

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.

RISING DIVIDEND PLUS

A portfolio of large and mid-cap companies in which dividend growth is the key variable, focusing on companies with proven long-term success or special current opportunities.

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.

The question: Will my money last as long as I do?

Many years ago an older couple came into our office to discuss replacing their portfolio—the sole source of support for their retirement life—with our strategies. There were plenty of securities that we thought had meager prospects, and several speculative issues which really were inappropriate. However, much of the portfolio consisted of blue chips purchased in the nineteen fifties and sixties, names like Merck and General Electric, held through good times and bad for the companies, held through the Vietnam War, Arab oil embargoes, rampant inflation, stagflation, disinflation, bubbles up and bubbles down. They never sold anything—it was like a grandma's attic of corporate equities.

There was a great treasure in that attic, great for them and enlightening for us. As we perused their assets and the cost of those assets, we began to connect the dots between what they had paid for the stocks and the dividends those companies were now paying. The so-called “current yield” on the portfolio was nothing to write home about, but the yield on what they had paid originally was astronomical. You might not notice that a certain stock was paying \$3 a share in dividends for a current yield of about 2%, until you realized that their cost for those shares, adjusted for splits, was, 30 years prior, also about \$3 per share. Not only had the stocks risen twenty- and thirty-fold over the decades, but their *return from income alone*, based on original cost, was in many cases over 100%. Each and every year they were making roughly 100% on those original investments no matter what the volatility of the stocks. Even adjusting for inflation, in current dollars their income return on cost was well over 30%.

Of course the stock prices grew because the underlying businesses grew. But could we separate that from the fact that dividends grew so much? Could Merck, Vioxx and all, possibly sell today at a price that would provide a dividend yield of 100%? Of course not. The stock price would rise if for no other reason than that the dividends increased. That, we saw, was the quantitative or numerical way of determining whether an investment was a good one: amidst the chaos of information and interpretation and competition and creative destruction and changes in the economy and the world, one principle stood out as elemental and immutable. *As the dividend increases, eventually the price of the stock producing that dividend will increase as well.*

The principle here is critical, both for investors seeking to accumulate wealth, and even more importantly today, for investors hoping that investment assets will support their later years. As the Baby Boom generation eases into retirement, the notion of distribution, of spending from assets, has become the subject of the day. Whereas in the past investment was all about accumulation and building, investors now realize that their investment capital must provide “life support” from now and into old age. The definition of “old age” itself has been greatly expanded by advances in medical science—and therefore the need for savings to support the distribution phase has stretched even further.

This problem is not simply a matter of scratching out numbers on a yellow pad. The problem is deep, and the proposed solutions that have been put forth to date don't seem adequate to us. What's deep is the “bag lady” fear that can

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*"If you retired in 1968, for example, you would have, unbeknownst to you, embarked on a 14-year period in which stocks did not gain the proverbial 10% per year, but in which, point to point, they in fact gained **nothing**."*

afflict both men and women. What happens to me if I'm not working and the market crashes? What happens if I live to be 95 rather than the 85 I expect and I can't pay anyone to help me? In the most subterranean levels of the unconscious, no matter how affluent we are today, we can imagine (and somewhere inside we have imagined) it all going horribly horribly wrong—our expenses got too high, our assets got too low, all the work and toil to build our wealth for naught, because it wasn't enough...

How can we make our savings last? A small industry of planners and advisors has arisen recently to address this problem, proposing plans that are, in our view, both overly complex and frighteningly fragile as solutions. Most suggest a withdrawal rate of 4-5% per year plus increases to reflect inflation, drawn from a portfolio of diverse assets that isn't very different from earlier portfolios recommended during the accumulation stage, just more conservative.

The question that arises when looking at these plans: will the assets be there to be withdrawn? Gains from stocks are always presumed, but history tells us that those gains don't necessarily arrive on a convenient schedule, and can be absent for years and years. This is a much trickier area than accumulation investment planning, because to some extent—through withdrawals and the steady increase of those withdrawals—the investor is always undermining the notion of long-term compounding. Without a presumption of rising equity markets there are fewer and fewer assets but the assets remaining are asked to produce higher and higher withdrawals. And rising markets must be part of the equation. If one relied only on bonds (which do not rise), for example, 5% withdrawals plus inflation increases could completely wipe out the portfolio in as little as 13 years during a period of normal inflation.

A 50-50 bond and equity portfolio using historical equity returns fares better, extending the assumed "life" of the portfolio to 20 years (though that's not exactly a "safe" duration for most people). The source of this duration extension is the assumed greater return from stocks. There is a further assumption that a

portion of the gains from stocks can be captured and spent, an assumption that, essentially, stocks will grow enough after taxes to compensate for the relentless withdrawals that attack the portfolio like carpenter ants.

Clearly, the more equity the longer the withdrawals may be sustained—in theory. But theory doesn't account for the realities a retiree will experience during a severe bear market. What if the market doesn't come back, or doesn't come back in time? A reasonable fear, for we've seen periods even in recent history where stocks have not performed according to theory. If you retired in 1968, for example, you would have, unbeknownst to you, embarked on a 14-year period in which stocks did not gain the proverbial 10% per year, but in which, point to point, they in fact gained *nothing*.

Putting aside for the moment the fact that there was some yield from equities during the period (though you might have invested in non-dividend-paying equities, anyway), at a withdrawal rate of 5% plus inflation you would not have lasted the entire "flat" period before ruin. You would at best have had almost no capital left to capture any gains from the bull market that began in 1982. You can see what we mean by suggesting most plans are frighteningly fragile. Over the past 100 years it has not been that uncommon for stocks to go 5 or even 10 years without gains. And all the while you're withdrawing. Gulp. If the "total returns" from which you are withdrawing do not arrive as predicted, and pretty much on a regular schedule, your plan risks failure. The results could be devastating.

