

MARKET OVERVIEW

Everyone has an opinion about the market, what makes it go and where it will go. Strong words and sometimes even stronger bets back up the prognosis. But in hindsight we see that even the lowest probability outcome is possible.

Sooner or later the bonds had to break, under relentless pressure from the Fed and an imposed curve inversion that, for the first time, had nothing to do with statistically reported inflation. It is as though the Fed has finally taken back The Law from the bond vigilantes. For more than a year “the conundrum” obtained, but after bond market sentiment and a number of leading bond market seers turned bullish at the end of last quarter (guessing that the Fed was finished or nearly so) it was only a matter of time before bonds went bearish. More surprising, though, was the behavior of the equity market in the face of rising rates. Stocks were broad and strong, and made at least tentative forays above the “trading range” which we had presupposed. While we can’t consider this extension beyond the previous recent tops conclusive at this point, it does prompt a reconsideration. Is there so much cash floating around that the entire market is subject to fund flow pressures as has been, for example, the REIT sector? Is the future of bond investment so inevitable that it has prompted asset-allocation shifts to equities even in the face of new pension fund accounting that favors bonds? Is it just a wiggle and an overshoot? Sorry, there’s not enough evidence, and the indicators that have any clarity are in such contradiction, that one can only say, as we said last time, “more of same.”

But we can offer some clarity for long-term investors who aren’t squinting at every zig or counting all the angels who can dance on the head of the Federal Reserve chairman. While we’re as vulnerable to the urge for economic and market futurevision as the next person, in reality the principle of owning *income producing assets that grow over time* is an eternal verity that has nothing to do with this quarter or the next quarter or multiple quarters in the hereafter.

Since we focus on rising income stocks, we’re often asked “how do your stocks perform when interest rates rise?” There’s typically a subtext to that question, as the well-educated interrogator seems to float on a sea of received knowledge that if one thing with a yield goes down then all things with a yield must go down. We trot out our correlation charts and show that since 1994 there has been absolutely no correlation between our performance and that of bonds, indeed there’s been a negative correlation. Somehow it seems that old habits of thought die hard, though, and that people don’t really believe that a high-yielding portfolio can defy the interest rate environment.

THE STRATEGIES

INCOME-EQUITY STRATEGY

A diversified dividend-growth strategy providing high current income, growth of income, and growth of underlying principal. Stocks are conservative, high quality, high yield, and are projected to have a rising stream of income.

BETTER THAN BONDS / UTILITIES

A conservative strategy offering growth and income for total return investors by focusing on opportunities in the broad utilities sector: electric, gas, telephone, and water.

DISTRIBUTION / MERGING UTILITIES

An opportunistic portfolio focusing on companies that are likely to be acquired during an era of utility consolidation and convergence.

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“The question for investors, is how to find bond-like income with equity-like total returns and minimum volatility.”

We’re not suggesting that dividend growth strategies will never respond to rising rates over the short term. They do and they have. But the real point for an income investor is that dividend growth portfolios don’t have to go along. While bond mathematics make losses inexorable and certain for fixed income when rates rise, many other factors affect our rising income stocks; they can provide high income and swim upstream against rising rates at the same time.

Taking our Income-Equity Strategy as an example, this quarter provides compelling anecdotal evidence that not only is this portfolio an effective participant in the equity markets (it’s outperformed the S&P 500 for 3, 5, and 7 years annualized returns and vastly so on a risk-adjusted basis) but it is also a useful approach for investors who want yield along with their growth and don’t want to be held hostage to the changes in interest rates. Our preliminary gross of fee total return for the quarter was 6.1%, while the long-term bond declined (3.6)%. That’s a 9.7% point difference, a 970 basis point difference.

When we first opened our utility strategy we called it “Better Than Bonds,” and it has been, net of fees, despite a hiccup in 2001-2002. With a substantially higher yield, perhaps we should re-name our Income-Equity Strategy “Even Better Than Better Than Bonds.”

While investors rightfully “slot” our strategies somewhere in an equity allocation, many might seriously want to consider their value as a bond alternative—especially in an era where the probabilities seem to favor rising rates (and declining bond values). The question for investors, is how to find bond-like income with equity-like total returns and minimum volatility.

Here’s a fun fact: The dividend income has risen every year (historically and as our management goal) in our strategy. If you invested in the Income-Equity Strategy at inception in 1997, by the end of 2005 your yield *from income alone* would be 7% on your

original investment, if you spent all the income along the way. On a dividend-reinvested basis your *income yield* on original investment would be over 11%. That’s from a portfolio rated A-/BBB+, and that yield is far higher than you could get today even from junk-rated bonds.

Investment success is not about correctly predicting the Fed or Industrial Production or new Manufacturing Jobs or even the current tastes of institutional managers. It’s really all about compounding. Let’s say you start with \$10 million dollars invested at the Income-Equity Strategy yield of 5.4% on 12/31/05. Since our projected growth of income for the portfolio is 6% (a number we’ve also consistently met in the past), the table below is what will happen to your yield on initial investment—assuming similar growth in income in future years. Bear in mind that a bond with a 5.4% yield will have a 5.4% yield in year 10:

End of Year Return on Original Investment, No Reinvestment Of Income, 6% Yield Growth

Year	Year
1) 5.40%	7) 7.66
2) 5.72	8) 8.11
3) 6.06	9) 8.61
4) 6.43	10) 9.10
5) 6.80	11) 9.67
6) 7.22	12) 10.25

