

LUMBAR D
INVESTMENT
COUNSELING

INSIGHT

Nasdaq Composite 2,175 * Dow Jones Industrials 10,679 * 30 year U.S. Treasury Bond 4.40%

BOTTOMS UP

Most investors start from the top down, with an economic forecast and a list of promising industries. Bottoms-up investors travel a different road; deliberately ignoring the usual riveting questions about interest rates and the stock market, and putting all their energies into finding good stocks at good prices. No grand strategic vision for these folks; they invest heavily in stocks when they see a lot of good bargains, and cut back on shares when few bargains are available.

This is a good discipline, and all investors should incorporate it, in some form, into their thinking. Lately we've been on a buying tear, because we've stumbled upon some obvious bargains. We bought AIG near its Spitzer-induced low, added to Avon and A J Gallagher, bought shares of United Technologies, and took the China plunge via the Matthews China Fund and the Templeton Dragon Fund.

In our last letter we discussed the Spitzer Stocks—AIG and A J Gallagher—and we still think that they are some of the best bargains on Wall Street. Avon (AVP - \$32)

might seem like a ho-hum cosmetics brand here in the United States, but it's a top-shelf name in China and the developing world. In those fast-growing nations the brand is supported by a zealous sales force of women who are absolutely thrilled to have the opportunity to sell prestigious cosmetics in their spare time.

United Technologies (UTX - \$50) is finding growth in many of the same nations—but with very different products. Jet engines and aircraft systems. Elevators and air conditioning for the world's burgeoning (and sweltering) middle class. The company is well managed, and the stock is surprisingly cheap.

Forget The Grand Strategy

It's no accident that there's a China theme to many of these ideas. Our greatest fear about China—that the government would, inadvertently or intentionally, destroy the profits of corporations—has been set aside for the next several years, because the nation's leaders recently

announced that they want to halt the long, steep slide in their stock markets. They've shown surprising skill in orchestrating their communi-capitalist plan for growth, and they've recently moved to clean up their troubled banking system. After learning that Chinese companies now pay good dividends to their shareholders, we bought shares of the Matthews China Fund (MCHFX - \$14).

— (Continued on page 2)

The Most Powerful Concept in Investing

When a stock goes up a lot—enough to enlarge your position to an "oversized" holding—sell some. If it goes down a lot—that is, more than you feel is justified—buy more.

This see-saw of buying and selling has been the source of a good part of our profits over the years. There's even a nifty slogan that describes the practice:

"Buy low, and sell high."

Bottoms Up
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We also bought shares of the Templeton Dragon Fund (TDF - \$19), after looking long and hard for a pan-Asian fund that focused on Asian consumers rather than the stocks of companies that export to the US. The Dragon Fund's largest holding (a wild 15% of assets) is a pan-Asian retailer that is bringing western-style grocery stores and upscale clothing brands to consumers from India and Malaysia to Taiwan, Korea, and China.



Forget the grand strategy. Look closely, and you'll begin to notice that the glass is more than half-full. Bears are everywhere, muttering darkly about \$100 oil, the end of the housing bubble, and an October crash. But bearishness is almost always good for the markets, and the truth is that corporate balance sheets are in great shape. Companies are swimming in cash, and they're hiring. Perhaps we'll see the price of oil decline, and the nation might awaken one day to find that Iraq is not another Vietnam. One thing we know for sure is that September and October will pass. There's money to be made in the markets, and you'll make it the same way you always have. One stock at a time.



STORM CLOUDS AND SILVER LININGS

Analysts are now projecting that the total cost of hurricane Katrina—for the federal government alone—will approach \$300 billion. That's roughly equal to all the outlays for Iraq and Afghanistan.

Just to be clear, that's \$300,000 each for a million people. The housing bubble may well burst in the rest of the country next year, but homebuilders all up and down the Gulf Coast are going to make their fortunes and retire.

The rest of us can stop worrying about the possibility of a recession in the next twelve months. Interest rates will rise—higher than they otherwise would have—and we'll eventually pay a price for the added debt. But the economy is carrying a big head of steam, and it's liable to get a second lift when oil prices finally decline.



High expectations and investor enthusiasm usually go hand in hand with a high stock price, high risk, and low returns

Low expectations, disappointment, and disenchantment go hand in hand with low stock prices, reduced risk, and high returns.



