STRATEGIES, TRENDS AND NEWS FOR TODAY'S INVESTORS Autumn 2003

LUMBARD INVESTMENT COUNSELING

INSIGHT

Nasdaq Composite 1,770.65 * Dow Jones Industrial 9,340.45 * 30 year U.S. Treasury bond 5.28%

WYSIWYG

What You See Is What You Get. All over the country investors have been asking, "When will the economy recover?" But the truth is that the economy *has* recovered. This *is* the recovery. Our (true) growth rate isn't much better than 2%, and the job market remains poor. But that's all you can expect in the years that follow an economic bubble.

Everybody knows that the first few weeks of the new millennium marked the peak of the largest stock-market bubble in history. But the dawn of the millennium was also the peak of an economic bubble that was fueled by debt. Consumers were borrowing and spending, and corporations were doing the same. The 6% growth of the economy wasn't so much the result of productivity gains as the result of turbocharged spending—and an unprecedented accumulation of debt.

Paul Wright of our investment advisory board points out that the business cycle is all about the expansion and contraction of debt. Every time the economy recovers from recession, it's because consumers begin to borrow (at very low interest rates) and spend beyond their incomes to buy houses and furniture and appliances and automobiles. Once the train is rolling, we're *supposed* to start saving and investing. During the last expansion—the Gay Nineties—we never stopped borrowing and spending, and now we're paying the piper.

The United States is a large, wealthy nation with a mature economy. For us, 3% growth is quite good, and 4% is unusually good. When you see numbers above 6% you know that something strange or wonderful is happening, and in 1999 Alan Greenspan decided to believe that it was something wonderful. He held interest rates down at a time when everybody—consumers, Fortune 500 companies, kooky little Internet startups, non-profit organizations, and hot dog stands—all were borrowing to beat the band. The result was a bubble in economic growth, and a bubble in the stock market. And a bubble in the value of the dollar, and a very strong real estate market.

Today, Greenspan is printing money like mad, and reinflating some of the bubbles that burst at the start of the millennium. If the economy recovers strongly, he'll stop printing money; which means that interest rates will rise and consumers will stop borrowing. The Congress might also tighten up its big budget deficit, by cutting spending or raising taxes—presumably taxes on consumption.

Congress has already acted to favor savings over consumption, by passing the new tax law. But that was an easy step, and if they don't act further foreign investors will do the job for them; because foreign loans to Americans have been growing at an impossible rate. Either consumers will back off voluntarily, or the Fed will raise rates and force them to back off, or the Congress will raise consumption taxes, or foreigners will refuse to supply $40 billion a month in new loans.

Sluggish but consistent growth looks much more attractive than the alternatives. Corporate

continued on page 2

> **"Will you seize this rare second chance to get rich in tech stocks?"**
>
> – An advertising flyer for a newsletter

WYSIWYG... *(continued from page 1)*

earnings should rise, but at a pace that disappoints the bulls of Wall Street. And those earnings will be rising from a base that's quite a bit lower than the bulls like to believe. According to David Bianco, CFA, head of the US Accounting Research Group at UBS Warburg, earnings for 2002 (as tallied by Wall Street) were overstated by almost 70%. Stock-option grants, special charges, overly-rosy pension assumptions . . . . today's accounting standards are still more Optimistic than Truthful. And, once again, any increased economic strength will cause a further increase in interest rates. Investors should keep some powder dry for the terrific bargains that are sure to be seen in the months ahead.

SELL HIGH
BUY LOW,

Here's a key point. The market's moves will be surprising in the months ahead. Before you have time to respond "Well, DUH!!" let us hasten to say that the market will ignore all the statistics about strong months and weak months of the year. It will make a mockery of the 50 day, 200 day, and 69.5 day moving averages. It will confound Fibonacci retracements and blast through Bollinger bands. Stocks with rising momentum will fall, and those with downside momentum will rise.

There is a great deal of information in stock prices. People with inside information or astute observations are quick to bet on their beliefs, and the result is that stocks anticipate changes in corporate earnings or the economy better than almost anything else. But for all their power in predicting the future, the one thing that stock prices cannot tell you is the future course of stock prices themselves. "Strength" and momentum indicators work only when the herd of investors following these indicators is expanding. As soon as their herd begins to dwindle the indicators will fail, just as surely as technology stocks began to decline the moment that the herd of tech investors stopped growing in March of 2000.

Avoid stocks that are rising strongly, and—most important—don't sell anything just because it's falling. Buy low, and sell high.

LETTERS TO THE EDITOR

To the editor:

That piece you wrote about CEOs was pure rubbish. I know a lot of CEOs, and practically all of them are handsome, articulate guys. Their shareholders should thank their lucky stars to have them—at any price.