As you can see your yield on original investment doubles in about 12 years. In reality it might be somewhat worse or somewhat better (our dividend-reinvested yield on original investment since inception has actually nearly doubled in only 7 years). And 12 years isn’t the end of it. By year 20, for example, your income return on original investment without dividend reinvestment would be 16.32%. World without end. In the *Fundamentals of Corporate Science* (a text for the CFA examination) the authors point out that if the Native Americans who sold Manhattan in 1626 had invested their \$24 at

SELECTED INDICES		
	1 st Qtr’06	12 Mo
S&P 500	4.2	11.7
Equity Inc	5.5	11.7
Util Fund	3.1	14.1
R3UTIL	6.1	11.6
LB Long	(3.6)	2.1
LBGC	(1.0)	2.0
R1000	4.5	13.2
Wilshire 5K	5.5	14.9

S&P 500 = Standard & Poor’s Index
 Equity Inc = Avg Equity Income Fund (Lipper)
 Util Fund = Avg Utility Fund (Morning Star)
 LB Long = Lehman Long Government
 LBGC = Lehman Bros. Gov/Credit Bonds
 R3UTIL = Russell 3000 Utilities
 R1000 = Russell 1000
 Wilshire 5K = Wilshire 5000 Market Index

10% and compounded the returns, “they would today have 31 quadrillion dollars—enough to buy all of the United States, Canada, Mexico, and most of the rest of the world.”

The process can go on forever, and if you don’t need income now, re-investment of the income in more shares acts like a turbocharger to generate even more income return over the years. By year 10 you are receiving a return on original investment equal to the long-term expected total returns from equities, but it is *from income alone*. It has almost no volatility. And in the meantime one may presume that the rising income has forced higher the value of the stocks producing it.

You are, in effect, rewarded for sitting. The process has little to do with formal categories of bond or equity, or categories of growth or value, or small or large. It has everything to do with finding solid businesses in which you want to be a partner, and committing to the long-term growth of both the business and income the business can provide you.

So, every quarter we give the update, but the above discussion is really the right understanding of what you’re doing, long-term. You’re compounding. Investing is just the process of compounding. □

ABSOLUTE VALUE STRATEGY

Due to limited space this quarter, the **Absolute Value Strategy** review is available exclusively on our website at www.mhinvest.com/absvalue.

	Absolute Value (Net of Fees)	HFRI Equity Hedge
1QTR06	3.4%	5.9%
1 Year	7.4%	16.6%
Since Inception* (Nov. 2003)	14.5%	11.5%

*Annualized

The essence of this strategy is found in our Overview section this quarter. We’re asked so often about prospects for performance of this portfolio in a rising rate environment we feel the need to drive home our point whenever possible. To re-iterate, we would suggest that investors consider our high-yield equity portfolio as a fixed-income alternative as well as a low-volatility equity strategy—especially in this era where reasonable expectations for positive returns from bonds have been...reduced.

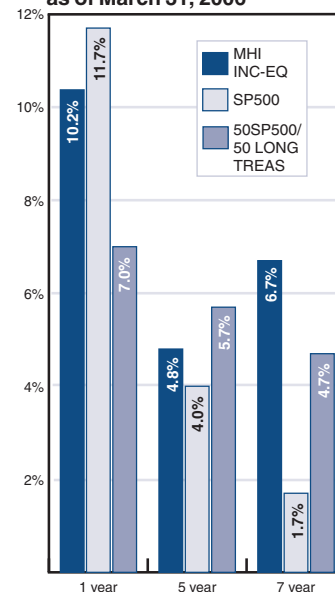
To be sure, rising rates may have an impact on returns, as they may for returns from all financial assets. But while a degradation of bond performance is a certainty in a period of rising rates, this strategy retains the opportunity to do well despite rising rates. And this past quarter was a perfect example, as we provided 9.7 percentage points (970 basis points) of added value over fixed income measures. On top of this, our current yield started and remains higher than long-term government bonds, and our income grows over the years, while bonds’ does not. We think of it as “unfixed income,” and we think the logic of the long-term superiority that dividend-growth on a high-yield base can provide over bonds is impeccable.

PORTFOLIO HIGHLIGHTS

Lots of positions added or upweighted in the past year bore fruit this quarter. Despite a so-so performance of the energy sector, our leader was Tidewater, with a gain of about 25%. The company, which provides service boats to the drilling industry, is running at 100% utilization in an environment of increased pricing. Autoliv provided a similar gain, after reporting an upside

“We think of it as ‘unfixed income,’ and we think the logic of the long-term superiority that dividend-growth on a high-yield base can provide over bonds is impeccable.”