John Lumbar, CFA
Photo by Rick Balboni

The dollar has declined 34% against the euro, but it evidently hasn't declined far enough. Our trade deficit with the expanded European Union rose to \$10.8 billion in June. The result is that Europe is forced to invest \$11 billion, each month, in the United States. You'd think they might prefer to put those dollars into Asia or Eastern Europe.



THE 50-50 PRINCIPLE

Here's a simple rule to guide the congressmen who are studying the nation's flood insurance programs. If there's a 50% chance that a house lot will flood in the next 50 years, nobody should build there. Is that really so hard?



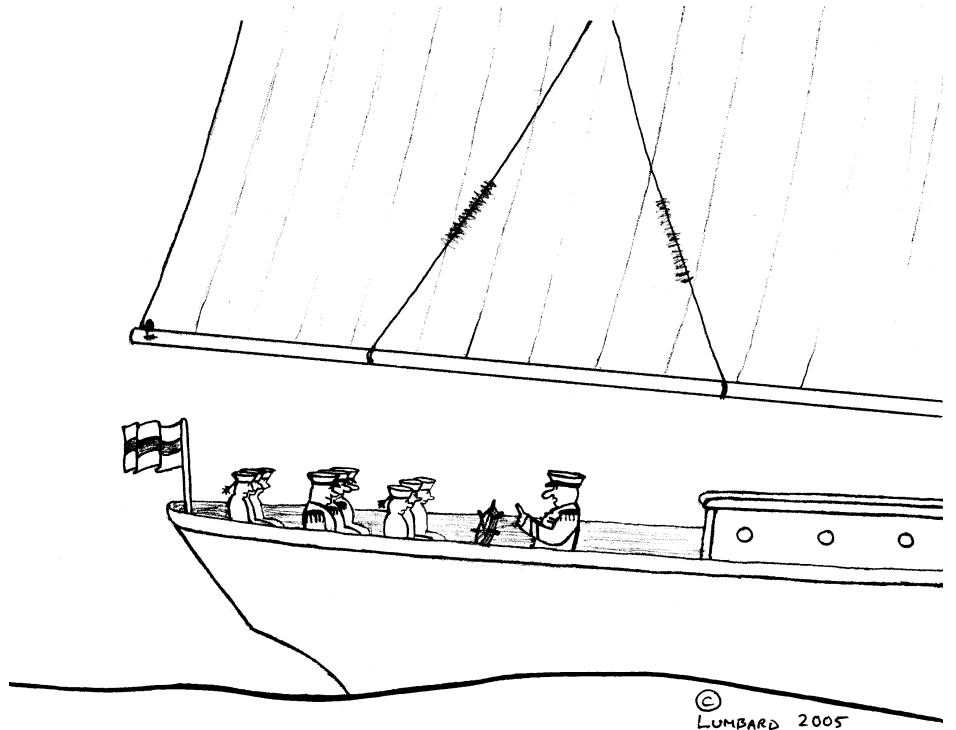
VACATION HOMES, REVISITED

If the coast of the United States is hit with another hurricane in the next year, the price of coastal real estate will plummet. These properties have appreciated sharply in recent years, and they are poised for a fall. Insurance premiums will rise, and newspaper articles will increasingly link today's warmer ocean temperatures and melting polar ice caps with increased storm damage. Perhaps those steep summer-rental prices are a bargain, after all.



One way to ease the strain of the future giant wave of retirement is to have Americans accumulate a lot of overseas assets that will pay them dividends and interest in their golden years. Americans do own a lot of stocks and bonds and real estate overseas, but in recent years our holdings have slipped while foreign ownership of American assets has grown rapidly—as a result of the trade deficit—and taken the lead. Foreigners now have a \$3 trillion advantage.

Each one of our client accounts has a significant investment in stocks and bonds from other nations.



As Chairman of this Board and CEO of this company, I'm proposing that our compensation committee be composed of directors who are themselves chief executive officers. Only a fellow CEO is in a position to understand the complexity and scale of today's compensation packages, and empathize with the needs of a Captain of Industry in these opulent times"

CEOs continue to grab an excessive and ever-growing share of corporate earnings. There's no end in sight, because they have the power to choose the directors who pay them. Usually they make an effort to choose the CEOs of other companies, who have a vested interest in ensuring that the average CEO paycheck rises sharply each year.