In fact, it may be time to question the concept of total return itself, when it comes to a distribution portfolio. As any accountant will tell you, total return is the sum of income and capital appreciation, and, your accountant will further tell you, except for tax issues there's no difference between appreciation and income. Money is money. End of discussion.

But when it comes to investors with a spending need, there is something more that definitely needs to be said, and understood. There is, for a withdrawing investor, a *qualitative difference* between 1) total return and 2) a return made up of income plus

SELECTED INDICES

	1 st Qtr07	12 Mo
S&P 500	0.6%	11.8%
Equity Inc	1.6	14.0
Util Fund	7.8	31.6
R3UTIL	6.7	30.2
Long Bond	1.0	5.8
R1000	1.2	11.8

S&P 500 = Standard & Poor's Index
 Equity Inc = Avg Equity Income Fund (Lipper)
 Util Fund = Avg Utility Fund (Morning Star)
 LB Long = Morningstar
 R3UTIL = Russell 3000 Utilities
 R1000 = Russell 1000

appreciation. The difference is that the *income portion of the return is always positive*, whereas the “appreciation” portion can fluctuate, and can be negative. Accumulators can and should tolerate some fluctuation in the interest of greater performance, but *withdrawers have to spend the money*. Now. And the income portion needs to grow even if the principal side doesn’t, because the spending need rises with inflation.

When our investments are in higher-yielding stocks, the income portion of the total return is well defined (as opposed to low yielding stocks where it plays a minor role). If your withdrawal need is the widely-accepted 4-5%, you can obtain that from the right portfolio of stocks. If your income need rises as a result of inflation (and we can expect that inflation may be higher than it is now, perhaps the same as the 1945-90 average of 4.7%), yield stocks that have increasing dividends can meet that increased spending need as well. A retiree can fund his or her living expenses without having to invade principal.

If you’re spending income, rather than “total return,” market fluctuations become irrelevant; if the portfolio is successfully managed for rising income the value of the

stocks producing that income will ultimately rise as well, though the schedule for that recedes in importance. It won’t matter whether growth is in vogue, or value, or mid-cap, or large—all that really matters to the value of the principal is that the income increases to pay expenses and meet inflation. The value of the principal will eventually reflect the rising positive income yield it delivers, and there is no need to invade it.

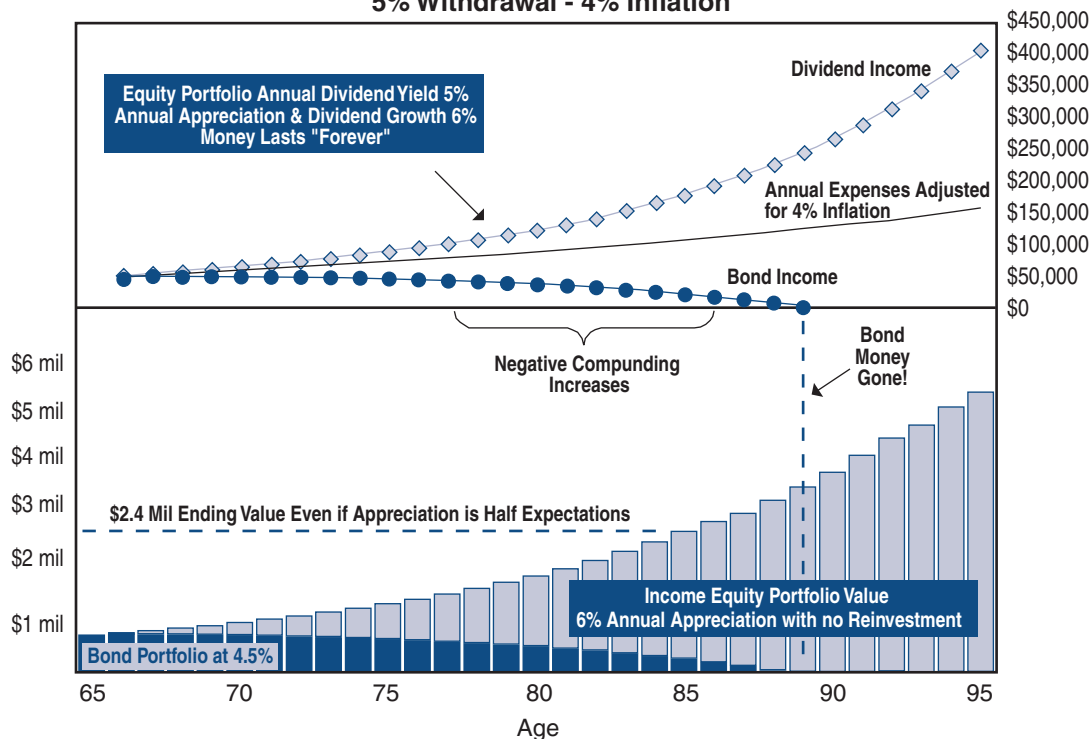
Clearly, an income-equity approach based on high current income is “built” for a retiree portfolio. Some diversification seems prudent, though we don’t know of any other plan with as high a probability of meeting spending needs and preserving capital indefinitely.

Not only is there no “exhaustion” date for the assets, they will be there in full, long after the retiree needs them, to help loved ones and charities.

And what about that older couple? The “good parts” of their portfolio, with triple-digit dividend yields on original investment, inspired us to design our Income-Equity Strategy. We’ve hitched our wagon to that horse, and clip-clop, clip-clop, it continues to forge ahead without getting tired. □

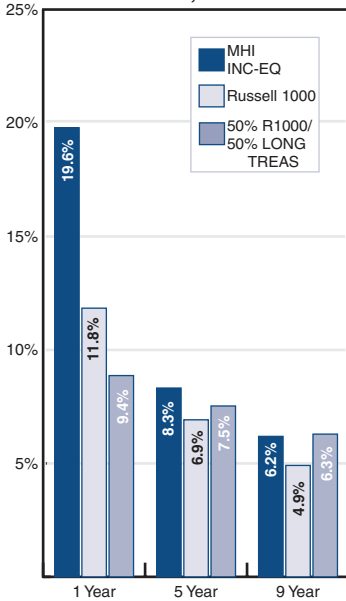
“If you’re spending income, rather than ‘total return,’ market fluctuations become irrelevant; if the portfolio is successfully managed for rising income the value of the stocks producing that income will ultimately rise as well, though the schedule for that recedes in importance.”

