

LUMBAR D
INVESTMENT
COUNSELING

INSIGHT

Nasdaq Composite 2,218* Dow Jones Industrials 10,785 * 30 year U.S. Treasury Bond 4.53%

POWER TO THE PEOPLE

The United States is full of surplus power. That might sound strange, at a time when everybody's talking about energy shortages, but our night-time demand for electric power is so low that it's a bit of a problem. One utility stores the excess power by pumping water up to a reservoir, and then running it back down through a hydroelectric plant during the day.

Most utilities have opted to simply build fewer big "base load" electric plants—the coal-fired and nuclear plants that produce power for 2 or 3 cents a kilowatt hour—because they are so expensive to build that they need to be utilized 24/7. During peak daytime hours—when office buildings crank up the air conditioning to counter the heat put off by millions of personal computers—the additional power demand is satisfied by "peaking" plants that produce high-cost power, but which are so cheap to build that it's OK to run them for just a few hours a day.

Obviously, the cost of electricity would drop dramatically if we built more base-load plants and shuttered the peaking plants, but

we'd have to find a way to smooth out demand. One answer is to charge up the batteries of millions of hybrid—and pure electric—cars as they sit in their garages at night. Their need for gasoline would be nearly eliminated. We'd save on our electric bills, and we'd even save money on the road; the Pacific Northwest National Laboratory estimates that you would be able to drive these cars for one-third of the cost of driving a gasoline-powered model. Gasoline is *three times* as expensive.

Significant change is never easy, but the cost savings—and elimination of oil imports—promised by this revolution will eventually overwhelm fierce opposition from oil companies and Not-In-My-Back-Yard activists. Those savings come in three parts; cheaper electricity, a lower cost-per-mile for automobiles, and a sharp reduction in the "external costs" of gasoline—oil spills, air pollution, support for terrorism, and greater expenditures for national defense. One of our clients—an electrical engineer—put it best:

"It's a way for America to demonstrate by deed, not just by words, that we've 'still got it'; and unleash another wave of disruptive technological change that puts us on top again. The benefits of reduced air pollution and smaller Western subsidies for over-wrought and apoplectic middle easterners are gravy."

The future can't come soon enough.

One of the oddities of the robust economic expansion of the last few years was that employees didn't push for higher wages. The unemployment rate stayed below 5%, but wages barely outpaced inflation. Corporate profit margins soared to record levels.

Blame can be laid at the feet of the media, who relentlessly pushed the idea that the economy was lousy. In any event, the tide is turning; wage increases are accelerating, and there's sure to be an impact on corporate profits in the year ahead.

A CLEANER AND SAFER FUTURE

The largest source of electric power in the United States—fully half the total—is coal. Yet coal is dirty and dangerous. It killed 47 miners last year, and the EPA believes that at least 14,000 more citizens are killed each year by the particulates, acid, and heavy metals found in coal smoke.

Over time our nation should replace all of its outdated coal plants with cleaner, more-expensive coal technology, or we should switch to



another fuel. Natural gas used to be everybody's favorite, but a slew of bankruptcies and half-finished plants stand as a reminder that the price runs up dramatically whenever we expand its use.

California, New York, New Jersey, Delaware, Connecticut, Maine, Vermont, and New Hampshire are installing Kyoto-style limits on carbon-dioxide that are already discouraging the use of fossil fuels. At least two other states are considering the measure, despite the low probability that wind, solar, and hydro power can expand rapidly enough to satisfy the nation's annual increase in energy demand—

let alone replace dirty coal plants or power millions of plug-in hybrid cars.

The only large scale, carbon-dioxide-free solution is nuclear power. It's also clean, inexpensive, and astonishingly safe. US naval personnel have been safely living cheek-by-jowl with nuclear reactors for decades, and you might be surprised to learn that we have long coexisted with 104 civilian reactors. Yes, we're still waiting for Nevada to quit blockading our only official repository for nuclear waste, but there's so little waste produced that the utilities have been storing it next to their plants in swimming pools—for 40 years—while they waited for the government to build a storage facility.

America's Hollywood-fueled fear of radiation has caused tens of thousands of coal-related deaths, and it shows up in other peculiar ways. We'd rather let people die of bacterial contamination than irradiate our food. Never mind that we're going to pop it in the 2.4 gigahertz microwave while talking on our 1.9 gigahertz cell phones, and then step out onto the deck to soak up some warm solar "rays" while we eat.