It's high time that shareholders, at every company, banded together to protect their interests. They should be offered two candidates for every director's seat, and only one of those candidates should be picked by the CEO. Investors should also be given

a chance to vote on the CEO's pay, choosing between the Megabucks package recommended by the Compensation Committee and a meager and humbling \$1,000,000 paycheck.

Meanwhile, the best we can do is to read proxy statements, vote against the directors who sit on irresponsible Compensation Committees, and vote in favor of any shareholder resolutions that seek redress. It's your money!





Drew D. Kellner

In our last issue we discussed the long-term growth of a stock with a 4.5% dividend that grew at 4.5% a year. At that rate the dividend would double in 16 years, and we assumed that the price of the stock would constantly grow at the same rate to keep the dividend yield at 4.5%.

The resulting stock appreciation and dividends, plus a big boost from dividend reinvestment, were enough to increase a \$100,000 investment to \$364,248 in 15 years.

It happens that Lumbard Investment Counseling has been managing an account for that time period. It was worth \$100,000 in October of 1990, and it has never seen any additions or withdrawals other than a 1% fee. This has always been a balanced account, with a large part of its assets in bonds. As of September 2 the account stood at \$369,786.

If you would like more information about our investment management services, visit www.Lumbard.com. Or call us, at (800) Lumbard, and we'll send our literature by mail. That's Lumbard, not Lombard! (800) 586-2273.

FINANCIAL PLANNING CORNER

How much income can you safely withdraw from your investment account? One important factor is the future level of taxation, and yellow flags are already flying. Despite what the AARP says, the Social Security system will begin to cause problems in about 15 years—soon after it starts cashing in the U.S. Treasury bonds that are the only investments held in the trust fund. Congress can't raise the cash to pay off the bonds without raising taxes, or borrowing more at crippling interest rates.

Plan conservatively, because you never know what the future will bring. If you have the option of putting part of your savings into a Roth IRA, do so. And you should ignore the experts who tell you that you can cut your tax bill by pushing capital gains into the future. You'll never see rates lower than the ones you have today.



Give us a call at 1(800) Lumbard. **Not (800) Lombard!**
(800) Lumbard. That's (800) 586-2273.

OLD HEADLINES FROM THE ARCHIVES:

“The Best Investment of 2001”

“ the safest bet is in European bonds. You'll benefit handsomely from the rising value of the euro, and . . . appreciation in the value of the bonds themselves.”

— Insight, January 2001

“Sell Merck and Pfizer. Buy Schering Plough.”

— Insight, January 2004. The revenues for Schering's new cholesterol drugs are closing in on \$2 billion a year

“Favorite Stocks”

“Our favorite stock of the last few years—big dividends, few heartaches, sizable holdings—has been Healthcare Realty Trust (HR - \$33).”

— Insight, Bug Season 2004.

[All of our newsletters, since Autumn 2002, can be found on our web site. www.lumbard.com]

THE FINANCIAL FOLLIES: FINDING FRAUD

It's not easy to uncover financial fraud. All of the information provided to investors comes from management. You're not going to be able to trip them up unless they are both evil *and* incompetent.

That's not to say that you shouldn't read the company's SEC filings. Few investors do, and even fewer take the time to also step back and evaluate the pressures and incentives that drive the decisions made by management.

For example, a CEO who receives a large part of his pay in the form of stock options has a huge incentive to inflate earnings. A study of 435 companies, performed by Jared Harris and Philip Bromley of the University of Minnesota, showed a strong correlation between heavy stock-option compensation and financial fraud—as measured by subsequent restatement of reported earnings.

But fraud is only a small part of the story. Earnings are rarely much better than a rough approximation, because the calculation of earnings for a large corporation is filled—necessarily—with assumptions and

estimates. An accountant can fairly produce a wide range of earnings reports by simply applying different levels of conservatism to complex financial transactions that span several years.

It goes without saying that these estimates will be more conservative when there is less pressure from investors and the chief executive officer. And there is no question that today's pressures are much greater than those that existed 20 years ago. In fact, we can state quite simply that today's earnings are overstated or inflated in comparison with the earnings of previous decades. That's not to say that the earnings are wrong, but investors should know that 2005 earnings are simply not worth as much as 1960 or 1980 earnings. Price-earnings ratios should be lower.

