

LUMBAR D
INVESTMENT
COUNSELING

INSIGHT

Nasdaq Composite 2,343 * Dow Jones Industrials 11,577 * 30 year U.S. Treasury Bond 5.2%

THE BUBBLE BATH

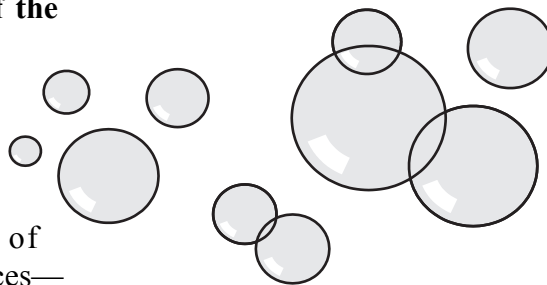
The air is coming out of the housing bubble.

Yes, it was a bubble. Prices soared, and millions of apartment dwellers with bad credit took advantage of aggressive lending practices—100% financing, interest-only mortgages, and low “teaser” interest rates—to increase home ownership to the highest levels America has ever seen. Speculators bought homes and sold them to other speculators, taking on huge leverage in the process. In fact, the debt-fueled housing boom of the last decade looked a lot like a debt-fueled frenzy in the financial markets, with a can’t-lose swagger and a proliferation of get-rich-quick night classes in how to gamble like the big boys . . .

“The day traders of the Internet moved into trading condos.”

— Warren Buffett

Now the party is ending. Home builders have announced plans to slow down the rate at which they build, but they’re still adding two million homes a year to a market that doesn’t have room for any at all. Speculators are lining up to sell



the condominiums and houses that they bought when the bubble was in full flower, and the lenders who issued millions of high-risk, bad-credit, high-interest rate mortgages are beginning to foreclose. Prices are falling.

There’s no reason to think that this real estate bubble will end as badly as the New Hampshire real estate bubble of the late Eighties, which took eight years to recover from a 30% decline. But there’s also no reason to think that we’re in for a soft landing. You don’t have to be a New Englander to know that bubbles burst rather than deflate.

This has been an era of bubbles. Alan Greenspan’s easy-money policies filled the pockets of investors and bankers with cash, and those lenders and investors were all too willing to join the herd of Baby Boomers stampeding through the real estate markets, the

commodity markets, and the Nasdaq. That Boomer herd mentality even extended to consumer spending, and the rest of America joined in with a carefree, bubbly willingness to borrow at all levels of household—and government—finance.

Interesting, then, that it was Alan Greenspan who mused, last year, that home-equity lines of credit and cash-out refinancing might be fueling 10% of consumer spending. That’s a big number, in a nation where consumer spending is 70% of the economy and a good rate of GDP growth is 3%.

Over the years we’ve had a tendency to identify bubbles too soon, warning of the imminent demise of the tech stocks and the decline of the U.S. dollar long before those events came to pass. We did a bit better with the real

— (Continued on page 2)

**“Sell in May
and go Away.”**

— An old
Wall Street Saying

The Bubble Bath — Continued from page 1

estate bubble, but we've been wrong on oil. The price of oil keeps moving higher, even in the face of a glut. Yes, a glut. Crude inventories have been rising by a million barrels a week, and now stand at the highest level in 8 years. Oil prices have nevertheless been rising, as bubble-addled bulls pray for a war that would interrupt supply. Talk about a cynical roll of the dice . . .

The relationship between price and oil production was underscored yet again when geologists discovered significant reserves in Montana that can be profitably extracted—from beneath old wells—only if prices stay high. Meanwhile, oil production in the Gulf of Mexico is approaching pre-Katrina levels, and the Saudis are building the infrastructure needed to expand their output from 11 million to 15 million barrels a day. The oil sands of Alberta are ramping up to join the major leagues, ethanol and biodiesel are gaining traction, coal gasification is getting closer, and Chinese oil imports are *falling*.