**Annualized Returns
as of March 31, 2006**



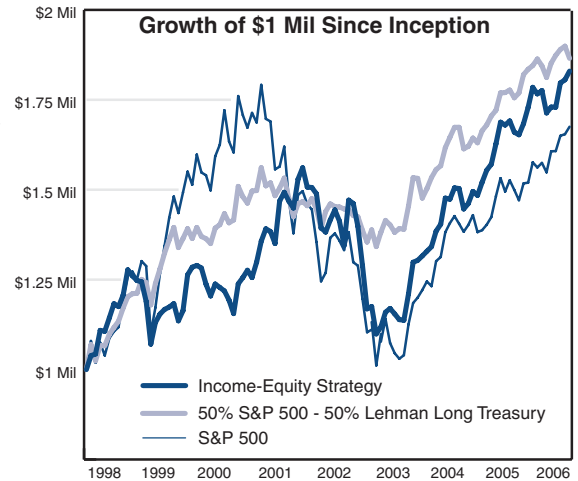
Disclosure: Gross of fees performance is based on actual results calculated by using Checkfree Security APL's portfolio accounting software, which uses the BAI method of calculating performance. Contributions are time-weighted to the day and performance is linked to monthly calculate cumulative performance consistent with FAF (Financial Analysts Federation) guidelines. A complete list of all composites is available. Net of fees performance is calculated by deducting an annual fee of 100 basis points from gross of fees performance. Returns are total returns, dividends are assumed to be reinvested & portfolios are matched across all accounts (each client holds substantially the same issues at the same weights.) Portfolios are typically fully invested and hold minimal cash, although cash holdings may fluctuate somewhat on a residual or transitional basis. No representation is made that future returns will approximate past results, and none should be implied.

"...last year a stated yield in the mid-5's turned out to be an actual income return of 6.8% from dividends and interest."

earnings surprise on strong margins. This one was especially gratifying because it is, broadly speaking, an auto parts supplier—a group that’s done miserably. But the auto content of its safety products (airbags, etc.) is growing rapidly, and the company has minimal exposure to the US carmakers. We’ve done really well with it, and may trim or step to the sidelines this quarter on valuation considerations.

ONEOK and Northern Borders Partners have become joined at the hip over the past year, and the combined “unit” gave us a boost when OKE, now general partner of NBP, announced a sale of assets to NBP which will benefit both entities. We were fortunate enough to have increased our weight in NBP at the end of last quarter, after the stock had declined precipitously. We also thought Energy Transfer Partners had much more upside in it, and the stock rose 13% plus a healthy dividend after various brokers chimed in with support for its prospects. We suggested last time that MLPs were undervalued, and we still think so despite some good gains for the quarter. Though many in the analyst community believe that these are “interest sensitive,” the past period should help disabuse them of that notion. Enterprise Products was just average though we think it can be a leader soon, and Kinder Morgan continued to consolidate.

Consumer non-durables weren’t especially strong, but our Campbell Soup made new highs on a positive earnings surprise accompanied by higher margins despite a warmer than average soup season. Financials were also lacking in interest (we’d previously shaved our financial exposure substantially) but Euroland star ING Group continued its corporate and stock price recovery, adding a 14% gain to help the portfolio. Drugs were



also kind of middle of the road, though Bristol Myers benefited from a settlement regarding their lead drug Lipitor, climbing 9% and erasing what had been a relentless if moderate previous decline. Our Baxter convertible preferreds expired; we replaced the common stock with Abbott Labs, historically inexpensive and set to benefit from an excellent deal with Boston Scientific, taking appropriate assets in BSX’s takeover of Guidant.

Elsewhere of note, our small position in telecom tower operator Global Signal (we never did find the right price to increase our weight) continued to rise, adding 13%. Keyspan received a takeover offer from National Grid (see the utilities write-ups for details), and a recovering utility distribution group helped Southwest Gas and Energy East to solid gains. AT&T was strong in a generally strong telecom sector. Capital Source continued to develop a constituency in its new life as a REIT (and raised over \$400 million for new deals which will likely add to growth in coming quarters and years), rising 10% in addition to a large special dividend which we took mostly in stock.

We added Bayer just a day or so before

Quarter Composite Net of Fees*

Income-Equity (Prelim)	5.8%
50/50 SP500 & Long Treas	0.3%
Russell 1000	4.5%

12-Month Composite Net of Fees*

Income-Equity (Prelim)	10.2%
50/50 SP500 & Long Treas	7.0%
Russell 1000	13.2%

5-Year Composite Net of Fees*

Income-Equity (Prelim)	4.8%
50/50 SP500 & Long Treas	5.7%
Russell 1000	4.7%

Included are all unrestricted portfolios that have been managed for one full quarter. As of 3/31/06: 537 accounts in composite, representing 61% of total assets in the strategy with a dispersion of 0.29. Inception: 5/97. We offer a customized version of Income-Equity that excludes Master Limited Partnerships. These accounts are not included in the composite and represent 30% of the total assets in the strategy.

Bayer offered to buy Schering AG. The growth profile of this company—the largest in Germany—is superior to US pharmaceutical counterparts while its valuation is in the same zone, and the more international exposure we can get in solid and stable companies, the better. Indeed, German business confidence is suddenly rising and there's a decent chance that Germany's dormant economic powerhouse may be finally ready to flex its muscles again. We also bought Potlach, another company converting to REIT status, looking for exposure to the forest products and paper industries at a reasonable price with a 6.5% yield. Obviously others were hunting the same game, since the stock has risen over 10% in the relatively few weeks we've owned it.

There wasn't a lot of pain on the downside. Proctor and Gamble surprisingly gave back earlier gains to close with a loss of about a percent. Investors are suddenly wondering if the Gillette acquisition will be as transformative as we've thought; we haven't changed our opinion. RR Donnelly declined for no reason we can discern, and should recover soon. St Paul was dragged down more by a weak financial group than by any change in its own fundamentals (possibly excepting investor fears that the company is seeking acquisitions). Unum Provident turned in disappointing earnings at a time when evidence of a turnaround is expected, so it's entered our watch list.