**Pro-Forma Principal and Income Growth
5% Withdrawal - 4% Inflation**



Pro-forma chart shown for illustrative purposes only. Actual returns may vary. There is no guarantee of future returns and none should be implied. Assumptions: \$1 million initial investment, bond coupon rate of 4.5%, annual dividend rate of 5%. Earnings, dividends, and price appreciation grow at the same rate of 6% annually. Assumed annual inflation rate of 4%. Income equity portfolio value is calculated with no income reinvested.

Annualized Net of Fee Returns as of March 31, 2007



Quarter Composite Net of Fees*

MHI Income-Equity*	3.2%
50/50 R1000 & Long Treas	1.2%
Russell 1000	1.2%

12-Month Composite Net of Fees*

MHI Income-Equity*	19.6%
50/50 R1000 & Long Treas	9.4%
Russell 1000	11.9%

9-Year Annualized Composite Net of Fees*

MHI Income-Equity*	6.2%
50/50 R1000 & Long Treas	6.3%
Russell 1000	4.9%

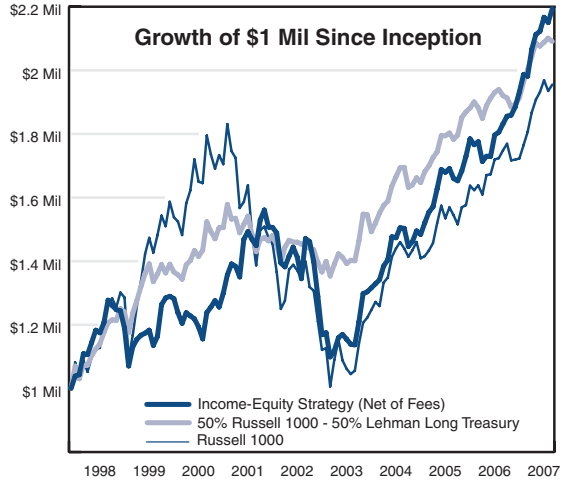
*Preliminary Returns. Included are all unrestricted portfolios that have been managed for one full quarter. As of 3/31/07: 718 accounts in composite, representing 58% of total assets in the strategy with a dispersion of 0.16. Inception: 5/97. We offer a customized version of Income-Equity that excludes Master Limited Partnerships. These accounts are not included in the composite and represent 22% of the total assets in the strategy.

Last quarter we suggested that the market was attractive but due for a pause, and that our stocks’ income would form a “defensive base when the market environment turns less sweet.” The crystal ball was fairly clear this time, as stocks ran into profit-taking turbulence during late February and early March, but our stocks felt little of this and our positive returns were both well ahead of the indices and quite in line with long-term average annualized expectations. A couple of our business financing stocks were nicked irrationally during the sub-prime panic. But we’re happy to say that despite the fact that many sub-prime lenders were among the highest-yielding stocks available, we held none of them.

We restrict ourselves to high-quality companies, companies with solid financial strength, companies whose basic business model does not involve playing an advanced form of three-card monte. When the beastie-boys are popular in the market we sometimes feel as though we’re on the outside looking in—but in our process it’s more important to avoid situations like the recent implosions than to seek rewards from every shaky and transient financial concept that comes along. There were red flags all along the way for these mortgage companies, ranging from the lavish lifestyles of salespeople, to questions about financial reporting. But the biggest red flag by far was the slowdown in housing sales and prices that began last summer. With affordability as a measure of market potential and pricing already thrown out the window, it was only a matter of time before the onset of mortgage chaos once the real estate market cooled.

PORTFOLIO HIGHLIGHTS

Our leading stocks came from a variety of areas. The acquisition of Schering AG has already begun to bolster both the top and bottom lines of Bayer AG (up about 20%), as earnings surged tenfold from last year—and were six



times higher than analysts expected. Presumably, the company had a better idea about the benefits of the merger than analysts’ fantasies. Sales were up 25%, indicating as well the leverage implicit in the combined companies. Also in healthcare, Abbott Labs was a double-digit gainer for us. See the Rising Dividend Plus report for the “story” on this stock (it’s one of the few overlaps between the two strategies). Equitable Resources beat expectations and near the end of the quarter provided an extremely positive update on its proved and probable gas reserves, prompting a further boost and bringing the quarter’s gains up to more than 15%—its’ second quarter in a row as a portfolio leader.

2007’s first quarter was also an outstanding period for MLPs, as investors once again warmed to the high-yield, growth-of-yield character of these stocks, and their continuing expansion of new opportunities. Energy Transfer, Enterprise Products, Kinder Morgan Energy Partners, Oneok Partners, and even former laggard Enbridge Energy Partners all delivered around the 10% range, plus substantial dividends. Other contributors included AT&T, R R Donnelley, Windstream, Colgate Palmolive, and Potlatch—it really was everything from wood products to energy to toothpaste for us on the upside this quarter. In our non-mlp version of the strategy, we

got a solid boost from Dutch financial services company ABN Amro, which is, as they say, in play.

Dragging returns were some of our larger companies such as Microsoft, Johnson & Johnson, Proctor and Gamble, ING, and Pfizer—all with single-digit declines. Declines which, parenthetically, don't really trouble us, as the fundamentals and news flow for these companies remains attractive. After our discussion of Canadian Income Trusts last quarter, the recent period proved an anti-climax: one up, one down, political machinations still ongoing in Canada with no definitive resolution as yet to report.

