STRATEGIES, TRENDS AND NEWS FOR TODAY'S INVESTORS Autumn 2006

LUMBARD INVESTMENT COUNSELING

INSIGHT

Nasdaq Composite 2,184 * Dow Jones Industrials 11,381 * 30 year U.S. Treasury Bond 4.87%

BUY BONDS

For more than a year we've been writing about the bursting of the real estate bubble, and it's not over yet. "Bursting" conveys the wrong message, because real estate prices tend to deflate slowly; when New England real estate prices fell in the early 1990s the decline took more than three years. It took eight long years for prices to rebound.

It won't be long before we see layoffs in the construction industry, and they'll be followed by layoffs in the industries that make building materials. Then we have to consider hardwood flooring, light fixtures, appliances, carpeting, window treatments, furniture, the trucks needed to deliver these goods, and the truck-part manufacturers who keep them running . . . most of America's remaining factories were lifted by the housing boom, and they'll all be affected by the loss of that supercharged demand.

Mortgage defaults are rising, and homeowners are borrowing less money via mortgages, home-equity lines of credit, and the like. The nation's money supply (M1) has been shrinking.

The members of the Federal Open Market Committee (of the Federal Reserve) have stopped raising interest rates, but once again they seem to have forgotten that—according to their own research—the full effect of an interest-rate increase is not felt for two or even three years. Typically the Fed is still raising interest rates when a recession gets underway. Two years ago the Fed Funds rate was at two percent — and it will be another two years before we feel the effects of today's 5.25% rate.

We're confident that interest rates will decline during the next year, and that there's money to be made in bonds. Our clients will receive a 30% return (including interest) on long-term US Treasury bonds over the next two years, if their yield declines from 5.2% to 4%.

That's a mathematical certainty. If you buy a $1,000 bond with a 5.2% interest rate, it will pay you $52 per year—and it will continue to pay $52 per year until the far-off day when it matures at a value of $1,000. If the same sort of bond is issued next year at 4%, the new bonds will pay just $40 – and your bonds will rise in value to $1,200. If they are U.S. Treasury bonds, their interest and principal payments are guaranteed—by the government's power to print money.

We also expect to make money on foreign bonds. We'll receive interest, and we hope to harvest capital gains as interest rates decline. But we also expect currency gains, because foreign central banks have been spending huge amounts of money to keep our dollar high. They're not going to be able to do that forever.

— *(Continued on page 2)*

> **"What the wise man does at the beginning, the fool does in the end."**
>
> — **Warren Buffett,** on the topic of buying low and selling high

Buy Bonds – *Continued from page 1*

Declining interest rates have the same effect on stocks that they have on bonds. They cause prices to rise. Companies that meet Wall Street's expectations for earnings growth will see huge gains. We think that the electric utilities, the drug companies, and other healthcare-related companies are good bets, and we're keenly interested in re-establishing a large position in Asian stocks next year. We took good profits on most of our Asian holdings in recent months.

The opportunities don't end with stocks and bonds. There's a brave new world of alternative investments that allow you to make money in any market. Diversification is always the best and lowest-risk strategy, even when you're tempted to flee to "cash"— putting all your assets into money-market funds, CDs, and other short-term investments. There's a good chance that the yields offered by these investments will slowly decline back to the insignificant levels of the recent past.

Over the course of years, cash equivalents have always offered the lowest return of any asset class. Gold and other newly-popular commodities don't fare much better. Investors should study these historical returns before making decisions about asset allocation, while being mindful of the fact that inaction—the failure to make a choice—can be the boldest and riskiest choice of all.

HEALTH CORNER

Lately the world's attention has been focused on avian flu, but for most of the planet it's still an abstract and future threat. Lyme disease and other tick-borne diseases are a clear and present danger. Most people think of Lyme as a Southern New England curiosity that's easy to treat with antibiotics, but researchers are becoming more and more alarmed about the complex dangers of tick-borne diseases and their rapid geographical spread.

Ticks of all kinds—large and small, and all over the nation—harbor a wide variety of dangerous *bacteria* (such as the one responsible for Lyme) and *viruses* such as tick-borne encephalitis. The latter is well established in such unlikely locations as New Mexico, Arizona, and Switzerland.

Of the bacterial infections, Lyme—well established in the Northeast, the northern Midwest, and on the West Coast—is the most dangerous. It's now well known that Lyme disease can cause a red bulls-eye rash, but that rash is present in less than 40% of patients. And it's much more difficult to test for the presence of Lyme than is generally appreciated; a single test for the presence of antibodies is inadequate, especially if you've had the disease for many months.

