STRATEGIES, TRENDS AND NEWS FOR TODAY'S INVESTORS Summer 2005

LUMBARD INVESTMENT COUNSELING

INSIGHT

Nasdaq Composite 2,092.03 * Dow Jones Industrials 10,587.93 * 30 year U.S. Treasury Bond 4.25%

PASSION

Everybody loves to read about a craftsman—chef, painter, or poet—who is passionate about his work. Passion and excellence go hand in hand.

It might seem surprising, then, to learn that passion can be a negative characteristic for investment professionals. Investors need objectivity, good judgment, and detachment; you might say that it's best to be *dis*passionate. It's wisdom, not blinding intelligence or attention to detail, that produces good investment performance. It's tempting to try to overwhelm the task with manpower and brainpower, but the canyons of lower Manhattan are littered with firms that became bogged down in the details or infected with the enthusiasm of the crowd. They failed to buy low or sell high.

This junction of passion and dispassion is where value and growth investors often part company. Janus, the once-high-flying mutual fund company, used to run ads about the passion that its analysts brought to the investment process. They'd count the shoppers in the stores of a retailer, or dive into manholes to verify new installations of fiber-optic cable—never mind that the nation was swimming in excess fiber-optic capacity. That field research made for good copy, but the real reason for Janus's success was that it used its fame and huge inflows of new investor cash to continually push up the share prices of a few favored companies. Those rising stocks caused the Janus funds to soar, encouraging further inflows of investor cash . . . . . it was the perfect "momentum" game, but it nevertheless came to a bad end.

An investor's best defense against this sort of tragedy is to remember that price almost always matters. Pursuing "great" companies at any price is a fool's errand; note that Coke, Cisco, GE, and Microsoft have been declining for years. In the real world unpopular stocks nearly always outperform well-regarded stocks, and portfolios of inexpensive stocks beat portfolios of expensive growth stocks. Everyone knows the name of a great value investor, but great growth investors are hard to find—even with the help of a search engine.

During his long career, Sir John Templeton was arguably the greatest investor of all. He had the courage to wade into unpopular and unthinkable overseas markets at a time when Americans were all staying home. He was a contrarian—a value investor's value investor—who took frequent advantage of the irrational fears of the thundering herd. Templeton is best known for a jarring and difficult-to-follow piece of advice that all investors should cherish:

"Buy at the point of maximum pessimism."

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THINK GLOBALLY

The central banks of China, Japan, and other nations have been spending hundreds of billions of dollars a year to keep their currencies from rising against the greenback. If they take a week off the dollar will decline sharply, and the value of foreign bonds will rise.

ASIA

Asian economies are growing like crazy, and there is every reason to believe that they will continue to outperform the US. They're more volatile, and they still depend heavily on exports to drive their economies; but as long as American consumers continue to borrow and spend, these economies—and all the world's economies—will grow.

Our clients own shares of Indonesian telephone, Korea Electric Power (up 100% since purchase), Honda, and shares of several US companies (such as Avon and AIG) that derive a significant portion of their earnings from fast-growing, developing economies. We also hold two emerging market bond funds, and—surprise, surprise—a stock fund that invests in China. After years of avoiding the wild and woolly Chinese market we were finally lured by solid growth, low prices—the Shanghai composite has dropped more than 50% in the last four years—and a newfound appreciation for the competence and good intentions of the government.

China is moving to clean up its banking system, the yuan is about to rise, and the nation's leaders recently announced that they want to halt the slide in their markets. The stocks even pay dividends. Who could ask for more?

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A HOUSE OF CARDS

There's big trouble brewing in the credit card business. The Comptroller of the Currency is asking the card companies to collect 4% of every customer's outstanding balance every month, and the likely result will be shrinking balances and defaults. But the bigger problem is identity theft; tens of millions of names and card numbers have been lost by the likes of MasterCard, BankAmerica, Polo Ralph Lauren, and DSW Shoe Warehouse—not to mention LexisNexis, ChoicePoint, Ameritrade, Time Warner, and the FDIC.

Eventually the card companies will be forced to sharply restrict the use of cards. If you stop and think about it, it's incredible that you are allowed to make purchases online or over the telephone by simply offering up your name and card number—along with those Top Secret digits on the back of the card.

So stop and *really* think about it. No encryption is safe in a world in which criminals on another continent can read your keystrokes by implanting a virus in your PC. No firewall is safe in a world in which a criminal can simply lift encrypted passwords from a virus-infected PC, or recruit 10,000 PCs to submit varying passwords until the code is broken. Our primary defense against these threats is the mantra that the bad guys haven't yet done any serious damage . . . .

