

## MARKET OVERVIEW

### THE STRATEGIES

#### BETTER THAN BONDS / INCOME

A fixed income alternative/equity income approach utilizing reliable dividend growth companies from across the broad market. Stocks are conservative, high quality, high yield, and are projected to have a rising stream of income.

#### BETTER THAN BONDS / UTILITIES

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

#### DISTRIBUTION / EMERGING UTILITIES

An opportunistic portfolio focusing on companies that are likely to be acquired during an era of utility consolidation and convergence, as well as companies poised to benefit from deregulation.

#### THE SBI PORTFOLIO

Based on the strategy detailed in Lowell Miller's book, *"The Single Best Investment,"* the SBI Portfolio combines value analysis with stable, moderate growth prospects from all sectors. The portfolio emphasizes companies with reliable dividend growth as well as strong fundamental characteristics.

#### ALPHA-BASED STRATEGY

An aggressive strategy focusing on small and micro-cap stocks using both value and momentum analysis. Seeks high returns and protects against high volatility with strategic use of cash.

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Here we are, half way through 2001, and there is no orchestral soundtrack, no all-knowing computer named HAL running our ship, no crew of handsome and perfect astronauts cruising silently through deep space. Something's wrong with this script! Investors are at a bit of a loss (even Wall Street's vaunted investment strategists are showing abrasions of the skull precipitated by excessive head-scratching), wading in what seem to be unfamiliar waters. This, we will be able to tell our grandchildren (and their children's children if all the promised miracles from genomics should come to pass), is what it feels like to be on the backside of a bubble.

We think it's impossible to overestimate what the effect of the awesome declines in the NASDAQ has been on investors. Frankly, if you told investors in these racier issues that they might be subject to declines of 50% and more in a year, not just on one stock but across an entire portfolio, we think there might have been far fewer volunteers willing to go to battle in the first place. A number of studies have confirmed this—the average investor would rather sell than buy when his or her portfolio has declined by 25%. But, despite a good bounce for the quarter, things have become so bad for four-letter stock investors that they simply don't know what to do.

From September of last year through April of this year, investors apparently thought there was some kind of aberrance at work, for the various contrarian sentiment indicators remained at bearish levels—meaning that investors continued to display confidence and optimism—throughout the decline. As you know, our favorite in this area is the open interest figures for index puts and calls. As opposed to put/call volume numbers, open interest provides a kind of inference regarding the views of more committed traders, since open interest represents the positions that remain open, or in force, after the dust of each day's trading has settled. Meanwhile, since these positions are leveraged options and an extreme form of participation in the equity markets, we presume that this set of participants exhibits a greater intensity of fear and greed than the typical un-margined equity schlub. Sentiment readings from this sector, then, are in our view far more telling than the aggregate of well-dressed strategists parading on CNBC—though we don't ignore the "talking heads" consensus as a contrary indicator. We've continued to study the index put/call relationships over the years, and have recently finished another big push in the subject.

It's a positive for the overall market when open interest in puts outweighs open interest in calls. It's a negative when traders are holding more calls than

*"...when it comes to the broad market of real companies with real earnings and a proven long-term role in the economy, we suggest that sentiment indicators have improved substantially..."*

puts. When calls are popular, complacency and optimism rule. Presumably, those interested in buying have already bought and are simply awaiting the arrival of "greater fools." When interest in puts is strong, the "wall of worry" that every bull market (save the tech market in 1999 and first quarter 2000) must climb is in place.

In 1987, for example, index open interest in puts far outweighed that in calls up until August. Suddenly, then, everyone wanted to buy calls and get in on this rising dirigible—even though market breadth was shrinking daily. The crash arrived like a giant gong, and put open interest subsequently dominated call open interest for several years; all the while the market moved higher, helped by a congenial Federal Reserve, trending up against the fear implied by dominant interest in puts. The image of the crash remained strong in the minds of investors, the fear of it, the tangible knowledge of "what could go wrong."

This didn't really happen during the 15-month old NASDAQ bear market (we refer to the OTC stocks here because they have been the leaders by far on the downside, but there are plenty of tech stocks populating the larger indices as well, and the S&P 500 or the Dow Jones Industrials have hardly been paragons of profit during this period.) All through the decline investors were apparently confident of a rebound, for at no time did the put open interest outweigh the call open interest—a most unusual string of readings.

Even now, the options open interest on the QQQ, or NASDAQ 100, remains tilted in favor of calls. In our way of looking at the world, this means that while the index may always be subject to short-term rallies, a rally of useful magnitude is not in the cards for the most aggressive areas of the market. We don't believe that sustainable rallies occur without a backdrop of fear or skepticism as reflected in the index open interest positions. Without substantial improvement here, investors in the

famous tech and new economy names would appear to face disappointment.