In fact, U.S. gasoline demand is now declining. Pundits used to believe that Americans wouldn't or even "couldn't" reduce their gasoline consumption, but it now seems clear that gasoline sales decline whenever we approach \$3 a gallon. That's a perfect free-market mechanism, but it puts all the incremental profits—trillions of dollars—in the pockets of anti-democratic governments, terrorists, and oil companies. If we had taken the advice of auto executives and *pushed* gasoline up to \$3 via gas taxes,

a good part of those trillions would now be flowing into the empty vault that we call the Social Security "trust fund".

History repeats itself, but it's a sorry commentary on society when history repeats itself in less than 20 years. The crash in energy prices that occurred in the 1990s set alternative energy back by a decade, bankrupting entrepreneurs and sending many good ideas to the dustbin of history. We're in the process of re-winding that tape—a perfect storm of stupidity—even as we watch the very recent history of the real estate market repeat itself in New England and much of the nation.



"It took us 125 years to use the first trillion barrels of oil. We'll use the next trillion in 30."

— Chevron

"The consensus view among peakists and anti-peakists alike is that the earth still contains 7 to 9 trillion barrels of oil, as against the 1 trillion we've already pumped out."

— The Boston Globe

"Then there are methane hydrates. The U.S. contains some 30 trillion bbl. worth of those frozen hydrocarbons off the shores of Alaska, the continental coasts and under the Rockies. There's little doubt they too can be extracted economically."

— Peter Huber, Time Magazine

CONGRATULATIONS

Congratulations to our own Drew Kellner, who passed the Chartered Financial Analyst Level I exam in December, on his first try.

best and brightest young minds on Wall Street—will have to try again.

The financial services industry has created dozens of new degrees and titles, some of which can be earned—as the Wall Street Journal puts it—"by spending a few hours attending a training session in a hotel ballroom." The multi-year CFA program, in contrast, demands more than 600 hours of study and a total of three day-long examinations.

The December exam had a pass rate of 34%, which means that 66% of the candidates—thousands of the



Drew D. Kellner

CASH

The new mantra at A. J. Gallagher (AJG - \$27) is that they only do 3 things with cash. They pay dividends (at a rate of 4.4%), buy back stock, and buy brokers by purchasing “mom and pop” insurance brokerage firms. Gallagher was hurt by attorney general Spitzer’s insurance-industry crusade, and it was hurt again when the insurance companies they represent lowered prices in response to increased competition. But it’s a simple and straightforward company that should be able to gain market share from the likes of Marsh & McLennan and Aon.

During the past 50 years, every downturn in the housing markets was accompanied by a downturn in the stock market.

RINGING UP THE PROFITS

Our expectation that Bellsouth would be acquired by AT&T has been fulfilled—kudos to a shadow member of our investment advisory board. Both stocks are up this year, and we got an extra boost by doubling the BellSouth positions a couple of months before the merger was announced. We’ve also collected big dividends in the time we’ve held the shares, and we’re looking forward to a huge jump in the dividends paid to BellSouth shareholders after the merger.

THE RISING EURO

Among American investors it’s fashionable to talk about the many problems of European socialism. But Europe is not as different from the US as we like to think. The graying of our population hasn’t yet hit us to the degree that it has over there, and we’ve been juicing up our GDP growth rate by running big budget deficits—bigger than the ones you see on the other side of the pond. We also run a deficit in our trade with Europe And how fast would the economies of Europe grow if their consumers spent like drunken sailors,—the way ours do?

Higher European taxes are largely the result of socialized medical care, and it’s worth noting that we spend all that and more—about 50% more—for health care that buys us higher death rates, more disease, and lower life expectancies. Our own socialized system, Medicare, is bankrupt and dysfunctional.

There’s still no reason to doubt that this will be the Asian Century, but in the short term Europe might surprise. Like Warren Buffett we have a significant investment in European bonds, and they’ve been rising as the dollar has declined.

QUADRUPLED !

For many years we’ve been giving you occasional updates on the progress of our “benchmark” account as it grew from a value of \$100,000 in October of 1990. The portfolio has always been invested just like a broad swath of our other accounts. We don’t show it any favoritism in trading, and it performs no better than 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 April 30 the account’s value stood at \$400,084.

information regarding performance, fees, and our account minimum can be found at www.lumbard.com.