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CALL ME

Susilo Bambang Yudhoyono, the U.S.-educated President of Indonesia, recently met with a group of farmers from his home state. In a fit of populism and accessibility he gave them his personal cell phone number, and said that they may call him with complaints day or night. Democracy is blooming in the world's most-populous Muslim nation; but the farmers gave the number to a reporter, who passed it on to Indonesia's 200 million people. Call 62-811-109-949.

GUARANTEED FRESH DAILY

ABC news says that you can now buy stolen credit card numbers online. Day-old bread and day-old credit-card numbers are deeply discounted, but those wanting a nice fresh number—harvested within the last 24 hours—will have to pay \$42. It's perfectly acceptable to charge it to a stolen card, as long as the transaction goes through . . . . .

THE PERFECT INVESTMENT

Drew D. Kellner

When looking at long-term investing, one of the big surprises is the importance dividends play in overall performance. 50 years ago stocks were purchased for their dividends and for the growth of those dividends. Even today, the era of momentum investing, the value of a stock is calculated by estimating future dividends, or the ability to pay future dividends. When a company does not pay part of its profits to its owners, the value of its stock is somewhat whimsical.

If you think that slow-growing stocks with 5% dividends are boring, you might be surprised to see the returns created by a modest amount of dividend growth. Dividend growth is related to the sustainable growth of the underlying business, but cannot exceed it in the long run. Let's assume a 4.5% dividend that also grows at 4.5% per year, causing the price of the stock to move upward at the same rate to keep pace (resulting in the same 4.5% dividend yield). We'll start with an initial investment of $100,000 and assume that the dividends will be reinvested in the same stock, or in similar stocks offering identical returns.

The returns during the first few years are unexciting, but after 15 years the initial investment of $100,000 has grown to $364,248. Extend the horizon out just 5 more years to 20 years and the same account now grows to $560,441 (an increase of 460%). Remember this example when the financial media discuss stocks whose prices have sky rocketed during trading, because those sorts of price increases are not sustainable. Slow and steady wins the race.

Drew Kellner, newly named as a partner of Lumbard Investment Counseling, is a native of Hollis. He has a BS and an MBA from the Whittemore School of Business at the University of New Hampshire, and is currently focused on administration, client relations, marketing, and trading.

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NIGHT TRADING: IT'S THE NEW DAY TRADING

A recent study by TradingMarkets.com shows that none of the average gain in the S&P 500 over the past 12 years occurred during daytime trading hours. There must be a lot of bad news announced during trading hours, because all of the gains—and then some—occurred overnight.

The new new strategy is to buy at the close, nervously hold your purchases overnight, and then sell in the morning . . . . A hard-bitten trader says he expects to sleep like a baby: "I'll wake up every few hours and cry."

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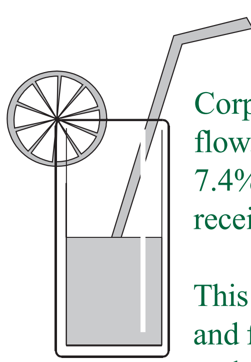
During the past four years the Chinese yuan has *declined*, dramatically, against the euro.

THE GLASS IS HALF FULL!



Corporate profits are up, along with cash balances and cash flow. Corporate debt is down. Wages are rising strongly—up 7.4% in the last year . Federal tax receipts are up. State tax receipts are up. The unemployment rate is down.

This is good news for corporations, for investors, for workers, and for the federal budget. We still have to worry about the trade deficit, the housing bubble, new-era crime, future inflation, and the use of bad accounting to minimize the size of the federal budget deficit. But let's not overlook the good news that's standing right in front of us, smiling.

John Lumbard, CFA
Photo by Rick Balboni

In 1990 Lumbard Investment Counseling opened its doors at Post Office Green in Hollis, with so few clients that the SEC kept dropping by to see if there was any funny business going on. Today, 15 years later, we're still at the same location; and our assets under management have grown to $47 million.

If you'd like to know how we got from there to here, visit www.Lumbard.com. Or call us, at (800) Lumbard, and we'll mail you a packet of our literature. That's Lumbard, not Lombard**!** (800) 586-2273.