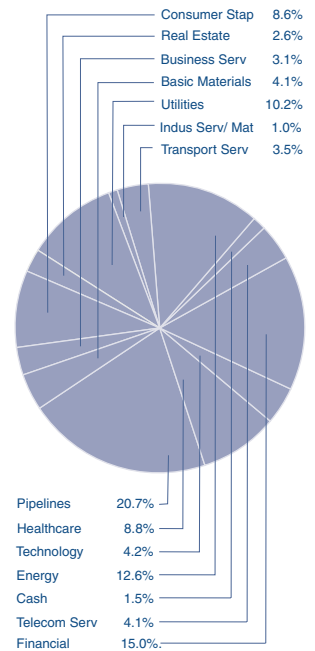
We bought insurance broker Arthur J. Gallagher. The company is historically inexpensive, and with Marsh McClellan's disposal of its Putnam investments subsidiary we think the chances for consolidation in the industry are quite good. With more than 4% yield we're comfortable participating in AJG's turnaround along with the possibility of some positive transactional news. We bought Diamond Offshore as a replacement for Tidewater. The two are in roughly the same industry, but DO is in the strong portion (offshore and deepwater drilling), while Tidewater's business in the Gulf of Mexico is slowing and soon to be subject to more competition. Not incidentally, we were able to capture a \$4 special dividend (about 5%) from Diamond Offshore. The ongoing yield of DO isn't enough for our portfolio, so it's not likely to be a long-term holding. We bought Microchip Technology for some exposure to the technology sector at an attractive yield of 3% and strengthening business trends. We added a small position in AirCastle, a lessor of aircraft to non-US carriers. We expect strong growth in earnings and dividends here, though a lowish capitalization size and liquidity has limited our weighting. In our non-mlp version we added Gatehouse Media, a consolidator of local weekly newspapers, and Worthington Industries, a high quality but inexpensive steel processor.

We sold Alberto Culver. The company's financial restructuring is about over, we've been well rewarded with a special dividend and stub stock Sally Beauty (which we also sold) with a total return of about 60%; since the continuing dividend will be too low, we're declaring victory and moving on. We took profits in Autoliv as it had reached our valuation parameters and business had begun to slow at the same time.

LOOKING FORWARD

The thrust-and-parry of the economic background, with each new data series contradicting the previous, is a benign environment for our portfolio. As we see it, the economy isn't going anywhere fast. Alpha in that case accrues to stocks with steady incremental improvements and sustainable cash flow returned to shareholders. There are a variety of scenarios in which we have and can do well; the current one, which we might describe as "growth stasis," characterized by a declining rate of economic growth but still qualifying as growth, should not pose obstacles to our continuing performance. Circumstances may change, but there's no evidence of that right now.

Our current "projected" yield is 5.2%. We place projected in quotations because we have a history of delivering higher cash yields than projections, through dividend growth, special dividends, and replacement stock selection. Having already harvested a large special dividend from Diamond Offshore, we're a bit ahead of schedule for 2007—though there's no way to tell right now how much more income above the projection we can provide, or even if when all is said and done the actual yield will, in fact, be higher. But our goal is the highest possible actual cash dividend yield consistent with high quality and dividend growth, at the lowest possible volatility—so we're up in the crow's nest with our binoculars. □



FUNDAMENTAL CHARACTERISTICS

Yield	5.2%
Proj Dividend Growth	8.0%
Payout Ratio	62.2%
Market Cap	\$35.8 Bil
Price/Book	2.9
P/E Ratio	14.9
S&P Rating	BBB+
Beta*	.54
R-Squared*	.50
Standard Deviation	11.6

*Relative to S&P 500, 5/31/97 - 3/31/07

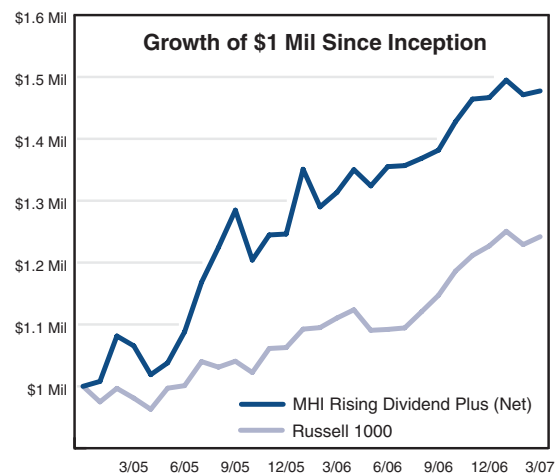
“One reason to invest in stocks with high dividend growth is that payout increases are a kind of measure that tells investors how management really thinks the future will be shaping up.”

Rising Dividend Plus employs large-cap and mid-cap stocks from all sectors, stocks whose leading characteristic is a rising dividend generated by consistent and sustainable growth. Here we focus on the *growing dividend* as evidence of the company’s success and as a signal from management about future prospects (high current yield is not the primary issue in this portfolio). The “plus” includes an emphasis on stocks with unique positioning or “stories” that we believe are not priced into the shares, and it also includes anomalies and factors such as extraordinary insider buying, raised company guidance, tailwinds from commodity prices, new products, restructurings, consolidation, or noteworthy technical conditions. Many stocks have been owned since inception of the strategy and we hope will be in the portfolio years from now. Others are, by intent or through the unfolding of events, rentals.

This past quarter the markets were shaken by profit-taking in China and problems in the housing market as well as some sectors of housing finance. We were not involved in any of these areas, so our stocks tended to ebb and flow with investor perceptions, ending up modestly positive—as was the case with the broader market. But the bulk of the portfolio performed well, and we had no real poor performers, at a time when many other stocks in the market did fall apart and didn’t rally back.