The news is different when it comes to the Russell 2000. Although trading is less active in these options, making the data commensurately less reliable, puts have dominated the open interest in the RUT.X all year and they still do, so we would anticipate further solid performance from the small stocks, though so many have done so well that there are zones in which a yellow valuation flag is beginning to rise.

The best news comes from the mainstream indices. The S&P 500, the Dow Jones Industrials, and the S&P 100, have all made great strides in the last couple of months from the standpoint of the option open interest indicators. We're finally getting some fear in the broad market! Indeed, there are, as we write, more puts than calls open on all three indices. The numbers are not huge and do not imply any kind of a climax bottom, but at least the air has cleared. Sentiment seen through this looking glass is not so great as to compel a rally, but no longer so bad as to inhibit or suppress one, either.

A missing piece has definitely been added to the puzzle. For investors interested in the larger equity picture (and not just the headline stocks), as we are, there are now several positive straws in the wind. Last time we pointed out the declines of 1962, 1974, 1982, 1991, and 1998, and noted that they were the times to be a buyer, not a seller, however scary those times might have been. Still, most investors would chafe at the notion of simply and naively buying because the markets are down.

In that case, when it comes to the broad market of real companies with real earnings and a proven long-term role in the economy, we suggest that sentiment indicators have improved substantially (though they do still leave something to be desired), valuations for the

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**SELECTED INDICES**

	2 <sup>ND</sup> Qtr'01	12Mo
<b>S&amp;P 500</b>	6.63	(14.20)
<b>Equity Inc</b>	4.12	7.13
<b>Util Fund</b>	(2.51)	(5.48)
<b>DJUA</b>	(5.03)	20.97
<b>LB Treas</b>	(1.76)	9.76
<b>LBGC</b>	0.30	11.13
<b>S&amp;P 400</b>	13.16	8.87
<b>Value Line</b>	8.31	(1.94)
<b>Rus 2000</b>	16.13	2.20
<b>Rus 2000 Val</b>	11.70	30.87

S&P 500 = Standard & Poor's Index  
 Equity Inc = Ave Equity Income Fund (Lipper)  
 Util Fund = Ave Utility Fund (Morning Star)  
 DJUA = Dow Jones Utilities Ave  
 LB TREAS = Lehman Long Treasury  
 LBGC = Lehman Bros. Gov/Credit Bonds  
 S&P 400 = S&P Mid Cap Index  
 Val Line = Value Line Price Index  
 Rus 2000 = Russell 2000  
 Rus 2000 Val = Russell 2000 Value Index

The large-cap utility indices such as the Dow Jones Utilities had a difficult time this quarter, as California issues continued to swirl about the sector and a retracement of gas prices affected the pipeline companies. But, as historically has been the case with our portfolio, we declined only about half as much as the average. We'd thought the quarter would be a bit brighter, especially in view of declining interest rates, and, indeed, we posted quite solid positive results up until June. But the combination of large-cap problems and a surprisingly quick correction in gas pricing set a bad tone for the final month of the quarter dragging down results. Indeed, the majority of our stocks were flat or up; a few heavyweights saw selling that was too much to overcome, and we wound up with a second consecutive quarterly negative return—only the third time this has happened in ten years. The positive factors that have been driving our portfolio for the past five years remain in place, however; the selling some of our stocks saw in June was a peculiarity of the marketplace and hardly warranted by continuing strong fundamentals.

## CALIFORNIA REDUX

There are forty-nine other states, and none of them have experienced the troubles of the “golden” state, but utility investors continue to be entranced by the goings on in that den of political maneuvering. Most of the media have assigned journalists to the “case,” thus insuring that as much misinformation as possible will be disseminated as widely as possible.

By the end of the first quarter, California consumers found that they had to pay up for their energy, demoting them to plebian status along with the rest of us. But the crisis was severe: it

increasingly became clear that all of the parties would have to kick in something toward the solution. Consumers had their rates raised and the state’s two major utilities entered bankruptcy or the next worse thing. What about those evildoers, the generators? Though the Federal Energy Regulatory Commission had previously exonerated the various independent generating companies from any legal wrongdoing, an administrative law judge has taken over the case and appears, as of this writing, to favor some kind of settlement from the generating companies. As we write, all the parties have convened in Washington to attempt a settlement. While no one can know exactly how all this will fall out, initial noises make it clear that California will not get the nine billion dollars it hopes for, nor will the generators walk off without a haircut. Duke Power, among others, has already indicated that 10% of their charges were attributable to a premium for credit risk, and that they would refund that much if they were paid. So we can reasonably assume that at least 10%, or nine hundred million, will be going back to the state. In the absence of proof of manipulation, it is difficult to see that number going much higher, especially since the world will clearly be different going forward. California has locked in much of its future needs through long-term contracts (you can bet they will try to re-open these down the road when it looks like they paid too much relative to the future spot price). Current prices are already down by one-half to two-thirds since January. And the number of plants nearing completion and/or substantially developed indicates that the state’s electricity needs will be in balance some time in 2002. Four thousand megawatts have just come on line—the first new plant in California in 13 years. Further, though many