France has already converted to nuclear power, and China—never one to pass up a competitive advantage—is building nuclear plants as fast as it can. We can continue down the dirty, dangerous, vulnerable, and second-rate path that we're on, or we can embrace a cleaner and safer future.

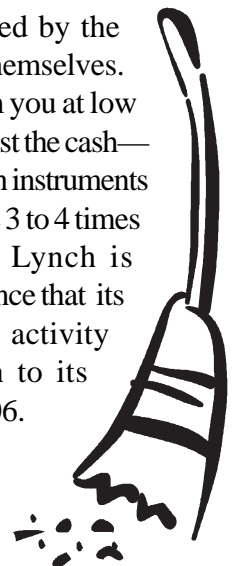


Drew D. Kellner

SWEPT UNDER THE RUG

If you have an account with one of the large securities firms, take a minute and look at the cash portion of your statement. Over the last several years Wall Street's biggest names have been quietly transferring cash out of money-market funds and sliding it into "bank deposits" with sharply lower yields; as low as 1.25% for clients who have small accounts.

The banks that hold these deposits are owned by the brokerage firms themselves. They borrow from you at low rates, and then invest the cash—for their benefit—in instruments with yields that are 3 to 4 times higher. Merrill Lynch is expected to announce that its profits from this activity added \$2 billion to its bottom line in 2006.



PEPCO

Our most recent stock purchase is Pepco, and we're not talking about Manny, Moe, and Jack. Pepco (POM, \$25) is an amalgamation of the old Potomac Electric of Maryland, Delmarva Electric of Delaware and Virginia, and Atlantic City Electric of Southern New Jersey. It's a region of modest growth and heavy regulation—two of the states have even started regulating carbon-dioxide emissions—so why would we want to own an electric utility there?

It's all about the regulators. The Federal Energy Regulatory Commission, which regulates the transmission of power over long-haul, high-tension lines, believes that inadequate transmission capacity has left the nation's electric grid vulnerable to blackouts. They're offering good

incentives to utilities that will help solve the problem. Pepco will get a 12% return on its planned investment in a 230-mile transmission line, and some of the cash will start to flow long before the line is finished—via a small surcharge on utility-customer bills.

Pepco is paid separately for "distributing" that power to individual homes, and it deserves a big rate increase in each of its service territories under existing (state) regulatory rules. Then there's a separate subsidiary that produces power, and sells it to the grid in a flawed bidding process that's about to be improved—to the benefit of the power producers. Lastly, there is reason to think that Pepco's power plants will begin to sell a lot more electricity than they have in the past.

That's because Pepco owns a lot of natural-gas-fired "peaking" and "mid-

merit" plants that were inexpensive to build, but which produce expensive power that can't compete unless there's a lot of demand. They sit idle, losing money all night, and then make hay when the sun shines hot and the air conditioning units come on. That hasn't happened often enough to make a good return, but any increase in the demand for power in the mid-Atlantic region will cause these plants to run longer and more profitably.

That increase in demand will come, because the nation's population is growing. You'd think that somebody would build more plants, but regulators, legislators, and Not-In-My-Back-Yard activists have discouraged anybody from stepping forward. There is not a single new plant on the drawing board. The sun is beginning to shine on Pepco, and you have the opportunity to make hay.

THE OIL GLUT

It's warm in Manhattan, so the global price of crude oil is falling. Never mind that it's cold in Minnesota and Japan; what matters is the weather that hedge-fund managers and crude-oil traders see outside their Wall Street windows. And right now they're running scared, because they know that they've purchased too many oil contracts. Each contract has to be backed by oil in a storage facility, and the storage tanks are full to the brim.

We've been calling for lower oil prices, on the grounds that it's nearly impossible to justify a quintupling of the price of oil or any other commodity. [If this were a tabloid we'd call it a sextupling, because the price rose from \$12 in 1998 to more than \$72 last

summer]. The laws of supply and demand are very powerful, and the only thing that gives us pause is the average American's indifference to higher gasoline prices. Big pickup trucks and SUVs are part of America's obesity boom

Even at \$2.50, gasoline is so cheap that it's difficult to develop alternatives such as biodiesel and ethanol. And if the price of crude oil falls below \$40 it will deal a devastating blow to coal-to-diesel, oil sands, and production from very deep and difficult wells.

