consumers went on a spending spree. Low mortgage rates kept housing starts at record levels, and the refinancing of existing mortgages increased spendable income. Rising revenues and huge gains in productivity enabled businesses to significantly increase earnings. The combination of improved cash flow and investment tax incentives contributed to higher expenditures on capital investments as the year progressed. Inflation has remained at very low levels due to excess capacity and limited pricing power in many industries. However, the consumer price index jumped up in March, 2004, to 0.5% (6% annualized) with the core rate (which excludes energy and food prices) increasing 0.4% (4.8% annualized). We will be closely watching to see if the March statistic was an aberration or the beginning of a new trend. Rapid economic growth in China and India has contributed to strong increases in the prices of many commodities, and there is a risk that this could cause inflationary pressures at the consumer level. A year ago the Federal Reserve was more concerned about deflation, but now it appears that the Fed will be refocusing its attention on constraining inflation.

One of the biggest disappointments for this 2001-2004 economic recovery was the anemic growth in total employment. While initial claims for unemployment insurance have steadily declined, new jobs created have averaged below 100,000 per month and well below the 200,000 per month that economists estimate are needed to absorb the new entries into the job market. However, new jobs jumped in March to 308,000, and hopefully this is an indication that job growth will continue to improve during 2004.

Another disappointment for investors has been the expanding federal budget deficit. A combination of expenditures for the occupation of Iraq and Afghanistan and foregone short-term revenue collections due to reductions in marginal income tax rates have caused the federal budget deficit to increase to over $500 billion estimated for 2004. In the short-term, we do not believe that this deficit creates a problem, and, in fact, the shortfall of revenue to expenses was necessary to combat terrorism and to spur the economy to a sustainable recovery. However, in the long term, we believe that these budget deficits will need to be reduced through restrained spending and/or higher collections due to greater levels of economic activity and employment.

All of the foregoing factors and conditions can be summarized in Exhibit A below:

Exhibit A

Comparison of Selected Economic Statistics

	03/11/03	04/16/04
Prior quarter GDP growth	1.4%	4.1%
Recent monthly retail sales (year-to-year)	5.3%	8.2%
Housing starts (thousands)	1,742	2,007
Industrial production (year-to-year)	0.5%	3.4%
Capacity utilization	74.8%	75.2%
Initial unemployment claims	419,250	360,000
New jobs	-108,000	308,000
Unemployment rate	5.8%	5.7%
Consumer confidence (Conference Board)	61.4%	88.3%
Consumer price index (year-to-year)	2.4%	1.7%
Oil price ($/barrel)	$36.72	$37.72
Scrap steel price ($/ton)	$107.33	$252.50
Aluminum price (cents/pound)	$0.638	$0.801

Looking ahead to 2004, economists forecast that the U.S. GDP should continue to grow at an above average rate of 4%-4.5%. A rise in interest rates could restrain some consumer expenditures in interest sensitive purchases such as housing and autos, but expanding employment and growth in capital spending are expected to pick up the slack in those areas. The low value of the dollar and strong demand from rapidly growing Asian countries should continue to benefit American producers of raw materials and capital equipment. Certain tax benefits also expire at the end this year, which should stimulate business investment in the U.S. during the balance of 2004. Finally, the fiscal policy of the federal government remains very stimulative with a projected budget deficit of over $500 billion. One area of concern is the high price of petroleum. If gasoline prices remain well above year ago levels, consumer spending could be constrained more than expected.

The Financial Markets

The improvement in the economy and initial success in the war with Iraq encouraged investors to buy stocks during the past 12 months. Measured from the closing low on March 11, 2003, the Standard & Poor’s 500 Average has increased over 40%. We present financial market statistics from March 11, 2003 and April 16, 2004 in Exhibit B.

Exhibit B

Selected Interest Rate and Stock Market Statistics

	03/11/03	04/16/04	Change
Federal Funds	1.19%	1.00%	-0.19
90-Day Treasury Bills	1.06%	0.91%	-0.15
Bank Prime Rate	4.25%	4.00%	-0.25
5-Year Treasury Note	2.51%	3.37%	+0.86
10-Yeat Treasury Note	3.58%	4.34%	+0.76
30-Year Treasury Bond	4.64%	5.17%	+0.53
30-Year Mortgage	5.14%	5.59%	+0.45
Bond Buyer Municipal Index	4.88%	5.03%	+0.15
Standard & Poor's 500	800.73	1134.61	+41.7%
Trailing 12-month earnings	$48.13	$55.55	+15.4%
Price/earnings on trailing earnings	16.6X	20.4X	
Forward 12-month earnings	$55.55	$61.25	+10.3%
Price/earnings on forward earnings	14.4X	18.5X	
Indicated annual dividend	$15.69	$18.24	+16.3%
Current dividend yield	2.0%	1.6%	

Source: Baseline

It is interesting to note that the yield curve has steepened during this period with short-term yields declining and long-term yields increasing. Much of the increase in long-term rates occurred in the past month as investors reacted to strong increases in employment, retail sales, and the consumer price index. If the economy continues to exhibit strong growth, we would expect the Fed to nudge short-term rates higher over the remainder of the year.