— Sincerely, Dennis Kozlowski

Mr. Lumbard;

I can't believe you said that $5 million is excessive compensation for a chief executive officer. We're talking about the captains of industry here. Shaquille O'Neal makes five times that, and he's just a basketball player. I used to play some round ball when I was younger, and I was damn good, too. But now I'm a grown up, with grown up responsibilities. I carry the weight of the world on my shoulders, and I expect to get paid for it.

— Bernie Ebbers

Editor;

CEO union? what CEO union? There's no such thing. You're just another pissant shareholder taking cheap potshots at anybody who is living large.

— Sincerely, Richard ("Rich" beyond your wildest dreams, sucker) Scrushy

Dear John,

How many wrongs *does* it take to make a right?

— Thank you, Joe Naccio

GOING GLOBAL

As we noted on page one, the growth of the late 1990s was driven by turbocharged borrowing and turbocharged consumer spending. The boom offered corporations a great opportunity to strengthen their balance sheets, but they instead chose to spend and borrow, and individuals did the same. Today corporations and consumers are trying to straighten out their finances, so the Federal government has stepped in to borrow and spend and keep the economy rolling.

The debt level that counts is the one that we owe to foreigners. Just three or four years ago we were collecting more interest and dividends from overseas than we paid out to foreigners, but today *we're* paying *them* almost $25 billion a year. And it's headed in the wrong direction at an impressive rate that is driven by our trade deficit, which now routinely tops $40 billion in a month, or $500 billion a year.

Bizarre imbalances rarely persist for long. Already we've seen the U.S. dollar fall against the euro, and the only reason it hasn't fallen against all currencies is that so many of the other alternatives are countries whose economies are built around exports to the U.S.

There is an absurd, unsustainable difference between the production costs for developing-nation manufacturers and the costs for American manufacturers. If it seems strange that everything in Wal-Mart is made in China, that's because it *is* strange (remember when Wal Mart wrapped itself in the "made in America" flag?). In the long run there is no way that we can pay for all these goods by selling engineering services and movies and music and airplanes to Chinese citizens.

Foreigners now hold more than a trillion dollars' worth of U.S. Treasury securities.

The decline of the dollar is one of the clearest and easiest trends in investing today. The way to participate is to purchase foreign bonds or foreign bond funds, because you'll earn a good interest rate while you wait for the currencies to appreciate.

You might also find some stocks to buy. We purchased shares of Korea Electric Power at an incredibly low price that was made possible by the government's inability to sell part of its 53% stake. The company offers the stodginess that one would like to see in an electric utility, but it operates in a country where electric power consumption is growing at better than 10% a year. The shares can be purchased on the New York Stock Exchange, and they're even covered by Value Line, the low-rent but fully-independent (no investment banking!) research service.

It's probably true that this is the Asian Century, but another good theme is American manufacturing stocks. Any company that has managed to keep an American factory alive during the disastrous conditions of the last five years is sure to benefit, both in its home market and abroad, as the dollar declines. In the same way, farmers should benefit enormously from rising prices for grain and beans. We keep looking for a farmland trust, or perhaps a farm-equipment company with a good dividend. We'll be happy to hear your suggestions.

"***Be Particular.*** That is, without a doubt, the Best Advice Ever Given in the History of the Entire World. Consider, if you will, the profound effect that following this advice would have on, say, your diet, your love life, your financial situation, your decision on whether to have the next drink. I mean, what do those two words not cover?"

– Jill Conner Browne, The Sweet Potato Queens' Book of Love

NUTS AND BOLTS

Fees, Custody, and Minimums at Lumbard Investment Counseling

Lumbard Investment Counseling is a traditional, value-oriented investment management firm with a global outlook. Our client accounts, which are held in the names of our clients, enjoyed solid growth in each of the last three years. The complete 13-year record can be found at www.lumbard.com; please note that our custodian banks have not measured all accounts, but only those larger than $550,000. And the figures need to be adjusted downward to reflect the impact of our fees, which vary according to the size of the account.

Happily, the effect of fees can be seen in the performance of a small account that joined us several months after we launched this firm. In October of 1990 the account was valued at $100,000, and since then it has always paid a 1% fee. There have been no other additions or withdrawals. This "growth" portfolio, and other euro-bond-laden accounts like it, significantly under-performed our measured accounts in 1999 and early 2000, but also rebounded more quickly. On July 31, 2003 it was valued at $296,859, up from $268,904 at the end of 2002.