In fact, if you've had the disease for many months you might experience (according to Carnegie-Mellon University) heart, eye, respiratory or gastrointestinal problems; or arthritis, meningitis, Bell's palsy, severe pain and fatigue, or depression. The disease can also mimic multiple sclerosis, and in this case a misdiagnosis could be particularly dangerous. Treatment for MS usually involves suppression of the patient's immune system, and that's the last thing you want to do when fighting a bacterial invader.

Prevention is always the best medicine, so wear long-sleeved shirts and trousers when out in tick country, get a vaccination for encephalitis if recommended in your area, and check your pets carefully when they come into the house. Ticks usually don't transmit disease until they've been attached for a number of hours, but you need to remove them carefully without squeezing.

KNEE SURGERY?

The Wall Street Journal claims that 1.2 million cruciate ligament operations are performed each year on the knees of American dogs. The average lifetime cost of caring for a dog is now almost $16,000. As financial advisers we recommend that you cover your dogs with tick repellant, and keep them indoors.

Photo by Rick Balboni

John Lumbard, CFA

*Find a stock that's a bargain.... and then make sure you know **why** it's a bargain.*

QUADRUPLED !

We have wonderful clients. For many years we've been giving you occasional updates on the progress of a $100,000 account that one of our wonderful clients established in October of 1990—and has kept segregated and untouched just so that we'd be able to track it.

The portfolio has always been invested just like our other "balanced" accounts. We don't show it any favoritism in trading, and over the course of decades it has performed like its peers. It pays fees at a 1% rate, and it has always been invested in a conservative-yet-global mix of bonds, cash, and stocks. On August 31 the account's value stood at ***$412,040.48***, up from $377,107 at the beginning of the year.

That excellent performance is matched by terrific service. Our full attention is directed to the needs of just 46 terrific clients who have given us the responsibility for managing more than $50 million. Further information regarding performance, fees, and our account minimum can be found at www.Lumbard.com.

SIERRA PACIFIC

Las Vegas builds at least 10 new schools every year, and projects that the rate will have to rise to 13 or more to accommodate an annual influx of 12,000 students. All Nevada is growing, and that growth should bring benefit to the state's primary electric utility, Sierra Pacific Power (SRP – $14).

Growth was hard to see when we first bought these shares, at $5.56. The California-energy scandals had forced the company to buy power at unreasonable prices from Enron, and a short-sighted regulatory commission was refusing to pass the cost along to consumers. Bankruptcy loomed. Now the crises have passed, the stock is up 250%, and analysts are beginning to warm to a future of reinstated dividends and the kind of customer growth that most utilities can only dream of.

"You won't encounter much traffic, taking the high road on Wall Street"

— Warren Buffett

OVERBOOKING

The Wall Street Journal says that more than 33,000 passengers were involuntarily denied boarding on overbooked US airlines from January to June. In response, millions of passengers are arriving at the airport earlier than ever before.

This has little to do with September 11, or airport security. The truth is that the nation is wasting millions of man-hours of time to put a few more passengers on each airplane.

Meanwhile, we should thank the TSA for continual improvement in the speed of its security checks. Now if they would just stop asking us to take off our shoes . . . .

Drew D. Kellner

2005 was the 20th consecutive year in which the United Sates was a net "debtor". Not since 1985 have we owned enough assets overseas — stocks, bonds, real estate, and loans to foreigners—to be listed as a "creditor" nation. During these years our foreign holdings have grown, but our debts to foreigners have skyrocketed. By the turn of the millennium we were far more than a trillion dollars in the hole, and a year later we were pushing two trillion.