While stock prices have increased sharply off their lows, we believe they are not over-valued relative to current interest rates. At least half of the increase in prices can be attributed to increases in earnings. Operating earnings per share on the S&P 500 increased 15% in 2003 and are expected to increase about 10% in 2004 and 9% in 2005. The remaining price appreciation can be attributed to significant improvement in investor confidence from lows surrounding the evasion of Iraq and the struggling economy one year ago.

We believe that the anticipated increases in interest rates should not adversely impact the stock market in 2004. A study by Ned Davis Research of the Dow Jones Industrial Average during past periods of Federal Reserve tightening since 1917 indicates that on average, stock prices were up 8% one year after the first increase in the Fed's target short-term rate. A year after the second rate increase, it shows an average rise of 3%, and a year after a third increase, a 3% increase in stock prices. Only after a fourth rate increase does the Dow tend to be down one year later. Of course individual cases vary, but generally in the past, the positives of an improving economy and higher corporate profits have trumped the potentially negative reaction to rising interest rates, at least in the early stages of Fed tightening. We also believe that stock prices are not immediately endangered by increases in long-term rates. Based on the Federal Reserve's model, the rate on the 10-year Treasury could increase over 100 basis points (1.0 percentage point) to 5.40% before it would signal that the Standard & Poor's 500 Index, at 18.5 times the 2004 earnings estimate, is overvalued.

While we expect that the anticipated rise in interest rates shouldn't adversely affect the stock market as a whole, we believe it may have a different impact on the various sectors. Sectors such as homebuilding, autos, financials, utilities, and Real Estate Investment Trusts (REIT's), that benefited from the declining interest rate environment during the past several years may now face a headwind as interest rates climb higher. However, economically sensitive sectors such as materials and industrials, as well as energy, may continue to benefit from strong worldwide demand for raw materials and industrial equipment.

Politics

One big difference between today and one year ago is that 2004 is a Presidential election year. President Bush enjoyed strong support a year ago as Americans rallied around him in the aftermath of 9/11 and the early successes in the invasion of Iraq. However, the recent increase in terrorist attacks in Iraq, Israel, and Spain and criticism of the Administration in the Clarke and Woodward books have eroded support for the President. In addition, Democrats have leveled criticism at President Bush during their campaign for the White House. The weakness in the job market has also hurt the President. However, if the March employment report is the beginning of a new hiring trend, this may help the President. Recent polls have suggested that the race between President Bush and John Kerry is very close.

We have been trying to determine what a Kerry victory in November would do to the financial markets. Of course, Republicans would tell you it would be a disaster, and Democrats would tell you the opposite. The reality is that historically, there is no significant correlation between bull markets and the party in the White House. However, the markets don't like change because it increases uncertainty. Generally, investors prefer the devil they know versus the devil they don't. Thus, signs that John Kerry may win the election could temporary weigh down on the stock market. As far as determining what agenda a Kerry Administration would push if he won the Presidency, we only have some clues based on his recent campaign speeches and his voting record in the Senate. He has indicated that he wants to raise taxes on the wealthiest taxpayers. We would expect that the reductions in the taxes passed under President Bush on personal income, estates, capital gains, and dividends would all be at risk. This would be disappointing to investors, but we doubt that it would significantly reduce economic growth, now that the economy appears to have sustainable growth. In fact, President Bush, if re-elected, may also have to let some of the tax breaks lapse (most of the tax cuts that were passed are scheduled to terminate between 2005 and 2011) in order to reduce future federal budget deficits.

John Kerry has also criticized the drug companies and has indicated he wants to lower drug prices and provide broader drug benefits to retired citizens. It is not clear how he would accomplish this, but it could involve price controls on drugs, which could adversely affect drug company profits. He has also criticized the energy companies and indicated he wants to reduce our dependence on foreign oil. However, it is also not clear how he would accomplish this goal, but it could be through a combination of price controls, taxes on energy consumption, or tax incentives for energy alternatives such as ethanol. This may have a favorable or unfavorable impact on the petroleum and electrical generation industries, depending on how the laws are written. He has also criticized American companies that outsource jobs to foreign countries. He may try to use the tax code and bidding on federal projects as levers to discourage outsourcing. Kerry will probably be a stronger advocate for enforcing environmental regulations.