Today, our minimum for new accounts is $400,000. Our annual fee for the first $500,000 in assets is 1.1%; it declines to 0.85% for the next $500,000, and 0.7% for the second million. The fee on assets above $2 million is one-half of 1%. Unlike other advisers, we pay the cost of custody at U.S. Bank and our other custodial banks. If you would like further details, please call (800) LUMBARD (*Not 800-Lombard !!*), and ask Jan for an information kit. You might also want to ask for our soporific SEC form ADV Part II; the regulations say you're supposed to make a *written* request, but we'll send you one anyway.

John Lumbard, CFA

Photo by Rick Balboni

" . . . . . it's impossible to boot a negligent board. The typical American corporation is a shareholders' republic in the same way that China is a people's republic."

— *James Surowiecki, The New Yorker*

TECO

The recent East-Coast blackout has many investors looking for ways to benefit from the coming increase in spending on electric transmission and generation. In this sort of situation you have to move very quickly—within minutes—to make money on the obvious stocks, but there are less-obvious beneficiaries. We have shares of TECO Energy, a Tampa-based utility which struggled to complete two huge new natural-gas-fired plants in Arizona and Arkansas. If they can find a way to sell all the power produced by those plants, the stock will double. The combination of a recovering economy and a national program of electric infrastructure investment might just do the trick.

"Judging by its press coverage, the euro is one of the least loved successes of modern times. Four years ago, the single European currency was said to have failed because it was falling. But now it is supposed to be failing because it is rising . . . "

— *The Wall Street Journal 5/14/03*

THE NEW TAX LAW: RETHINKING TAX-ADVANTAGED ACCOUNTS

by Sherrill St. Germain

With the passage of the new tax law on May 28, investors have been asking: "How do I take best advantage of the tax cuts to help me reach my retirement, college funding, and other goals?"

FIRST, THE FACTS:

- The tax rate on long-term capital gains has been reduced from 20% to 15% for taxpayers in the top 4 brackets. It is just 5% (0% in 2008!) for those in the two lowest brackets. *Note: These rates do not apply to gains on the sale of collectibles, or to unrecaptured Section 1250 gain.*
- For taxpayers who favor dividend-paying stocks (other than REITs and some foreign companies), the news is even better. Previously taxed as ordinary income (maximum rate 35%), dividends on shares meeting the required holding period are now taxed at long-term capital gains rates.
- The rates expire in 2008 unless Congress extends them.

So should investors abandon 401Ks, IRAs, 529s, etc., in favor of less restrictive taxable accounts, now that the cost of doing so is substantially lower? It depends. Investors close to retirement might be better off paying 15% on earnings from taxable accounts now (vs. up to 35% on retirement plan distributions a few years out) and preserving the option to harvest capital losses. For younger investors, especially those with employer matching, the benefits of tax deferral over many years should more than compensate for higher rates at distribution time.

With their federal and (usually) state income tax-free treatment of earnings and high contribution limits, Section 529 plans remain an important college savings vehicle. For more flexibility of investment choices and use of the money, use a Roth IRA as well, if eligible. Also, if you'll be selling assets to pay college bills, consider gifting the assets to a child who qualifies for the 5% capital gains rate. (Watch gift tax and college financial aid eligibility!) With rates unlikely to ever be lower, this might be a great time to sell long-held assets regardless.

No matter what choices you make, you'll want to place "tax-inefficient" investments such as REITS and high-yield bonds into tax-advantaged accounts. Assets which qualify for the lower rates (such as common stocks) should be held in taxable accounts.

With all of its nuances, limitations, and interdependencies, income tax planning is usually best addressed on a case-by-case basis. Today, the difficulties are magnified by the enormous uncertainty about future tax rates; 5 years from now, 10 years from now, and far beyond. As with investing, a bit of diversification – i.e. using a combination of tax-advantaged and taxable accounts – can mitigate the impact of an unfavorable tax change.

With apologies to Ben Franklin, nothing is certain except death and taxes… and, as recent history has shown, changes to the tax code.

Sherrill St. Germain, a fee-only financial planner, is a resident of Hollis. She is not affiliated with Lumbard Investment Counseling. The term "fee only" means that she charges an hourly fee (at a $100 rate) for services; thus, her advice is not tainted by the receipt of commissions for the sale of insurance or mutual funds.

The pay of the average CEO is now 190 times the pay of the average hourly worker, up from 42 times in 1980. According to Mercer Human Resource Consulting, which surveyed 350 major U.S. companies, the total direct compensation for chief executives rose 2.2% in 2002, to a median of $6,100,000.

That's because they did such a bang-up job last year.