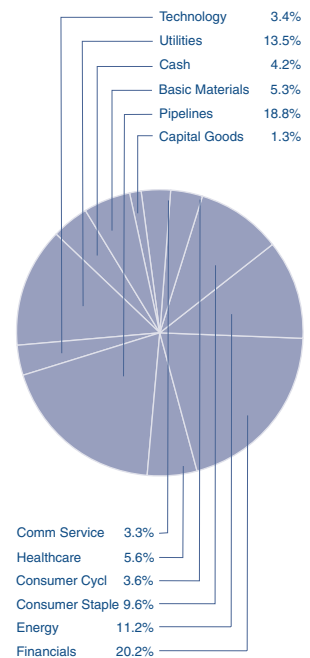
It's an uncommon phrase for us, but we have to say we *gave the boot* to Clear Channel on a modest rally. We originally bought this stock almost one year ago when the company promised a large special dividend. Since it was coming from the company's mighty cash flows, which would thereafter remain undiminished, we thought it was a reasonable choice for the portfolio, even though radio's

glamour days may be over and new competition has arisen from satellite services. But management did not deliver the dividend as promised. Indeed, management kept changing their promise, failing to deliver, and changing again. We're feeling deceived, and one of our risk controls is to vote with our feet when management turns mendacious, so we're out.

LOOKING FORWARD

We've got a few stocks that have been excessively strong that are candidates for trimming, but otherwise the valuations in our portfolio remain modest. Our PE and Book Values are a little below the market, our yield is over three times the market and higher than long-term government bonds. We hold several stocks that are takeover candidates, many stocks whose fundamentals are fine but which just aren't the apple of investors' eyes at the moment, and a number, like Microsoft, which we view as sleeping giants. As did AT&T, they might awaken at any time. The market may be dicey, but our cash flow is high and growing, and our "team" of stocks doesn't look to us like it needs much in the way of freshening up. We expect little help from the indices going forward—it will be all about individual stock picks, and about individual stocks meeting or exceeding investor expectations.

As of the end of the first quarter the portfolio yield from dividends was 5.1%. The five-year dividend growth rate in the portfolio is 10.3%, and projected dividend growth is 6.1%. The yield can fluctuate to the upside—due to special dividends and dividend increases—last year a stated yield in the mid-5's turned out to be an actual income return of 6.8% from dividends and interest. □



FUNDAMENTAL CHARACTERISTICS

Yield	5.1%
Proj Dividend Growth	6.1%
Payout Ratio	43%
Market Cap	\$31 Bil
Price/Book	2.7
P/E Ratio**	14.9
S&P Rating	BBB+
Beta*	0.6
R-Squared*	0.5
Standard Deviation	11.7

*Relative to S&P 500, 3/31/00-3/31/06

**REITs use P/FFO ratio

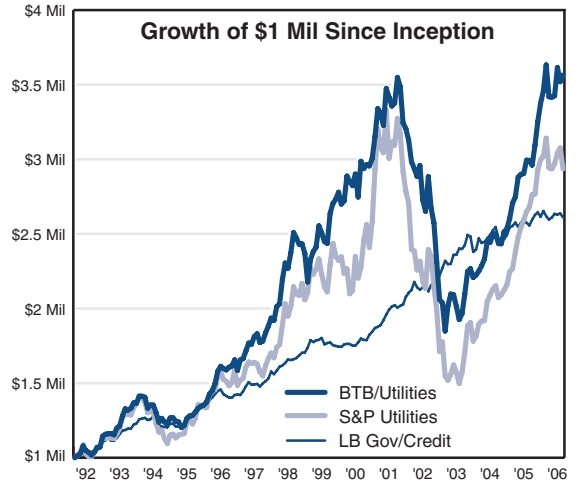
“We’ve been noting the gradual increase in utility industry consolidation over the past year (we remain optimistic that ‘gradual’ will become ‘vigorous’ before long), and have positioned our portfolio to benefit from the trend.”

The first quarter was a fine object lesson in two points we’ve been stressing for some time: first, that the world of utilities does not begin and end with the “brand-name” large-cap electrics that populate the popular averages such as the Dow Jones Utilities, and second, that diversification is a good thing, even within a sector. Our stocks provided a solid positive quarter even as the DJU declined significantly, and did so with a rather broad mix of company types. The Russell 3000 Utilities was even a tad better—primarily due to the heavy weight of telecoms in this index (we’ve reversed course and begun adding domestic phones in the 4th quarter of 2005, but not at the weight of the index) and the excitement provided by AT&T’s takeover offer for BellSouth.

Global warming? Though the nation experienced the warmest winter in 112 years (27% warmer than normal), and our portfolio is geared to “average” weather, diversification into domestic and foreign phones, as well as some supplier stocks, helped to overcome the expected soft tone of the large electric indices.

PORTFOLIO HIGHLIGHTS

Last quarter we noted that our gas stocks were discounting future gas prices that were unrealistically low. Did equity investors know that the upcoming winter would be a record-breaker in its absence? We doubt that, but the concomitant softness of natural gas prices proved the point, as half of our gas stocks actually helped overall returns in the portfolio; one can only assume that gas equities are priced very conservatively compared to product prospects. Further, gas is no longer just a winter commodity, as its importance in electricity production has risen greatly (and this



has been a big factor in our commitment to the group).

We’ve been noting the gradual increase in utility industry consolidation over the past year (we remain optimistic that “gradual” will become “vigorous” before long), and have positioned our portfolio to benefit from the trend. This past quarter our holding Keyspan received an offer from Britain’s National Grid at 17 times earnings, giving a boost to returns and helping re-establish the private market value of gas distribution companies. National Grid hasn’t spent its war chest, and we continue to hold additional companies which we believe fits its U.S. expansion plans as outlined in the company’s special report two years ago. We sold KSE, as its market price, reflecting the certainty of the deal, was very close to the acquisition offer and we did not think the chances of a competing offer were great.