What John Kerry would do in the area of foreign policy is also unclear. He supported the war in Iraq originally, but he voted against the last appropriations bill to fund the occupation. He says he would try to get more support from the United Nations and other countries for our military and rebuilding efforts in Iraq and Afghanistan. It is not clear how he would deal with future terrorist threats. How well he addresses these issues in the coming months will likely have a material impact on his chances in winning in November. The other factor is that politicians have often said one thing during an election campaign and then changed their mind once they are elected and are forced to bend to political and budgetary realities.

Of course, the President can only get new legislation passed with the cooperation of the Congress. Thus, the Senate and House of Representatives races are probably as important as the Presidential election. Even if President Bush is re-elected, if the Republicans lose control of the Senate and/or House, he will likely face more legislative gridlock in his second term. Similarly, if John Kerry is elected President but the Republicans retain control of the Senate and/or House, he will be limited in his ability to control the political agenda.

First Quarter Earnings

Companies have just begun reporting their results for the first quarter of 2004, and analysts are expecting strong gains in most cases. The companies in the S&P 500 Index are expected to report a 19% average earnings increase in the first quarter over the first quarter of 2003. This represents a slight deceleration from the 23% increase in the fourth quarter, but it still indicates a very robust rate of growth. A summary of some of our portfolio companies that have already reported is presented in Exhibit C.

Exhibit C

First Quarter Earnings of Selected Companies

Company Name	Actual EPS	EPS Est.	Q1 EPS 2003	% Chg. 04 Vs 03
Alcoa	0.37	0.41	0.23	61%
Altria	1.16	1.13	1.07	8%
Amgen	0.57	0.56	0.42	26%
Apache	1.06	1.05	0.97	8%
Automatic Data Processing	0.50	0.50	0.54	-8%
Bank of America	1.99	1.80	1.59	25%
Best Buy	1.42	1.39	1.16	22%
Capital One Financial	1.84	1.53	1.35	27%
Cardinal Health	0.99	0.99	0.86	13%
Colgate Palmolive	0.59	0.59	0.56	5%
ConAgra Foods	0.39	0.38	0.31	26%
eBay	0.31	0.26	0.18	42%
EMC	0.07	0.06	0.02	250%
First Data	0.44	0.44	0.38	14%
Fiserv	0.47	0.44	0.38	19%
Gannett	1.00	1.00	0.93	8%
General Electric	0.32	0.32	0.32	0%
Intel	0.26	0.27	0.14	86%
Johnson & Johnson	0.83	0.80	0.69	20%
Marsh & McLennan	0.94	0.91	0.81	14%
Microsoft	0.34	0.29	0.27	26%
Morgan Stanley	1.11	0.96	0.82	35%
Nokia ADR	0.22	0.22	0.19	16%
PepsiCo	0.46	0.46	0.39	18%
Pfizer	0.52	0.51	0.45	16%
Qualcomm	0.53	0.48	0.38	28%
State Street	0.67	0.66	0.44	52%
U.S. Bancorp	0.52	0.51	0.47	10%
Wells Fargo	1.03	0.98	0.88	15%

Source: Baseline

Investment Strategy

We believe the U.S. economy will continue to expand at a higher than average 4%-4.5% annual rate and that interest rates will gradually increase during the year. We believe the yield on the 10-year Treasury could reach 4.75%-5.25% by year-end compared to 4.34% currently. We continue to believe that equities offer better value at current prices than bonds. We do not expect the anticipated initial increases in interest rates to adversely affect stock prices in 2003. We expect strong economic growth to benefit the earnings of companies in the industrial, materials, and energy sectors. However, the rate of earnings growth is expected to decelerate as the year progresses. As a result, we plan to gradually transition portfolios to a more defensive posture during the year by reducing commitments to information technology and cyclical stocks and increasing commitments to companies in the consumer staples and healthcare sectors. Many of the companies in the consumer staples and healthcare sectors lagged the market in 2003 and currently offer attractive valuations and competitive growth rates. However, we believe that rising interest rates could create a headwind for some of the companies in the consumer discretionary (housing and auto), financial, utility and REIT sectors. We expect the stock market to remain volatile due to hostilities in the Middle East, potential terrorist attacks, and the political dynamics of the Presidential campaign. Given this uncertain environment and the significant gains in stocks during the past 12 months, we believe that a temporary market correction of 10%-20% could occur sometime in 2004.

Edson L. Bridges II, CFA
Edson L. Bridges III, CFA
Randall D. Greer, CFA
Brian M. Kirkpatrick, CFA
Douglas R. Plahn, CFA