SOCIAL SECURITY

The problem with Social Security is indistinguishable from the problem of federal deficits. That's because the Social Security trust fund is entirely invested in US Treasury bonds—IOUs from the federal government. When the trust fund goes to "cash in" the first of those bonds in 2018 (13 short years from now), the Congress will have to raise taxes or borrow. In effect, the IOUs in the trust fund give it nothing more than the right to demand that the government raise taxes in the future to pay the Social Security beneficiaries of the future.

What good is that? The whole point of having a Social Security trust fund is that we don't want to have a crushing tax burden when the outlays start to exceed the system's income. Social Security itself won't be much good to anybody if the monthly stipend is taxed at 75%.

Meanwhile, nobody is talking about Medicare, which is bankrupt *today*. This year Medicare will pay out $295 billion in benefits, but collect just $161 billion from its 2.9% tax on the earnings of every worker (the Medicare portion of FICA). The shortfall is being borrowed from the Social Security Trust Fund . . . . .

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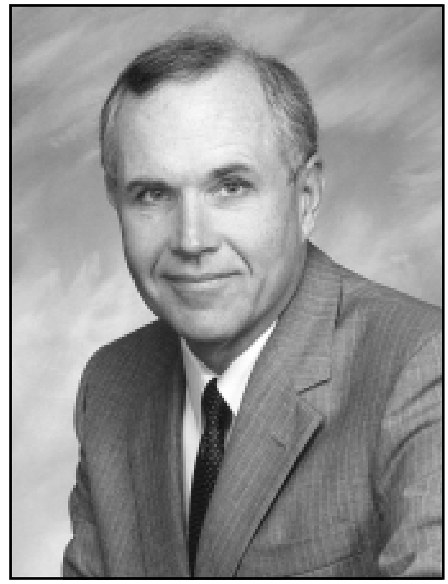
"All drugs are poisons. That's how they work."

— David Ferguson, PhD, MD



David Lowrance

We've also been joined on a part-time basis by forensic accountant David Lowrance, CPA (retired). David has passed the Series 65 exam and registered with the SEC as a Lumbard Investment Counseling investment adviser and research analyst. David also (under the name Lowrance Associates) assists public and private corporations as a financial and investment consultant and an interim Chief Financial Officer—with a special focus on Sarbanes-Oxley financial reporting.

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The tax bracket for a single, self-employed American worker earning $30,000 is 25%. Because he's self-employed he has to pay an additional FICA payroll tax of 15.3%; and we still haven't counted state income tax, state sales tax, and local real estate tax.

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

SPITZER STOCKS

One of the stocks we purchased just after September 11 was American International Group (AIG - $56). It was a great time to invest in the nation's largest and strongest insurance company, but as time went by we became more and more uncomfortable about the company's "black box" accounting—and took profits on our shares. It was impossible to know what was going on behind the curtain in AIG's huge and complex empire, and the all-to-steady growth of the earnings indicated that there was at least some manipulation going on.

Thanks to the pressure exerted by New York Attorney General Spitzer, AIG's management has now been replaced; and the earnings for the last 5 years have been revised downward by about 10% per year. The new numbers are probably reliable, because management had every incentive to push those earnings as low as possible. New CEOs almost always try to push down earnings and expectations, because their future success will be measured by the degree to which they're able to make earnings rise.

Following Templeton's dictum about buying at the point of maximum pessimism, we took the plunge at $52 a share, just before the last of the bad news came out. AIG is the biggest player in a business in which size is rewarded, and it participates in a large number of fast-growing markets. The company has a huge and unique business in China—it was founded in Shanghai in 1919—and it is the largest life insurer in Southeast Asia and other fast-growing parts of the world.

Another company that felt the heat of Spitzer's cleanup campaign was AJ Gallagher (AJG - $27). We see it as a well-run, rapidly growing, ethical insurance broker that happened to be tarred by an industry-wide insurance scandal. Gallagher's earnings took a hit when it volunteered to stop accepting "contingent commissions", but the company's underlying growth never slowed. In fact, Gallagher is picking up market share from Marsh McLennan and other companies that *were* charged with wrongdoing. The stock is a bargain, and it pays a 3.7% dividend.