PORTFOLIO HIGHLIGHTS

One reason to invest in stocks with high dividend growth is that payout increases are a kind of measure that tells investors how management really thinks the future will be shaping up. Thus to state an odd kind of paradox, it should not really come as a surprise that nearly all of the companies we hold beat analyst expectations for earnings and/or revenues, and/or raised guidance. This group includes, Abbott, Air Products, Anadarko, Avery Dennison, Ball,



Colgate-Palmolive, Devon Energy, EnSCO, Emerson Electric, Intel, Johnson&Johnson, Legg Mason, Maxim, Microchip Technologies, Northern Trust, JC Penney, Scotts Miracle-Grow, Sigma Aldrich, State Street, Tyco, United Health, Walgreen, Whirlpool—well, we only hold 30 stocks just now, and a few merely met expectations. Given the many possible choices available through this strategy, those that disappointed or were dull with more of the same in the cards—including American Express, Autoliv, Sonoco Products, and Motorola—were sold for good profits and replaced with cheaper stocks showing more promise. We also sold Goldman Sachs, taking a roughly 50% profit (an act through which, we’ve been taught, we’ll never go broke). Interestingly, the net of the sales would have produced a subsequent negative return had we held them, though our portfolio was strong the latter part of the quarter.

We’re often heard to trumpet “the story of the stock” as our way to zero in on a particular candidate that fits the parameters of our model but also holds the promise of extra alpha. What we mean by this is that the stock holds a potential that causes it to stand out from the rest on the stag line, strong as that stag line may be. This story might be as simple as that it is a well-oiled earnings machine from which we can expect persistent earnings and dividend growth—where the level of certainty about this is much higher than for other, seemingly similar

Quarter Composite Net of Fees*

Rising Dividend Plus*	0.7%
Russell 1000	1.2%
S&P 500	0.7%

1-Year Composite Net of Fees*

Rising Dividend Plus*	12.5%
Russell 1000	11.8%
S&P 500	11.8%

2-Year Annualized Composite Net of Fees*

Rising Dividend Plus*	17.8%
Russell 1000	12.5%
S&P 500	11.8%

*Preliminary Returns.

Included are all unrestricted portfolios that have been managed for at least one full quarter. As of 3/31/07: 10 accounts representing 94% of assets in the strategy, with a dispersion of 0.02. Inception: 12/04.

stocks with similar valuations. Typically, though, there is some asset or activity of the company which could result in large gains if it becomes palpable—but investors are pricing the stock just like other similar companies, with zero credit for “the story.” If and when the story comes true, we expect an upgrade in revenues and earnings, and in the multiples investors are willing to award for those earnings. If the story doesn’t come true, well, it’s still a good company that fits our model and should outperform to some extent anyway. We don’t depend on the ‘story’ for our overall investment case, but we’re rewarded if ontogeny is on our side.

Our leading stock this quarter, Abbott Labs, is a classic case. Early last year it was a pretty good health care company, with a long history of steady and sustainable earnings and dividend growth, a management with demonstrated capability to grow both organically and through acquisition, an admirable return on equity of 29% (about twice the average company), moderate and manageable debt with excellent credit, a repeating non-cyclical business model, 10% revenue reinvestment in research and development to ensure future growth, a vast and effective distribution system, a fixture in corporate America with an \$80 billion market cap—who wouldn’t want to own the whole company? An investor didn’t really need intelligence in any great measure to buy this and profit eventually, simple patience would suffice.

At that time, to use one easy measure, the stock sold for 15-16 times forward estimated earnings. So did Johnson & Johnson. Within a slightly broader band of 14-18 times you could find Baxter, Bard, and the whole pack of mainly pharmaceutical companies like Glaxosmithkline or somewhat troubled Merck. Abbott however, had made a great deal with Boston Scientific(BSX) to obtain the Xience stent business of Guidant when BSX decided to buy

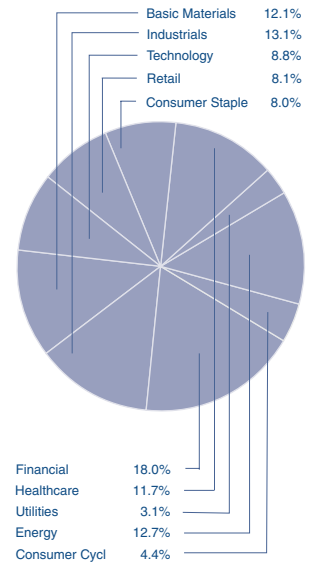
Guidant. BSX needed a partner to supply funding and to take portions of Guidant’s business that would otherwise have made the deal problematic from an antitrust perspective. Abbott wanted to get into that business anyway; when the opportunity arose they jumped, and due to the circumstances they got in cheaply. If the Xience product worked as advertised, it would be a much better stent and could quickly take a large market share (ironically, including Boston Scientific’s own market share). Investors were apparently skeptical that BSX would let a good thing get away, even though they were really forced to by antitrust issues, and Abbott found no strong price support.

Abbott did creep higher but actually underperformed the broader market from July through January, before starting to slowly rise in price. A 10% dividend increase in February provided assurance that our basic, ‘storyless’ case was very much intact. And then in March comes the news that yes, Xience does work as advertised—and in the stent neighborhood there’s now a very large and athletic new kid in town! Suddenly we hold a large-cap stock up about 40% from last spring’s pricing. That’s a good story!

LOOKING FORWARD

Not all stories do come true, but we continue to seek strong franchises whose future success is confirmed by a pattern of dividend increases. These are already good stocks—every quantitative study we’ve seen has confirmed this—and we seek those with something extra that can make them even better...

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.