That statement seems to imply that the price of oil can't possibly drop below \$40, but it will. In the 1990s the price of oil dropped far enough and long

enough to wipe out all of our fledgling alternative-energy industries. A surge of interest in plug-in hybrids and electric cars would cause a collapse in the price of gasoline that would launch another cycle of gluttony, dependency, shortage, rising prices, and geopolitical concern.

There has been a lot of talk of "sacrifices" in the war on terror, but the average citizen hasn't been asked to do anything except remove his plastique-filled shoes in the airport. The federal government needs to take a leadership role in pushing the nation into the next era. Halting the slide in gasoline prices is a good place to start.



HOW TO BUILD WEALTH



John Convery, CFA

Years ago the Continental Bank in Philadelphia ran an ad campaign in which they showed a homeowner writing out monthly checks for his mortgage, his utilities, and other expenses. He sat at a desk writing out a check to his savings account, and then stamped his hand with the word “Paid”. The point was that he “paid himself first”, by adding to his savings account. I don’t know how successful the ad was, but it was successful in motivating me; and I owe that bank a debt of gratitude.

This concept of savings—a deeply-ingrained habit in many parts of the world—has rarely been fully embraced in this country. Wealth, economic stability, and the promise of Social Security have caused it to erode even more. Many Americans contribute to 401K plans, and most are willing to speculate in stocks or real estate, hoping for a big payoff. But the practice of voluntarily setting aside a portion of each pay check as savings is rare indeed.

Even the concept of paying off the mortgage—a form of forced savings—seems to be disappearing. Most Americans now see their homes as piggy banks; a source of low-cost financing that happily appreciates over time. That robust appreciation is now coming into question as the real estate market turns south, and homeowners are beginning to notice the impact of real estate taxes and maintenance expenditures.

The key is to set your expenses at a level that’s smaller than your income. If you are living beyond your means you’ll find that you won’t make much progress unless you tackle your biggest expenses (such as your house and car), but almost anyone who lives in this country has the ability to make huge cuts in the family budget.

At first you use the extra cash to pay off any credit card or high-interest-rate debt. There’s no need to make



extra payments on your mortgage, because the conventional 30-year mortgage offers a nice balance between ultra-low-cost financing (the result of favorable tax treatment) and steady, long-term savings that result from paying down the principal.

Now you can begin to build real savings. Those savings will grow faster if you invest them in the common stocks of well-run, sensible companies. Buy at good prices, and hold for the long term.

The safe path to wealth requires many years of discipline, but as time passes the growth of your money will appear, via the magic of compounding, to accelerate. The first time it doubles is always unimpressive, but the third doubling is always an eye-opener. Try it now, on paper, so that you can absorb the lesson before you retire.



“Thirty per cent of the Chinese population will be over 60 by 2050. Demographers sometimes say that China is in a race to get rich before it gets old.”

— The New Yorker

After decades of shrinkage, the United States now has 17 million workers in manufacturing. Japan has 12 million, and Germany—surprisingly—has just 8.5 million. China has 109 million.

“The art of taxation consists in so plucking the goose as to obtain the largest amount of feathers with the least possible amount of hissing.”

— Jean Baptiste Colbert, 17th century finance minister to France’s Louis XIV

SMALL IS BEAUTIFUL

It's hard to manage billions of dollars. We haven't tried, but we know how hard it is to buy or sell 30,000 shares of a thinly-traded stock. When the manager of a large mutual fund has a sudden urge to sell a few million shares of a stock—even a blue chip—that's just been hit with bad news, he's going to knock the price down so much that the cost of his brokerage commissions will seem irrelevant by comparison.

Small investment advisory firms can buy and sell the stocks of companies large and small without ever disturbing the markets. The result is that our trading costs are lower—a lot lower than the 0.47% that Wake Forest University estimates as the annual hidden cost at the average mutual fund.

A similar advantage can be seen with other thinly-traded securities. During the last several weeks we've been buying a rare and elusive bond issued by the AAA-rated European Investment Bank. The bond was issued at par value in 2005, with a promise to pay interest of 9 5/8% until it matures ten years from now at par value. We bought most of our bonds at 79% of that par value, which means that our yield-to-maturity was greater than 14%. If the bond's price recovers to par during the next two or three years we'll be able to sell with a far greater annualized return.

**Turkish
Delight**

Naturally, there's a catch. The bonds are denominated in New Turkish Lira, and there's a good chance that the lira will decline and take away part of that huge return. Turkey has been battling inflation (as Paul Volcker did for our nation in the 1980s), and they've pushed short-term interest rates to 20% at a time when inflation runs at 10%. The likely consequence is a Turkish recession, followed by a dramatic drop in short and long-term interest rates.