We pointed to ONEOK as irrationally sold in our previous report, noting that investors had fled the stock on the weak earnings report, ignoring the fact that the company was in a transitional mode and that its deal to acquire the general partnership

Quarter Composite Net of Fees*

BTB/Util (Preliminary)	4.1%
Russell 3000 Utilities	6.1%
S&P Utilities	(1.2)%
LBGC	(1.0)%

1-Year Composite Net of Fees*

BTB/Util (Preliminary)	19.1%
Russell 3000 Utilities	11.6%
S&P Utilities	9.5%
LBGC	2.0%

10-Year Composite Net of Fees*

BTB/Util (Preliminary)	8.4%
Russell 3000 Utilities	3.4%
S&P Utilities	6.8%
LBGC	6.3%

Included are all unrestricted portfolios that have been managed for at least one full quarter. As of 3/31/06: 159 accounts representing 94% of assets in the strategy, with a dispersion of 0.12. Inception: 9/91.

interest of Northern Borders was likely a move that would lead to enhanced prosperity. This quarter, investors ran to the other side of the ship as OKE announced a deal to transfer assets to Northern Borders, and the stock made the round trip from goat to hero, finishing up over 20% for the period. OKE has a number of parts with high potential, and we continue to consider this a key core holding for the long term. It's the type of situation, like a Kinder Morgan, that could have a surprisingly large upside. We'll see, and collect a nearly 4% yield (which was increased 10% in the past year) in the meantime.

Foreign phones and industry suppliers were a big driver for us. We added these earlier as an alternative to domestic phones, based on higher growth, better protection from local regulators, and fund flows into international markets. PT Telekomunikasi Indonesia may be difficult to pronounce, but it is a dominant telecom in the South Pacific region with current earnings growth well above 20% but valued similar to U.S. domestic telecom companies whose growth is, as the saying goes, not so good. The stock was our portfolio leader, with a gain of 25%. Likewise China Mobile—the largest wireless company in China—has been shooting the lights out with subscriber growth substantially greater than most observers have expected, and it too rose to new highs during the quarter. Domestic phones, which were among the strongest performers in the broad market this quarter as they rose to correct previous undervaluation, helped the portfolio as well, with gains of 10-14% for AT&T, Sprint, and Verizon. Interestingly, T and VZ still have, even after the quarter's rally, dividend yields which are substantially higher than the large-cap electrics. Yet future growth, while

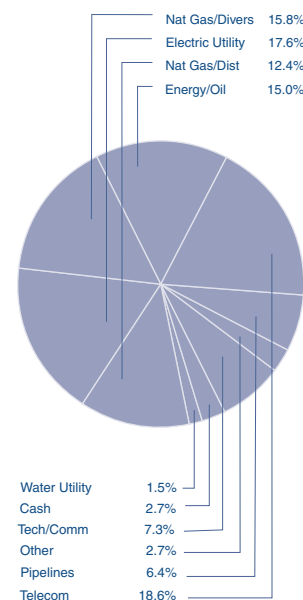
subdued compared to the past and threatened from many places, is sure to be equal to projected gains from large electric companies.

We've added some suppliers into the mix, with good results. Automated meter company Esco added a gain of over 12%, and wireless phone handset maker Nokia rose some 15%. These are not heavily weighted positions because their intrinsic volatility isn't a great match for our portfolio assets, but there's a definite place for them in the quest for alpha. They'll pass in and out of the portfolio more quickly than our mainstream stocks; we intend to treat these as opportunistic amenities to the basic portfolio.

Among the few downers, Telefonos de Mexico corrected off its previous strong performance in 2005 but remains among the cheapest global telecoms. Pioneer fell on what we think are transient concerns (and a rise in Ultra neutralized the effect, among our gas issues), and new position Telstra, the Australian telecom, backed down a bit as a result of noise from the local regulator. Also, Questar fell for a change, though it's still more than 50% above its 2005 opening price.

LOOKING FORWARD

We don't think large-cap electrics are ready to resume their earlier position of relative strength, so there may continue to be a cloud on utilities generically. But we think we can continue to find names that move on their own dynamics. Lately some of the weak have been strong and some of the strong have been weak. While this portfolio hardly seeks to exploit every wiggle, there's ample room for us to try to shift ahead of the ever-changing cycles. □



FUNDAMENTAL CHARACTERISTICS

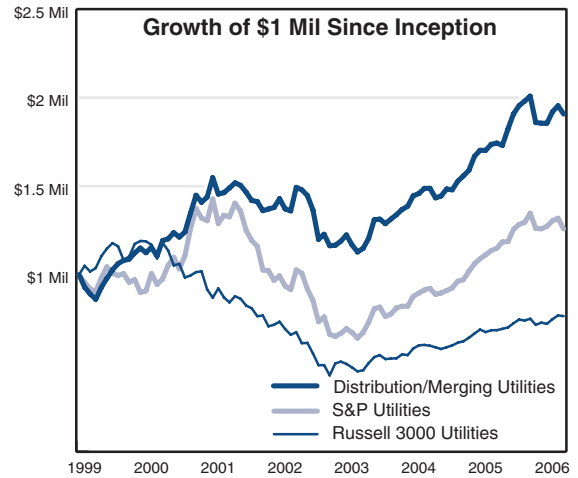
Yield	3.0%
Proj Dividend Growth	5.7%
Payout Ratio	55%
Market Cap	\$17 Bil
Price/Book	2.2
P/E Ratio	16.5
S&P Rating	BBB+
Beta*	0.7
R-Squared*	0.4
Standard Deviation	14.8