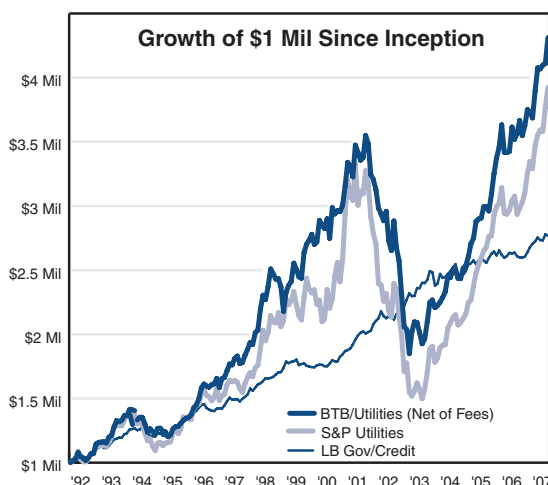
FUNDAMENTAL CHARACTERISTICS

Yield	1.4%
Proj Dividend Growth	13.7%
Payout Ratio	28%
Market Cap	\$38.9 Bil
Price/Book	3.1
P/E Ratio	17.9
S&P Rating	BBB+

“If there is a single theme that unites them now, and unites many non-utility companies as well, it is the need for upgraded infrastructure.”

There have been many years with major fourth quarter gains for utilities, and after such periods we often find that those gains dissipate in the first quarter, or at least in the beginning of the first quarter, as it is revealed that institutional investors were just “parking” in the sector to preserve gains made elsewhere. But the “no parking” signs must have been up this time around, for with merely a slight nod to the China Syndrome Correction, utilities of all kinds went on to another stellar quarter. As we noted last time, this kind of performance makes us more nervous than ecstatic, but there are strong elements to the bullish case—lest we forget to hold our ground in this essential services universe (emphasis on “essential”). Many of these elements are also discussed in the Distribution/Merging Utilities quarterly review; while there are often diverging forces driving these two portfolios, at the moment the energizing factors seem to have converged.

If there is a single theme that unites them now, and unites many non-utility companies as well, it is the need for upgraded infrastructure. This includes new generation plants—there are over 70 new domestic plants at some phase of development plus consortium plans for new nuclear facilities—as well as new and upgraded long-distance transmission and switching functionality. There is also a glint in the eye of electric companies: the possibility of broadband data carried over power lines. As we note in the Distribution review, some observers think the cost of what’s needed will equal the value of all existing investor-owned utilities. Too, there is a huge wave of investors, both private and public market varieties, who seek stable earnings and dividend income. This wave includes retirees (it is expected that the U.S. population aged 65 and over will double within the next 25 years and will include 1 out of every 5 Americans) as well as company and state/municipal retirement plans who have decided that degrees of certainty trump degrees of potential appreciation in their quest to insure that they can meet their actuarial assumptions



for steady returns that will meet their future obligations. This wave has been built to tsunami proportions by the convergence of need and heightened uncertainty about the future course of financial equilibria, and it has been under secular upward pressure recently by the issuance of many billions of dollars of new shares in “income” funds and dividend-oriented exchange-traded funds.

We have spoken before about “rushing rivers of cash and dry streambeds of income,” and utilities are one obvious site to which those rushing rivers are being diverted. Further, we can’t discount consolidation on a global scale as a factor supporting prices. Current deals for TXU, Spain’s Endesa, and Scottish Power, are several among many, and the trend has hardly waned. Electricity, natural gas, and telecommunications, are basically commodity businesses, where economies of scale are an advantage in the marketplace, so the urge to merge is never very far away from day to day business. Too, with each new deal there are fewer companies left; the remainder acquire scarcity value.

PORTFOLIO HIGHLIGHTS

The themes of infrastructure growth and company consolidation touched most of our portfolio-leading performers this quarter. Merchant generator NRG Energy (up 29%)

Quarter Composite Net of Fees*

BTB/Util*	6.0%
Russell 3000 Utilities**	6.7%
S&P Utilities	9.3%
LBGC	1.5%

5-Year Composite Net of Fees*

BTB/Util*	8.4%
Russell 3000 Utilities	8.1%
S&P Utilities	10.4%
LBGC	5.6%

10-Year Annualized Composite Net of Fees*

BTB/Util*	9.3%
Russell 3000 Utilities	6.1%
S&P Utilities	9.6%
LBGC	6.5%

*Preliminary Returns.

**Russell 3000 Utilities inception date is June 1995 so this index is not shown on the Growth of \$1 Mil chart.

Included are all unrestricted portfolios that have been managed for at least one full quarter. As of 3/31/07: 161 accounts representing 95% of assets in the strategy, with a dispersion of 0.10. Inception: 9/91.

on an excellent earnings report and a growing sense among institutional investors that spark spreads (the difference between electricity prices and the cost to produce) have left the dark ages of oversupply behind. News of the offer for TXU also boosted NRG and other generators, since investors perceive the TXU acquisition as a generator acquisition (Texas is fairly free-market in electricity, compared to other states). Likewise Dynegy (up 28%), in recovery mode for some time, became increasingly attractive on news of its purchase/merger with generator LS energy. The combined company has more attractive financials and what we might call generator-bulk than DYN did before, making it a more attractive takeover candidate.

Mobile telecom enabler Qualcomm rose as demand for advanced mobile phones grew throughout the world. Too, news that AT&T will be using Qualcomm standards and equipment is a major plus, a plus not sufficiently recognized in the stock price. Increasing, it looks as though the mobile video path QCOM has carved will be the major technology direction going forward. Northeast Utilities is another major beneficiary of infrastructure spending. They have enough transmission/grid work booked to keep them busy for the next five years, and all of that work will receive regulated rates reflecting a favorable return on investment. MLPs Enterprise Products and Kinder Morgan Energy Partners both delivered double-digit gains (in addition to their hefty dividends)—these are leading players in developing natural gas transporting and processing infrastructure. Brasil Telecom (up 8.2%) also had a nice quarter—financial piranha have been sniffing around this one for more than two years, and we expect it won't be long before news breaks. If not, we can be content with it as a proxy for the increasingly strong Brazilian economy and currency. Equitable Resources (up 16%) keeps showing up on our leaders board, prompting us to wonder about valuation. But its easy-access Appalachian properties are worth more than

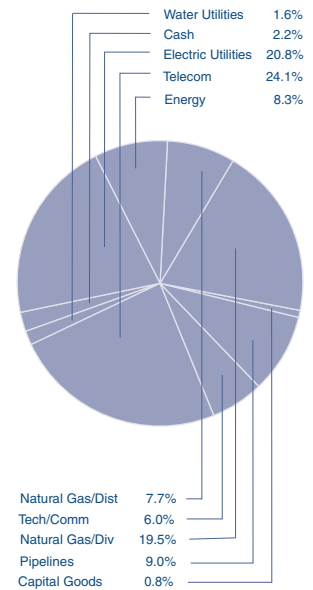
oil and gas producing assets elsewhere, and its utility is about to grow mightily if they can complete a deal for Dominion's Pennsylvania operations.