Photo by Rick Balboni



John Lumbard, CFA

That excellent performance is matched by terrific service. Our full attention is directed to the needs of just 46 clients who have given us the responsibility for managing almost \$50 million. Further

BOOKING PROFITS IN BEIJING

Last summer we made a big commitment to China (as well as Taiwan and Hong Kong), by purchasing shares of the Matthews China Fund (MCHFX) and the Templeton Dragon Fund (TDF). Both funds focus on the stocks of companies that serve Chinese consumers rather than American consumers, so they stand to gain from a rise in the value of the Chinese yuan.



These investments were part of a larger “Asia” strategy that included individual stocks such as Korea Electric Power and the Indonesian Telephone company (which you probably know as Perusahaan Perseroan PT Telekomunikasi), and the truth is that these stocks outperformed the funds. But the funds have done very well, and we continue to hold them. If there’s going to be another bubble on the world markets in 2006, China would be a very good place to inflate it.

China is a huge and dynamic nation, and its stock market is carrying a lot of momentum, bouncing up from an absurdly low level. At the time we bought these funds, the market for Chinese “A” shares—the ones that are largely restricted to Chinese

citizens—had fallen 50% over the course of five years. Surveys were showing that only 5% of Chinese citizens believed that stocks were a good investment, and foreign investors were exhausted after having been burned, repeatedly, by changes in government policy that clobbered the profits of industries or individual companies.

We jumped in when the government announced that it was unhappy with the decline of the stock indices and determined to turn them around. That sort of announcement might not mean much in a Western nation, but in China it was a signal that corporate profits and investor rights would be respected, at least for a couple of years.

Since then the Matthews fund has moved up slowly but steadily from \$14 to \$19 a share, and the Templeton fund has climbed from \$18 to \$25. That’s enough of a move to attract the world’s momentum investors, who drive stocks and commodities to ludicrous levels—and then bail out in a panic over the course of a few months. For now we’ll stay with the herd.



WATERWORLD

According to Chemical & Engineering News, there are three reasons why the city of New Orleans should be built someplace other than New Orleans.

- 1) The city is sinking. Geologists believe that it will sink 3 feet by the end of the century.
- 2) The intensity of hurricanes is increasing. According to Kerry Emanuel, professor of atmospheric science at MIT, the destructive power of northern-hemisphere hurricanes has nearly doubled since 1975, because the water in tropical regions is getting warmer every year.
- 3) The oceans are rising. Michael Oppenheimer, a physicist at Princeton University, believes that sea level could rise as much as three feet by the end of the century, “with a much larger contribution from melting glaciers than we have heretofore expected.”

The views of these scientists are now well accepted. A scientific panel convened by President George “The Nation Is Addicted To Oil” Bush just concluded that the earth has indeed been warming, and that human activity is an important cause. As we said in our last letter, this is a very, very good time to sell oceanfront property.

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(800) Lumbard. That’s (800) 586-2273.

A FISTFUL OF DOLLARS

According to Alan Blinder and the Minneapolis Fed, our economy doesn't feel the full effects of an interest rate increase until two years have passed. As we contemplate the likelihood of an increase in the Fed Funds rate to 5%, it's worth remembering that we'll have to wait another year to find out what 3% feels like.

Here in New Hampshire we have few illegal immigrants, and the result is that an unskilled worker can make \$20 an hour mowing lawns. Illegals are clearly having an impact on the least - fortunate members of our society.

Everybody's complaining about the high cost of prescription drugs, but the truth is that there are now good generics for almost every need—and the list gets longer every month. In June the world's second-biggest cholesterol drug goes off patent.

"Ask your doctor about Zocor."

Senator Judd Gregg, chairman of the Senate Budget Committee, points out that "Emergency" off-budget spending has become a runaway train; carrying such emergency items as oyster restoration and the relocation of a library on a military base. He calls for a return to the principles of the Gramm-Rudman-Hollings balanced budget law, without any safety valves or provisions for emergencies. When it comes to budgets, inflexibility is a virtue.