*Relative to S&P500, 3/31/00 - 3/31/06

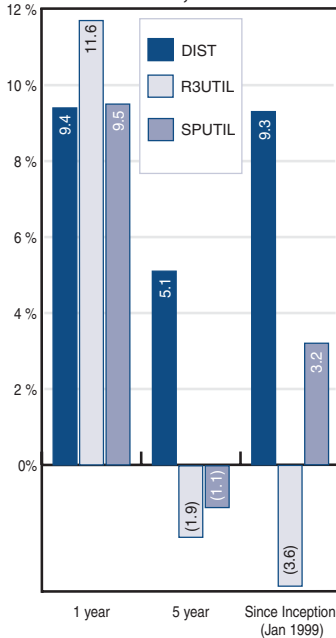
Despite a poor quarter for the large-cap electric indices (Dow Jones Utilities and S&P Utilities), which was not unexpected, we had very respectable returns in this strategy. While we had a few items with good news that helped boost returns, broad underlying strength and resistance to the sector declines were what worked in our favor.

After something of a drought—though accompanied by continued good performance from the portfolio anyway—we finally have a deal of just the type we’ve been contemplating. National Grid, which has already purchased Niagara Mohawk, New England Electric, Eastern Utilities, and Providence Energy, made a decent offer for our holding Keyspan at \$42 a share. We’d rate Keyspan as a pretty good catch, maybe not the best distributor in the world, but well-managed and in a reliable demographic area. Demographics is one feature that always attracted us to KSE; the company is not only the old Brooklyn Union gas, but also has the natural gas franchise for Long Island, where there is a fertile field of customers they might convert to gas heat from oil. This gives it “growth demographics” despite a general population area which is mature (though it is that mature population which makes it merely an okay distribution in our rankings). Officers of National Grid cited that same Long Island element as part of its reasoning for buying KSE, proving that even a naïve outsider can come to the same strategic conclusions as executives in the trenches all day, if nothing else. But in a way we’re glad it’s going to become NGG’s issue, because for the past few years KSE had seemingly failed to realize any of its great potential, showed little growth, and had managed to sell off its oil and gas production subsidiary just before the big run-up in gas stocks.

In some ways one might have thought that the takeover of KeySpan by National



Annualized Returns as of March 31, 2006



Quarter Composite Net of Fees*

Distribution (Prelim)	2.8%
Russell 3000 Utilities	6.1%
S&P 500	4.2%
S&P Utilities	(1.2)%

1-Year Composite Net of Fees*

Distribution (Prelim)	9.4%
Russell 3000 Utilities	11.6%
S&P 500	11.7%
S&P Utilities	9.5%

7-Year Composite Net of Fees*

Distribution (Prelim)	12.0%
Russell 3000 Utilities	(4.2)%
S&P 500	1.7%
S&P Utilities	4.8%

Included are all unrestricted portfolios that have been managed for one full quarter. As of 3/31/06: 218 accounts, representing 96% of total assets managed in the strategy with a dispersion of 0.22. Inception: 1/99.

Grid—we can’t say the deal and the parties involved were unexpected—might have stimulated even better performance in the group. Yet we can well recall during the heyday of takeovers in 1999 and 2000, our astonishment that even neighboring utilities seemed little affected in price by the many deals that were announced. In the banking sector, for example, one deal will create a price ripple throughout the sector, but not here. We can’t say there’s a spot-on explanation for this, except that the companies may be too small to interest arbitrageurs and M&A players, and they may be put off by the uncertainties and wait times for regulatory approval of the deals.

In any event, what we like about this deal—in addition to collecting an upgraded price for KSE—is that it re-establishes the private market value for a distribution utility after several years of minimal activity in the space. As we peruse our portfolio we begin to breathe a little heavier, for based on this private market value, nearly every stock we hold has an upside potential of 20-40% in a transaction. And that number might rise as we move forward, in a potential scenario of increasing scarcity of available assets.

We don’t think NGG is done as a buyer, and we think we have a good handle on which targets may be next (it’s not really that

mysterious, if you look at what they've bought already). Obviously, we hold these target companies at significant weight in the portfolio. But there are lots of other areas where the activity may increase. NGG is really only interested in distribution and transmission assets (they've in the past expressed the hope that they could run the US electric grid, as they do in Great Britain). But in recent years the glut of generating assets that developed in the 1998-2002 time frame is slowly shrinking. Realized electricity prices and spark spreads are expanding, and many of our companies which provide generation as well as distribution should become increasingly attractive. Between that direction and the private market values established for distributors by the KSE deal, it's all we can do to keep from licking our chops. We hope the rise in interest rates won't put a damper on deals, though, and fantasize that there will be a spate of transactions soon to beat the slowly closing financing window.