We bought AES, a global generator that ran into problems during the utility melt-down period but has walked through fire and recovered, we think, its appeal. We added Corning as an enabler—more infrastructure—since the glut of “dark fiber” laid in the late nineties and early in this decade is almost all used up, believe it or not. Fiber demand is set to rise again this year and add to the already full-out demand for flat-screen glass used to make the terminals which attach to the fiber's output. We also added smallish positions in Philippine Long Distance and Turkcell—inexpensive telecom companies in rapidly growing areas, and, for the latter at least, areas of intense consolidation.

We sold Deutsche Telecom after a good rally when the company once again reported downbeat earnings and prospects. Likewise meter maker ESCO once again disappointed—but we'll be interested in this company when there's evidence of it returning to the right track. We sold WGL Holdings as fully valued.

LOOKING FORWARD

Given the forces driving these stocks that we adumbrated in the opening paragraphs of this review, what's the right valuation for them? Should it be similar to the past? Should this time be “different?” This is really the question of the hour. There's no doubt that most of the companies in the electric industry are better than they were, more focused, more profitable, less risky, and with decent growth prospects from generation, transmission upgrades, and benefits from consolidation. But in our view—which to be frank we held when the stocks were somewhat cheaper—there's no reason why electric companies should sell at valuations higher than they were in the 1950's, when life was young and perky, and it was all about—guess what—building out the infrastructure(!) □

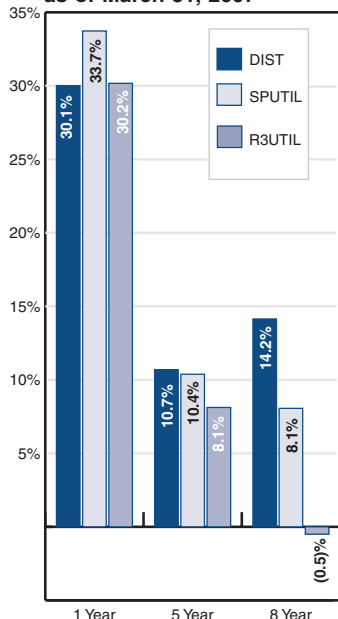


FUNDAMENTAL CHARACTERISTICS

Yield	2.3%
Proj Dividend Growth	6.1%
Payout Ratio	37.3%
Market Cap	\$28.2 Bil
Price/Book	3.1
P/E Ratio	18.5
S&P Rating	BBB+
Beta*	0.59
R-Squared*	0.41
Standard Deviation	14.0

*Relative to S&P500, 3/31/97-3/31/07

Annualized Net of Fee Returns as of March 31, 2007



Quarter Composite Net of Fees*

Distribution	5.3%
Russell 3000 Utilities	6.7%
S&P Utilities	9.3%
S&P 500	0.7%

1-Year Composite Net of Fees*

Distribution	30.1%
Russell 3000 Utilities	30.2%
S&P Utilities	33.7%
S&P 500	11.8%

7-Year Annualized Composite Net of Fees*

Distribution	11.0%
Russell 3000 Utilities	(2.4)%
S&P Utilities	8.1%
S&P 500	0.9%

*Preliminary Returns.

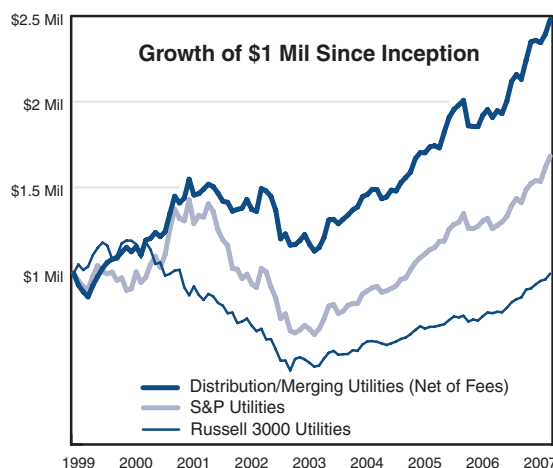
Included are all unrestricted portfolios that have been managed for one full quarter. As of 3/31/07: 224 accounts, representing 94% of total assets managed in the strategy with a dispersion of 0.19. Inception: 1/99.

Last quarter we suggested that this portfolio was larded with good values (relative to private market values as demonstrated by numerous deals) and many interesting recovery stories which had been unfolding as hoped. But we thought as well that “some correction should not be unexpected,” after last year’s rather spectacular gains. Indeed, there was a correction that lasted oh...several days... and the portfolio went on to deliver another solid quarter. In part, at least, we saw at slightly reduced prices the quick emergence of a buying constituency composed of private equity, acquisitive utilities, and dividend-seeking investors of all kinds.