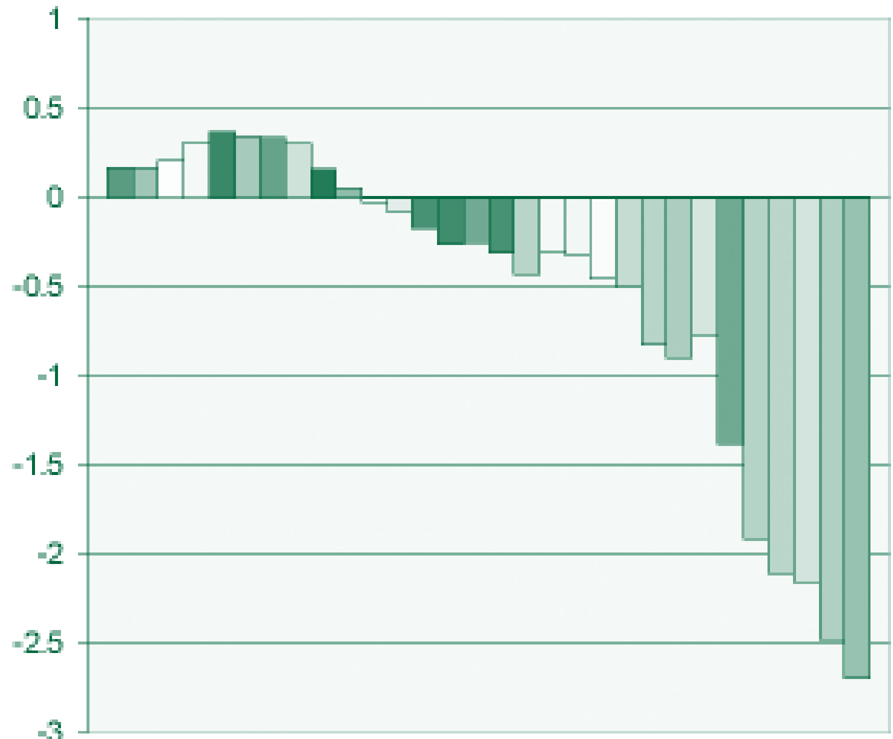
The nation has not yet felt the pain of paying any of this money back. Foreigners have always been willing to lend us more, and we've even spent all the money in the Social Security Trust Fund. Today our net debt to foreigners is $24,454 for each American household, or $2,690,000,000,000.

HIDDEN EXPENSES

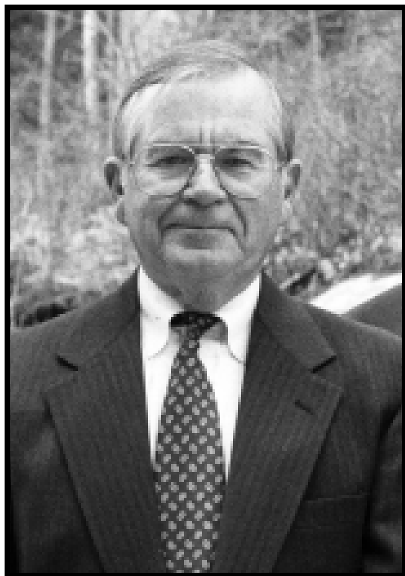
If you're in the market for a mutual fund, check the expense ratio—and also the fund's trading expenses. Every mutual fund has to pay brokerage commissions on the stocks bought and sold within its portfolio, and you have to cover the cost. These commissions are NOT included in the fund's expense ratio, and neither are the trading costs related to bid-ask spreads. Those bid-ask spreads, incidentally, loom large for investors who buy individual stocks through a discount broker. The $7.95 commission is nowhere near as inexpensive as you might think.

Professor Edward O'Neal of Wake Forest University says that the combination of brokerage commissions and spread costs at the average large mutual fund reduce investor returns by about 0.47 percent. That's a very significant addition to the average expense ratio of 1.54 percent, and it's enough to triple or quadruple the costs reported by a low-expense fund such as an ETF.

It's not easy to uncover these trading costs, but check the fund's annual turnover, or the speed at which the fund trades stocks. O'Neal found that total costs—trading costs and expense ratios—ranged from just .21 percent for a very-low-turnover index fund to a jaw-dropping 8.59% for the fast-trading PBGH Large Cap Fund.



OWNERSHIP



John Convery, CFA

In February the Semiconductor Industry Association reported that worldwide chip sales rose 6.8 percent in 2005, and that they were expecting about the same for 2006. That's a big comedown from the 30% growth rates that investors talked about in the gay 90s, but the truth is that the revenues of most U.S. companies grow at just 6%.

That's OK. A company with 6% earnings growth and a 3% dividend should give you a 9% return; and you can boost that return substantially by "buying low" or "selling high". Take away the dividend—as so many companies do—and you're left with the hope that earnings are going to grow quickly, or that the company is going to buy back a huge number of shares. In recent years many investors have pinned their hopes on share buybacks, only to find that they had been snookered—because the share repurchases didn't cause any noticeable shrinkage in the number of shares outstanding.

In fact, Intel spent $41 billion on stock buybacks between 1990 and 2004, without causing the share count to decline at all. It's quite noticeable that Intel was a bitter opponent of the new rules that force companies to acknowledge that stock options have value, and should be treated as an expense of the company.