You'll remember from our last newsletter ("Buy Bonds") that bond prices go up when interest rates go down. We think that the appreciation of the bonds will offset the decline of the currency, and that in the worst case we'll walk away with a "current" yield (9 5/8% divided by our price of 79) of 12%.

Small is beautiful.

SEC rules, thankfully, are long on substance and short on red tape. One exception is the requirement that each year we offer part II of our form ADV to clients and prospective clients.

The form is remarkable in that it contains little information that anyone would find useful—but the SEC requires that we offer it in writing, and that you respond in writing to request a copy.

We'll send you one even if you call on the telephone. Call us at (800) Lumbard, which works out to (800) 586-2273. That's Lumbard, not Lombard. (800) 586-2273.

Photo by Rick Balboni



John Lumbard, CFA

QUADRUPLED

For many years we've been reporting on the growth of an account that one of our wonderful clients established sixteen years ago—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 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 (at the moment just 48% of the assets are invested in equities). 2006 was another great year; on December 31 the account's value stood at **\$436,740**, up from \$100,000 in October of 1990.

That excellent performance is matched by terrific service. Our full attention is directed to the needs of just 45 terrific clients who have given us the responsibility for managing more than \$53 million. Further information regarding performance, fees, and our account minimum can be found at www.lumbard.com.

REALTY CHECK

We've also been calling for lower real estate prices. In recent months a number of pundits have stepped forward to say that home sales and prices are rebounding, and that we never had a bubble in real estate because there was no euphoria or irrational behavior.

Irrational behavior? How about the wild speculation that swept through the hottest markets, with speculators taking on leveraged risk that would bring nighttime terrors to the most aggressive commodity trader? Or the \$800 billion that bankers and mortgage lenders gave to bad-credit/no-credit borrowers, often with no money down, in 2005? A whopping 10% of the nation's mortgages now fall in the "sub-prime" category . . .

Euphoria? How about the brand-new, turn-of-the-millennium idea that "***you can get richer by living in a larger home***"? It ignores huge, in-your-face expenses such as real-estate taxes, mortgage payments, and maintenance.

Trillions of dollars in adjustable-rate-loans are still adjusting upward. 5.7 million vacant housing units—1.3 million more than normal—are available for sale or rent. Builders are planning to put up another 1.6 million empty homes this year. It's far too early to call for a bottom in real estate.



TERROR IS FOR PRAGMATISTS

The media continue to miss the key issue of today's international diplomacy and geopolitics: *Terrorism is a successful strategy*. It opens negotiations with unwilling governments, changes the course of elections, and has a tremendous track record as a tool of fund raising.

As long as this statement is true, we will continue to pay a price measured in thousands of lives and hundreds of billions of dollars each year—as well as the intangible costs of fear, barriers to trade, and disincentives to entrepreneurial activity. There is no goal or priority in our foreign or domestic policy that is more important than proving that terrorism will not be a successful strategy in the future.

That's easy to say, and hard to do. Terrorists will not alter their strategies unless they suffer repeated failure; and each of their victories must be countered with many more failures, over the course of years. We imposed failure on al-Qaeda after 9/11—they learned that attacking U.S. territory is counterproductive—but the lesson

"In the period from 2001 to 2003, top-executive compensation amounted to 9.8% of the companies' net income, almost double the 5% in 1993 to 1995."

— The Wall Street Journal

was limited to the notion that Americans will not withdraw when they cannot withdraw.

There is little reason for optimism. Years will pass before Europe takes a thoughtful and tough stand against homegrown terrorism. The American public has little stomach for maintaining embassies or troops in the face of deadly attacks. Our media continue to pursue sensationalist and unhelpful agendas, such as painting Saddam's Baathists—who used terrorism with thoughtful deliberation as a means of regaining power—as heroic underdogs. Hollywood continues to poison our diplomatic efforts by bombarding the Muslim world with images and language that its peoples find to be offensive.

Battling terrorism is more important than politics. It's more important than our "need" for cheap oil, more important than commerce, and more important than our desire to be taxed lightly. There are countless lives at stake, along with freedoms and rights that are already slipping away in many parts of the world. Let us not forget that there was genuine fear in the land in the fall of 2001, which caused gentle people to call for blood. Rather than ricochet from one extreme to the other, let's focus on the task and move forward with courage and conviction.

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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