No doubt the proposed deal for TXU was a stimulus, reminding investors generally that utility infrastructure assets are prized in today’s world—and there are plenty of would-be acquirers. Interestingly, the repeal of the Public Utility Holding Company Act has made deals such as the TXU situation possible—anyone, utility, hedge fund or oil company, can make an attempt at a takeover today. At the same time we’ve seen a kind of balkanization of the local regulatory regimes, as regulators have become more territorial and assertive in an apparent effort to defend their turf against greater powers granted to the Federal Energy Regulatory Commission. Thus earlier deals for Public Service (New Jersey) and Constellation Energy (Maryland) were either rejected by local regulators or subjected to such onerous terms that the would be acquirers walked away. This has not been the case for smaller deals and deals that don’t involve generation, however, and the lower capitalization sizes are where our portfolio remains focused.

PORTFOLIO HIGHLIGHTS

The leaders in our portfolio this past quarter were all recovery situations whose stories have “come true” or are in the process of coming true as real-time developments emerge. Dynegy (up 28%) didn’t provide the happiest



earnings report in our group, but the company has regained solid footing and by the time you read this should have approved a transformational transaction in purchasing LS Power, an important independent generator. We like generation at least as much as distribution now. That wasn’t the case when we started this portfolio in 1998, amidst a surplus of power plants being built with funny money. But now that surplus is past history, and new generation is needed even in regions that were formerly well supplied.

Transmission (over longer distances, to distribution areas) has also become a more prominent element in the utility valuation mix, and is likely to become a very important contributor to utility growth in the years ahead. In a nutshell, the entire transmission grid in the US needs to be repaired, rebuilt, and upgraded. And these investments receive attractive rates of return on investment from the FERC, which is the regulator of last resort for the grid and interstate activities generally. It was no surprise, then, that ITC Holdings made an offer for transmission assets owned by our Alliant Energy (up 19%), but the price was surprisingly high. Alliant also sold its Illinois electric and gas distribution businesses, as well as New Zealand interests, altogether gathering up a significant cash infusion, completing a back-to-basics program that may make it attractive to an acquirer seeking what is basically now plain vanilla local monopoly utility.

Third among the turnaround stories was Northeast Utilities (up 17%). Investors focused only on current asset value and past earnings history missed the special sauce in this one—regulators had approved plans for over \$4.9 billion in regulated investment, almost half for new grid projects, for which the company receives an attractive and guaranteed rate of return on its investment. Now the prospects for this built-in growth are being built-in to the stock.

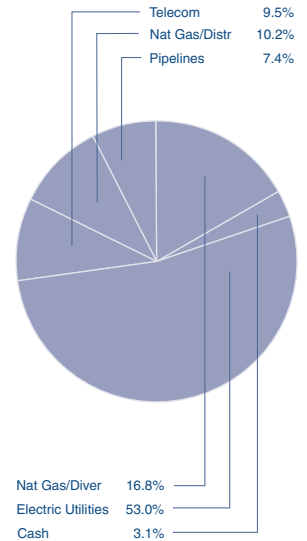
Among other contributors, American Electric Power is another company with ample grid opportunities ahead, Enbridge Energy Management is a recovering MLP story that could well be consolidated in an increasingly competitive industry group, Edison International beat earnings expectations by more than 20% and raised its dividend 7.4%, Questar found that there is even more gas than previously thought in the Pinedale, Southern Union is taking steps to enhance shareholder value after being prodded by activist hedge fund Sandell Asset Management (many hedge funds have become the common shareholders new best friend), DPL reported excellent earnings and the sale of a plant to American Electric Power, Sierra Pacific settled the last of its Enron-era cases with a newly amenable regulator—this turnaround is just about done and we expect the company to begin paying dividends again this year. NiSource had a decent quarter, but our real enthusiasm here is for their restructuring announcement, which should be forthcoming this quarter. CMS sold additional assets, continuing its process of reversion to life as a plain vanilla electric company.

We bought Alltel, a stock we've held before. There's not much left to acquire in domestic telecom, and AT is a reasonably priced candidate which fits the theme of this portfolio quite well. We bought Duke in order to get Spectra—its gas operations—which we think has great potential. Transaction activity has been strong in foreign telecoms, so we added small positions in Turkcell and Hutchinson

Telecom to participate. Stocks sold Scottish Power (an essentially done deal), Southwest Gas (fully valued) and Nicor (fully valued).

LOOKING FORWARD

As one of the best performing groups since bottoming in 2002, utilities have been rediscovered as a reliable source of earnings and dividends by investors seeking both in a world of greater-than-usual uncertainties. Ironically, many companies have found sustainable pathways to growth after the turn of the century meltdown among many that were seeking growth to excess. Those that haven't will continue to be bought by others, as well-run companies seek to enhance profitability through scale. Next up in this evolution is the reconstruction of the national grid, and this is an area in which many previously slower-growth utilities can develop and shine. In conjunction with the growing need for new power plants as well as the quest for non-polluting energy sources, a roadmap which justifies seemingly high current prices has evolved. Indeed, some observers have suggested that new infrastructure expenditures (which create both regulated and unregulated returns on investment) over the next twenty years may equal the entire current market capitalization of *all* U.S. investor-owned utilities. So there's rather more than meets an eye biased to see the group as it existed decades ago. Nevertheless, our earlier cautions regarding a transient pause in stock prices—which we would perceive as a buying opportunity in the absence of changed circumstances—still obtain. □



FUNDAMENTAL CHARACTERISTICS

Yield	2.8%
Proj Dividend Growth	5.4%
Payout Ratio	49%
Market Cap	\$8.5 Bil
Price/Book	2.2
P/E Ratio	18.1
S&P Rating	BBB+
Beta*	0.36
R-Squared*	0.15
Standard Deviation	13.0

*Relative to S&P 500, 12/31/98 - 3/31/07

Annual ADV Update

If you would like a copy of our current ADV Part II, please contact Marilyn at:

(845) 679-9166 or marilyn@mhinvest.com.

The ADV will be mailed to you, free of charge.

Question:

You want to retire this year,
and spend \$200,000
from investments each year (in today's dollars)
to support your lifestyle.
How much will you need
to withdraw annually
35 years from now
if inflation averages 4%?

Answer:

Approximately \$800,000.



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