We'd rather invest in companies that are run for the benefit of the shareholders. Dividends are the means by which a corporation gives a piece of its profits directly to its owners.

Back in 1978, 67% of the nation's publicly-traded corporations paid dividends. By the turn of the millennium that figure had dropped to just 21%. In this era of historically low payouts it's remarkable that—according to Fidelity Investments—***56% of the returns provided by the S&P 500 in the last 25 years were due to dividends***.

Hundreds of American companies have seen the light—and started to pay their shareholders for the first time—in the three years since the Congress reduced the tax rate on dividends to 15%. Growth is good, and share buybacks have their place; but investors should focus their efforts on finding companies that are run for the benefit of their owners.

BRISTOL-MYERS

The highly-paid CEO of Bristol-Myers (BMY - $21) has egg on his face and an antitrust investigation under way, after having the wool pulled over his eyes (the eggs came later) by a Canadian manufacturer of generic drugs. Now the market for Bristol's blockbuster drug Plavix has been flooded with copycat generics, and the CEO of the Canadian company is crowing about his deliberate deception.

That's ugly, but behind the headlines Bristol has a bevy of new drugs—for schizophrenia, bipolar disorders, rheumatoid arthritis, Hepatitis B, AIDS, and cancer—that are performing quite well. Still in the future is Sprycel, a drug for chronic myelogenous leukemia that's similar to—and possibly more useful than—Novartis' famed Gleevec.

We believe that the patent on Plavix will eventually be upheld. It *was* upheld—note the irony—in the *Canadian* courts, and it's an important matter for the U.S. courts because there are scores of drugs whose intellectual-property protection will vanish if this "single isomer" patent is overturned. If we're wrong, the CEO will lose his job and the board will probably put the company up for sale. Buy Bristol-Myers below $22.

Call us for further information at (800) Lumbard. **Not** (800) Lombard**!** (800) **Lumbard.** That's 1 (800) 586-2273.

A GLUT OF OIL

A great disappointment is reverberating through the oil markets. The hurricane season was a bust. The Nigerian rebels proved to be humbugs, and nobody dropped a nuclear bomb on the oil fields of the Middle East. Adding insult to injury, some greedy oil companies have found billions of barrels of new oil in the Gulf of Mexico.

At least we can count on Bolivia. El Presidente Evo Morales, champion of cocaine, took the advice of his buddy Hugo Chavez and nationalized Bolivia's natural gas fields. The result was that they stopped producing; those selfish international oil companies shut off the gas and departed, and they *refused to come back even when Morales asked nicely.* Chavez waits in the wings for a windfall.

And then there's Mahmoud Ahmadinejad (or is it Houshmandzadeh?), leader of Iran and conqueror of Mike Wallace, who didn't just sit around hoping for higher oil prices. He shut off Iran's oil exports, stockpiling tens of millions of barrels—much of it in leased tankers—— as he waited for the start of the Hezbollah war. Talk about windfall profits! Wall Street's oil traders owe him more than a debt of gratitude, because those 3,000 rockets weren't cheap . . . . .

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"According to the latest research, a 10% increase in the number of workers reduces a worker's wage by 3 or 4 percent. Over the past 20 years, immigration (much of it illegal) increased the number of workers without a high-school diploma by 16%, implying a 6% decline in the wages of low-skilled workers."

— National Review

HOUSE POOR

In our summer 2005 issue we wrote that vacation homes are lousy investments. Yes, they go up in value, at a rate that is slightly faster than the rate of inflation. But homeowners tend to overlook the enormous annual cost of real-estate taxes, maintenance, insurance, and mortgage payments. You're not going to make money on a second home unless you buy it at a huge discount—and do the maintenance work yourself.

The key point is that this is *consumption* rather than *investment*. Land is an investment, but structures are a money-losing proposition unless they produce rent (or allow you to avoid paying rent). The same is true of the $155 billion that homeowners spent on improvements and additions last year—and it's also true of the now-common practice of buying an oversized home as a vehicle for making money. Jonathan Clements of the Wall Street Journal recently compared the costs and benefits, over the course of a lifetime, of buying a large house or instead settling for a small home and using the annual savings to build a large investment portfolio. He examined two scenarios for a 35 year old with a high income—a $400,000 home and a $1 million home—and concluded that it costs an additional million dollars to live in the larger house for 30 years.

To put it another way, you can stuff an additional million dollars into your investment portfolio by choosing to live in a smaller house. When you stop to think about it, the notion that we could all get richer by living in bigger houses just didn't make sense.

— 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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