The most trustworthy and dependable earnings and earnings forecasts are those that have just been slashed; preferably by a new CEO who has every incentive to establish low expectations as he starts his new job. American International Group offers a good recent example, and the stock still looks like a bargain even after a 15% move upward.

The earnings of many companies will take a big hit next year when they begin to properly account for stock options, in response to a ruling from the Financial Accounting Standards Board. The companies say that there won't be an impact because

“everybody already knows” that the reported earnings will be lower, but in many cases we're talking about 50% lower—or 75% lower. It's hard to believe that tech-stock investors will simply shrug off the cuts.

Investment analyst Peter Bernstein proposes that all earnings reporting be abolished, on the grounds that the calculation of earnings requires so many guesstimates that we'd be better off limiting ourselves to the information contained in dividend announcements. Dividends are a fact, not an estimate.

A company that pays a big part of its earnings out as dividend tends to be run for the benefit of the long-term shareholders. The owners. Big dividends force the CEO to be more frugal with salaries all up and down the line, and he'll have less cash available for bad acquisitions and other acts of self-aggrandizement.

It's certainly possible to make money on the stock of a company that stiffes the shareholders while giving big bucks to the CEO. It's even possible to make money on a company with overstated or nonexistent earnings. But your chances are better with a corporate culture that's focused on making money and giving it to the owners. You, and your fellow shareholders.

Every six weeks, the world population grows by a number equal to the population of New York City.



CLASSICAL GAS

The price of gasoline—well above \$3 as we write—has moved dramatically higher in the last two years. Many myths have been shattered along the way.

We don't know what the future will bring, but it seems clear that \$2.50 gas didn't cause a recession. It also didn't cause inflation; trucking costs went up a little, but gasoline is far less important to our service-oriented economy than it used to be.

And yes, there *is* a price level at which consumers begin to cut back on their gas consumption. We're there. The upcoming figures for nationwide consumption will show the first decline since the 80s; and now that consumers have realized that—Holy Toledo!!—it costs money to drive a car 10 miles, consumption will continue falling.

The last time gas prices spiked, consumers made changes in their fuel consumption habits that lasted for years. According to the Rocky Mountain Institute, during 1977–1985 oil use *fell* 17% even as GDP rose 27%. Imports from the Persian Gulf fell an outsized 87%.

What's most remarkable is that the public used to assume that the cost of driving a car was zero. Even when motorists were complaining about the cost of \$2 gasoline, they never stopped to think that—according to the IRS—the total cost of driving a mile is now 40.5¢. Some would happily drive five miles out of their way to save a nickel a gallon on a fill-up.

Those who do cut back their weekly mileage will save far more than they

realize, because they're still not aware that the cost of gasoline is less than half of the cost of driving a mile in a car. The cost of tires, repairs, and depreciation are so large that the recent increase in gas prices will cause many drivers to *save* money.

It's quite likely that China will soon embark on a national program designed to leap ahead to the fuel sources and propulsion systems of the next generation. If we continue on our current path, we will be left in the dust.

These facts argue strongly that we shouldn't let gasoline prices go back below \$2.50. They will, if we do nothing; because the forces of supply and demand eventually affect even the oil market. But the current low level of gasoline taxes is poor policy. In effect, we've decided to tax income rather than consumption.

It's a policy that discourages savings, threatens our national security interests, and invites all sorts of environmental problems. It's not likely that we'll soon adopt any of the consumption-tax proposals that are circulating around Washington—they involve scrapping our entire tax system and replacing it with sales or value-added taxes—but raising the gas tax is easy. And, of all the consumer goods you can tax, gasoline is by far the best choice.

John Lumbard, CFA

STATS

For each person killed by a Black Bear there are 45 killed by dogs, and 249 by lightning The most dangerous animal in America is the deer. 168 drivers die each year in collisions with Bambi. That's 14 per month The monthly death toll from automobile accidents is 3,500 Americans, and total casualties (killed and wounded) run about 242,000 a month

the bumpers and frames of trucks match up with those of cars, and absorb the energy of a crash the way car frames do. And we could save thousands more by mandating that pickup trucks and SUVs be no taller than the large pickups of the 1980s. Drivers have been dying to sit high above the traffic, but we can't all sit higher than everybody else on the road

We could easily save thousands of lives each year by mandating that



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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