Back in the good old days an investor reading the description of a CEO's pay package would see a single paragraph detailing pay and bonuses. The same information in today's proxy statements goes on for pages and pages. There's the salary, the bonus, the restricted stock, the options, the long-term incentive plan, the deferred-compensation plan, the unintelligible-euphemism-for-extra-cash plan, the gold-plated retirement plan, the aircraft, the team of white horses a total of \$18 million a year for the median CEO among the nation's 100 largest corporations.

After all that, you're still left wondering whether you got the whole story; and with good reason. The latest news is that some CEOs have been collecting dividends on shares of stock that they don't even own, or changing the dates on their stock options to add millions of dollars to their value.

Would somebody please remind us why stock options were a good idea? One study, by Harris and Bromley, suggests that CEOs who receive a lot of stock options are more likely to lie about earnings. Another, by Moody's, finds that "companies with the highest-paid bosses, adjusted for things like company size and performance, were far more likely to default on debt or to suffer major cuts in bond ratings." (New York Times quote).

There's one last item that you don't usually see in the proxy statement. Like kindergarten teachers, directors have become so concerned about "self esteem" that they award millions of dollars to those who fail. Pay for Performance? We're living in a Lake Woebegone world in which all CEOs are above average, and everybody deserves to win a gold star.

— £ —

**"A million for you,
A million for me.**

**A million for you,
A million for me"**



A STRONGER WORLD ECONOMY

For years economists have been complaining about the imbalances in the world economy. Japan and Germany, two of the biggest economic engines on the planet, have been in a slump. China produces, saves, and invests, but rarely consumes; according to the World Bank the savings rate for the entire nation exceeds 40%. All the world's consumer demand seems to be coming from the United States, and American

consumers (and government) have been going deep into hock to keep the world economy growing.

As noble as that sounds, it can hardly be considered a good way for us to prepare for the day when we'll be a nation of retirees

Lately the US dollar has been declining gently, and the euro—soon to be the home currency of more than 25

nations—has resumed rising toward its new status as a second reserve currency for the world. “Eurosclerosis” seems to be giving way to Eurphoria, or at least Eur OK. Japan's stock market is at six-year highs, buoyed by stronger economic growth, falling unemployment, and rising corporate profits. And now China is taking steps to encourage the consumer spending that will power its growth in the future.

“Whenever you find yourself on the side of the majority, it's time to pause and reflect.” — Mark Twain

According to the Congressional Budget Office, the 2003 capital-gains-tax cut (from 20% to 15%) caused an increase in capital-gains tax collections from \$269 billion in 2002 to \$539 billion in 2005. Total federal tax receipts for the last 12 months (March, 2006) were up 14.4%.

“Don't scrap the Alternative Minimum Tax, fix it. Lower the AMT rate to 20% . . . Simplify the form so it fits on a post card . . . And then abolish the standard IRS code and hold a bonfire celebration in front of the Capitol to burn the tax forms, instruction manuals, and IRS documents.”

— The Wall Street Journal

For years the markets have shuddered, intermittently, in fear of another terrorist attack in the United States or on the oil infrastructure of the Middle East. It's more than just a little remarkable that the former never occurred.

In the second World Trade Center attack the terrorists demonstrated a high level of skill in fundraising, training, planning and execution, proving that they can and will strike again when they perceive a benefit. Clearly, they now believe that attacks within the United States are counterproductive.

Nothing has happened. Nothingness is easily overlooked, but it's all we could have hoped for.

The next U.S. recession will cause the usual ripple of anxiety in all the nations that have built their economies around exports, but we're not far from the day when the rest of the world will be able to grow without our help.

This is not a good time to stuff additional cash into the very-full stock markets of Asia, or anywhere else. But investors should begin turning their attention to the opportunities that lie beyond our shores, because it's a near-certainty that the world economy will grow faster than the U.S. economy in the next 25 years. The spread of democracy and capitalism around the globe has opened huge opportunities for investors willing to learn about and venture into new markets. We will continue to take part.

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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