PORTFOLIO HIGHLIGHTS

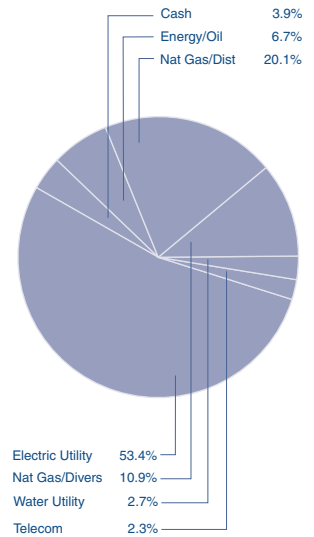
In addition to profits in KSE, which we've already taken, we got a nice boost from ONEOK, which is finally making effective use of its ownership of the general partner of Northern Borders Partners (for more on this, see the Income-Equity write-up). We recently returned Century Telecom to the portfolio after the company announced a massive stock buy-back, and were greeted with a nearly instantaneous 20% gain. Now it's getting a little dear, so this may inadvertently turn out to be a trade. Investors have visions of big things for water companies, boosting California Water more than 15%. It's starting to get closer to private market value for a water company, so it's another on what we might

call our beautiful watch list ("beautiful" referring to how it got to the list). Idaho has some stream flows again, and that's good news for Idaho Power, which rose 10%. We're still waiting for the company's industrial-level fuel cell division to break from product development to full-scale manufacturing and distribution, at which point we think it will make the company attractive indeed. Sierra Pacific reported strong results, and we think this will be the year for a dividend resumption—another feature that will help boost the stock.

On the downside, CMS Energy had a good earnings report, soundly beating expectations, but the stock had only sellers, and declined by 10%. This is a volatile turnaround story, and we don't pay too much attention to its price fluctuations as long as the fundamentals remain positive. AEP declined in sympathy with large-cap electrics, and Questar found profit-takers as gas prices slid on warm winter weather.

LOOKING FORWARD

We're intrigued with the Keyspan deal, and we're ready for more. We've identified many potential buyers for our stocks, and with the private equity world a-slosh in cash, we wouldn't be surprised to see financial buyers emerge, though likely in partnerships with operators, since financial deals haven't met with much success among regulators. Large-scale real estate properties have been changing hands at cap rates far lower than private market value for local monopoly utility distribution companies—and real estate properties are in a competitive business. It would seem only a matter of time before consolidation, as expressed in the KSE deal, picks up its pace. □



FUNDAMENTAL CHARACTERISTICS

Yield	3.2%
Proj Dividend Growth	4.6%
Payout Ratio	53%
Market Cap	\$4 Bil
Price/Book	1.8
P/E Ratio	16.6
S&P Rating	BBB+
R-Squared*	0.2
Beta*	0.4
Standard Deviation	13.0

*Relative to S&P 500,
3/31/00 - 3/31/06

“In a rising-rate environment, stocks with high dividend yields tend to do poorly. It’s like owning a bond.”

- *The Wall Street Journal*

“Yield equities generally follow the bonds.”

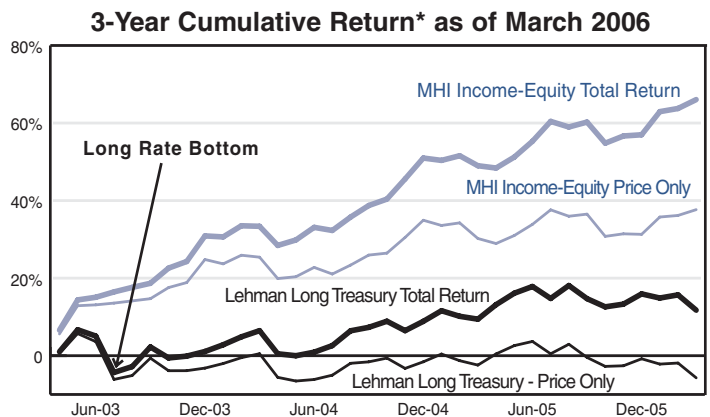
- *Analyst on CNBC*

How do these old wives’ tales get started? We don’t know, but they do, and the notions are constantly re-inforced by naïve commentators and journalists in the media who pounce on one data point that may agree with their received notions and ignore all others. No matter how it started, however, such “wisdom” is found everywhere in investment periodicals and research these days because of two factors: 1) income-oriented stocks have had a spectacular run, and 2) long-term interest rates have been moving up, pushed by the Fed’s hikes to the discount rate. Everyone knows that rising interest rates mean that high income producing stocks will underperform the broader market...don’t they? Actually, both theory and fact show that, if anything, the opposite is true.

To understand why rising interest rates hurt growth stocks more than income stocks we need to look at a bond market measure called duration. Duration measures a bond’s sensitivity to interest rate changes just as beta measures a stock’s sensitivity to changes in the overall stock market. A typical thirty-year U.S. Treasury bond has a duration a little over 14 at this time, meaning that if interest rates rise (or fall) one percentage point, the price of the bond will drop (or rise) about 14%. As even a beginning CFA candidate knows, all else being equal, a bond with a higher coupon rate (annual cash payments) has a lower duration than a bond with a lower coupon rate, and that zero coupon bonds (which are bought at a deep discount to their face amount and don’t pay any annual interest payments) have the longest durations of all. In other words, bonds that pay more cash sooner have less sensitivity to interest rates than do bonds that pay little or nothing in the interim but have a big payout at their maturity. Just as bills fluctuate less than long-term bonds, the more time it takes to get your money, the more changes in interest rates and the compounding effect on those changes affect the price of a security.