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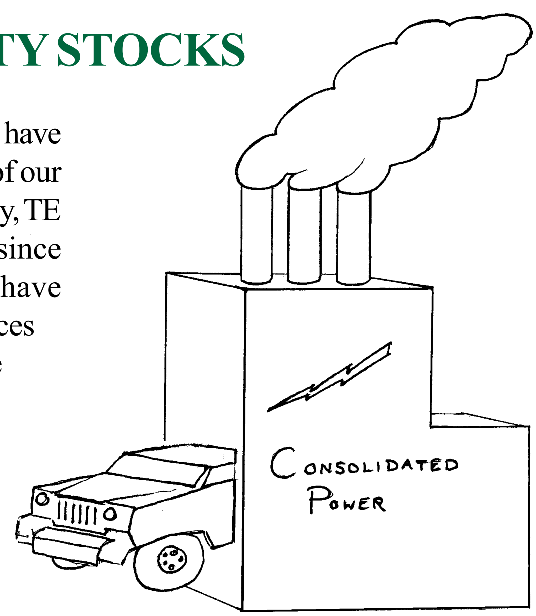
AVOIDING IDENTITY THEFT

The key to avoiding loss from identity theft is to read your credit-card and checking-account statements every month. Your bank will cover the loss as long as you report the theft promptly, and agree that you will help to press charges if a suspect is found.

SPORTS-UTILITY STOCKS



The hottest stocks of the last year have been the electric utilities. One of our three utility stocks (TECO Energy, TE - $18) is up a ho-hum 25% since purchase, but the other two have doubled. Sierra Pacific Resources (SRP - $12) was cheap because its regulators had been beating up on the company, unfairly, for years; we bought just after the Governor of Nevada wised up and replaced the chairman of the regulatory commission. We couldn't see any good reasons why Korea Electric Power (KEP - $16) was such a bargain, but the stock was selling for 5 times earnings. Electric-power demand in Korea rises at a rate of 10% a year . . . . .

THE WORST INVESTMENT YOU'LL EVER MAKE

"Sure it's a risk. But where else can you make this sort of money so fast?"

— The buyer of an oceanfront vacation home, quoted in the Wall Street Journal

Homes are lousy investments. That might seem like a shocking statement, at the tail end of a long and frothy rise in home prices, but we're talking about houses—structures—rather than land. Land prices will decline significantly in the next real estate downturn, but over the course of decades land has been an excellent investment. The same can not be said for homes.

So why are people—millions of people—speculating in vacation homes and condominiums? Because home prices have soared in the last few years, and because homeowners pointedly ignore the huge amounts of money and time they pour into maintenance, remodeling, landscaping, and real estate taxes. The elements batter the roof and walls, insects and fungi eat at the frame, and humans tear at the interior surfaces. Appliances break, the septic fails, the furnace dies, the water heater floods the basement, the insurance bills mount up, the tax man calls . . . .

Meanwhile, most homeowners are laying out large additional sums for new flooring and double-pleated blinds and a splinter-free new deck. The expenditures are justified by the pleasure they derive from the upgrades—but that's consumption, not investment. It's much harder to justify the same upgrades for a vacation home that you only plan to use 8 weeks a year. Suddenly you're spending your vacation days and spare dollars on maintenance, driving to Maine to meet the building inspector over the septic-system repair, and hoping that another second-home boom will come along to give you an opportunity to sell.

Vacation homes are like yachts. Renting is a terrific bargain.

Your primary residence, on the other hand, gives you a huge tax break from the federal government. You have to live somewhere, and it happens that the traditional 30-year mortgage is a terrific forced savings program. Every month you pay off a little bit of the principal; if you can pay the taxes and cover the maintenance costs without borrowing, you'll move steadily towards full ownership of a large and valuable asset. But today we're seeing a lot of "interest only" loans with no principal payments, as well as 100% financing with adjustable-rate loans. If interest rates rise sharply or home prices fall, hundreds of thousands of people will mail their house keys to the mortgage company. That happened here in New Hampshire during the real estate debacle of 1989-1996, and the result was that the mortgage companies auctioned off the homes, driving prices lower.

When Japan's real-estate bubble burst, the nation's land prices fell for fourteen consecutive years.

Invest in haste, repent in leisure.

A Hollis resident who bought his current home in 1991 recalls that the seller had refused a $340,000 offer in 1989, unwilling to negotiate the $350,000 asking price. Two years later—after spending thousands on real estate taxes and maintenance for an unoccupied house—she accepted his cash offer of $175,000.

Homeowners don't receive monthly statements, so they're spared the pain that stock and bond investors feel when prices fluctuate. But home prices can and do decline. Not everyone can afford to wait ten years for a better selling opportunity, and those who leverage up with big mortgages will find that it's easy to lose their entire investment and then some. We've seen it right here in New Hampshire, and it wasn't so very long ago.

— 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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