If we fired the CEO and offered the job to a middle manager at $600,000, would we really be worse off?

EXTERNALITIES

Oil. *Black Gold*. Nations lust after oil reserves, but their real-world experience is like a horror from an old movie. The treasure carries a curse that corrupts and destroys everyone who possesses it. Look at the nations that export oil; Nigeria, the Congo, Angola, Russia, Venezuela, Iran, Iraq, Syria . . . . apart from a few tiny nations that are absolutely swimming in oil, you can make a blanket statement that all oil-exporting nations suffer poverty and poor economic growth. In contrast, the poor, barren, destitute nations that are forced to import all their oil include Taiwan, Singapore, Korea, Japan, and Switzerland.

Oil revenues push up a nation's currency, crowd out exports, and crowd out internal economic development. The oil nations also have routinely suffered tyrants, corruption, and loss of the freedoms that we take for granted here in the United States.

"We are drowning in the devil's excrement"

– Juan Pablo Perez Alfonso, former Venezuelan oil minister, describing the value of crude oil.

Few of these problems affect the United States—the world's second-biggest oil producer—but it's still utterly foolish to accelerate U.S. oil production when we have such small reserves. Oil security means having oil in the ground, ready for emergencies; it does not mean having oil production which sucks our underground reservoirs dry. We should end all subsidies for domestic production, and import all that we can while the price is low.

That price will go even lower when Iraqi production ramps up, because the nation has staggering reserves—some 100 billion barrels, or 10% of all the oil in the world. But in times of turmoil the price of oil will rise sharply, and in the long term the demand from China and India will push the price inexorably higher.

Today, the price of gasoline is at an artificially low level. If you include the cost of military expenditures earmarked for the Persian Gulf, the total cost of the oil we buy is somewhere around $100 a barrel. Amory Lovins, CEO of the Rocky Mountain Institute, figures that the true price of gasoline is well over $3 per gallon, even before figuring in the cost of air and water pollution.

To economists, pollution and the cost of maintaining troops in the Persian Gulf are "externalities"; costs that are borne by someone other than the consumer making a decision to purchase gasoline. If you don't increase the price of a commodity to reflect externalities, the market will be distorted; and consumers will buy more than they should. Unlucky bystanders will bear the costs of pollution and noise and ATVs creating holes in their lawns—and bear the cost of the income taxes that pay for our increased military expenditures.

We're using income taxes to subsidize gasoline purchases.

Higher gas taxes would mean lower consumption. A mere 10% reduction in oil consumption would eliminate half of our imports from the Persian Gulf. And our experience from the 1980s shows that we can easily achieve that reduction. According to Lovins, from 1977 to 1985 our GDP rose 27% even as oil use *fell* 17%. During that time our net oil imports fell 42%, and imports from the Persian Gulf fell 87%.

Increased gas taxes would hasten the arrival of the Next Big Thing in automobiles. Everybody likes to talk about fuel cells, but the hybrid drive systems appearing—now!!—in cars from Toyota and Honda offer more power, better handling, lower repair costs, and vastly improved energy efficiency.

If one third of our nation's cars were hybrid-electric, all Persian Gulf imports would cease. That might happen without any change in the market-distorting way we collect our taxes. But as long as the dirt-cheap price of gasoline does not include all the hidden costs, rational consumers will make irrational decisions about its use.

John Lumbard, CFA

Performance Results:

The performance results presented below are for our "Benchmark Account", using January 1, 1998 as the date of inception. The performance results for the Benchmark Account are calculated by Lumbard & Kellner, LLC's current custodian, U.S. Bank (prior to 2004 State Street was the custodian). The account pays fees based on our firm's fee schedule from the 1990s (top rate of 1%), and the percentages shown are net of fees and expenses—that is, the returns shown would have been higher if fees had not been deducted. The performance results for the Benchmark Account include the reinvestment of dividends and other earnings, but there have not been any other additions or withdrawals since inception. The comparative indexes shown are the S&P 500 Composite Index, Dow Jones Industrial Average, NASDAQ Composite, Barclays U.S. Aggregate Bond Index, and the Citigroup 3 Mo T-Bill Index.

Actual returns for individual client portfolios managed by Lumbard & Kellner, LLC may vary and will not necessarily coincide exactly with the returns for the "Benchmark Account." Past performance of the "Benchmark Account" does not guarantee future results. No assurances or guarantees can be given or implied concerning future investment results for Lumbard & Kellner, LLC or any investment index. Future returns may differ significantly from the past due to materially different economic and market conditions and other factors. Investments within portfolios, and therefore, portfolios, involve risk and the possibility of loss, including a permanent loss of principal.

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