Over twenty years ago, a colleague’s firm was, among other things, trying to develop the concept of

“Equity Duration”, calculating the effect of changes in interest rates on stock prices. They found that because of the many factors influencing interest rates, especially economic activity and its effect on profitability, it was very difficult to calculate a concrete number like the 14 for the thirty-year Treasury Bond mentioned above; there are just too many moving parts. However, they did find that Equity Duration was a useful tool to rank stocks from most interest rate sensitive to least sensitive. And they found that, just like with bonds, stocks that pay more cash sooner (income stocks) have less sensitivity to interest rates than do stocks that pay little or nothing in the interim but have a big payout when you sell them (growth stocks). Income stock prices are actually LESS sensitive to changes in interest rates than are prices of growth stocks. Bear in mind here we’re talking about



Income Received on \$1 Mil Investment Since Rate Bottom

Long Treasury**	\$144,000
MHI Income-Equity*	\$208,000

large changes over broad time periods; small changes can always prompt sector rotations which may look like rate-related effects but soon fade.

You don’t have to take our word for it either. Last year David Blitzler and Srikant Dash, analysts at Standard and Poor’s, wrote a research paper on equity duration that said in part: “Based on our empirical model, duration (or interest-rate sensitivity) is higher for high-growth stocks” (Blitzler, David M., Dash, Srikant, “Equity Duration – Updated Duration of the S&P 500,” Standard & Poors Company, January 4, 2005, www.standardandpoors.com). Their report confirms what we had learned in the early 1980s.

*Gross of fee performance numbers. Performance and dividend income numbers were taken from an actual representative account.

**Long Treasury rate assumed to be 4.8%.



The Single Best Investment **Creating Wealth with Dividend Growth** The Classic—Revised and Updated

The Print Project has just released the second edition of *The Single Best Investment*, the classic by Lowell Miller (President and Chief Investment Officer of our firm). This book is a great introduction and overview to the thought process that guides all of our investment management at Miller/Howard, and we urge you to DEMAND a copy from your local bookseller (it's in stock now at Barnes and Noble and Amazon)!

It's a book for investors, as opposed to traders or seekers of the next new thing, a book that provides what we think is a sane and practical approach to owning equity assets in a world overflowing with too much information and even more noise. It's all about being a partner in a business that pays you cash now, and offers the reasonable hope of future growth and even more cash later. The book will help you maintain the broad scale perspective so necessary for success when investing, and help you maintain confidence and calm during those inevitable periods when the market is not generous.

In short, this book will help you be the investor you want to be. It does so through providing both insight into the process, and practical tools for achieving investment goals.

Some interesting quotes:

“There has been a notable return among market strategists and in the media toward time-tested classic approaches of investing. Among the foremost elements of classic investing is the demand for dividends.”

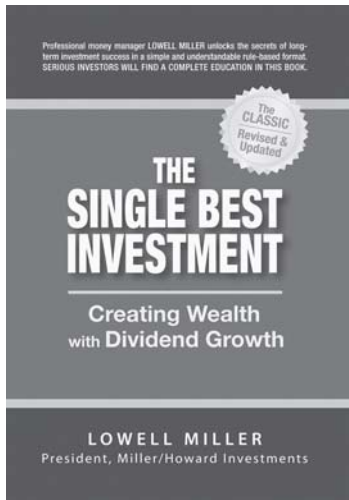
“An investor, in the true, traditional sense of the word, is someone who recognizes that “shares” are not little numbers that jump around in the paper each day. They represent a long-term partnership interest in a real and going business—one that you're confident will grow and continue to pay you increasing dividends many years from now.”

“Companies should offer three things: high quality, high current yield, and high growth of yield. Stocks that fit this profile come from a variety of categories; elements determining ‘high quality’ definitely vary from industry to industry. But these are the stocks that, like a great relationship, will support you over a lifetime, through thick and thin.”

“Dividend growth is a key feature of the companies you should buy and hold long term. Yet few investors actually take advantage of it, choosing instead to speculate and trade. Dividends are quiet; they don't make the news and they almost slip by unnoticed, like the quiet increases in inflation over the years that you must constantly battle. As those (rising) dividends are reinvested, over time your net worth multiplies again and again. You create an internal compounding machine in your portfolio, that works even as you sleep.”

When *The Single Best Investment* was first published the world was in the midst of the technology bubble, and the book fell on deaf ears—something like casting pearls before swine, we think. Now the “New Economy” is old, and investors have once again re-discovered the eternal truth that business is hard and slow, and investing requires careful analysis and patience.

This is the book that separates the wheat from the chaff of investing. It provides a kind of recipe from which investors may bake their own bread, or watch with understanding as Miller/Howard does it for them using the very same principles. Investors should read it and consultants should give it to their clients.



NOW AVAILABLE!

**The Single Best Investment:
Creating Wealth with Dividend Growth**
The Classic—Revised and Updated

by Lowell Miller
(President and Chief Investment Officer
of Miller/Howard Investments, Inc.)

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MILLER/HOWARD INVESTMENTS DIVIDEND-GROWTH STRATEGIES

PORTFOLIO	FOCUS	YIELD	EST. GROWTH OF YIELD	5-YEAR BETA	P/E	1-YEAR NET OF FEES RETURN
Income-Equity Strategy	Dividend growth companies, broad market	5.1%	6.1%	0.6	14.9	10.2%
Better Than Bonds/Utilities	Utilities sector: natural gas, electric, telecom, and water	3.0%	5.7%	0.7	16.5	19.1%
Distribution/Merging Utilities	Local distribution utilities, takeover candidates	3.2%	4.6%	0.4	16.6	9.4%

as of March 31, 2006



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