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**Quarter Composite Net of Fees\***

BTB/Util (Preliminary)	(3.89)%
DJUA (total return)*	(5.03)%
LBGC*	0.30%
Ave Util Fund*	(2.51)%

**12 Month Composite Net of Fees\***

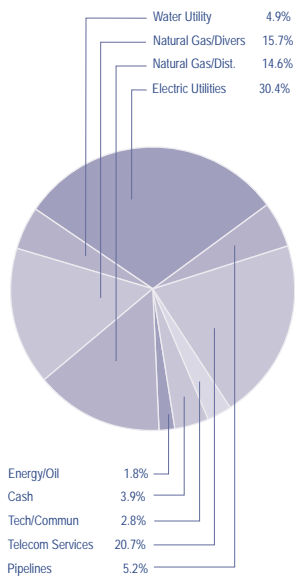
BTB/Util (Preliminary)	10.03%
DJUA (total return)*	20.97%
LBGC*	11.13%
Ave Util Fund*	(5.48)%

**5 Year Composite Net of Fees\***

BTB/Util (Preliminary)	14.69%
DJUA (total return)*	14.86%
LBGC*	7.38%
Ave Util Fund*	11.81%

\*See Performance Disclosure on page 7.

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believed it would never happen, the state's residents are actually successfully conserving energy. During peak periods, the savings have been as high as 12%. Amazing what tolerating a little less air conditioning will do! So, the headlines continue, but the problem, albeit with the potential of a few stresses this summer, is basically already solved.

In addition, the key independent generating companies which have been driving down the DJU only have portions of their business in California. In some cases the percentage of revenues is rather small. Still, they are being treated in the marketplace as though their entire business was in servicing California and their key issue is in appeasing Governor Gray Davis (Gray is the color just before a blackout). Not. And, we might add, we have no doubt that these companies have built plants to operate long-term in California under normal conditions and at normal prices, rather than as the marauding gypsies who will pitch a plant wherever there's a shortage, as they've been portrayed by some.

## PORTFOLIO HIGHLIGHTS

We have only about 20% of pure electric companies in our portfolio, and only 2.5% of independent generation, so we need to look at other factors besides the poor tone set by the generators.

The second factor weighing on our stocks this quarter was the decline in natural gas prices. The April-May softness was to be expected, as this is a shoulder season for gas, with little pressure in the way of heating or air conditioning needs. The tail of the winter was unseasonably warm for heating, and then June was unseasonably cool compared to last year, requiring less electricity for air conditioning, and injections of gas into storage were suddenly on the rise.

In our opinion, it is the traders that need an injection. While it's true that there is more gas relative to demand than there was last year,

storage facilities are still less than half full and still well below the historic average. Meanwhile, this summer, with practically every week that passes, a new gas-fired electric plant will open its doors. Oh yes, that new 4,000 megawatts in California? Gas fired. Meanwhile, though rigs have been working overtime in the Gulf of Mexico and elsewhere, and there are 50% more rigs working than there were three years ago, actual gas production has hardly budged. It's up 1 or 2% by most estimates.

Recently one analyst has suggested that only half the electric plants now on the drawing boards nationally will get built, due to a lack of sufficient natural gas as fuel. Whether he's wrong and more gas-burning plants are built than he expects, or he's right and plant construction slows to create more coal plants because there's not enough gas, the case for firm and rising gas prices is certainly supported. Further, even if some plans change and coal plants replace some scheduled gas plants, the same time frame for coal plant construction will (finally!) see the emergence of fuel cell applications—and the most probable fuel for these is gas and liquefied gas.

Meanwhile, our gas-related stocks, which dragged the portfolio down for the first time since the summer of 1998, are more involved in transportation of gas than gas pricing. It's true that over the years we have moved from a volume-only relationship to the gas industry toward a significant element of exploration and production in our stocks, but the essence of our companies is still in transportation. El Paso, Williams, Enron, NiSource, MDU, Keyspan—these all own some production, but would be well worth current prices if one valued the production at zero. Questar has potentially enormous production for a company its size, and here the company, at 11 times next year's earnings, is clearly being valued without its sizable "growth kicker."

On the brighter side, our telecommunica-

### UTILITIES PORTFOLIO CHARACTERISTICS

Beta*	0.43
Dividend Payout	52.96%
Sharpe Ratio	0.73
Projected Dividend Growth	4.55%
Treynor Ratio*	21.76
Current Yield	3.6%
Annualized STD	12.77
Market Cap (MDN)	\$4.9 Bil
Price/Book	2.19
Quality (Equity Rating)	B++
P/E Ratio (MDN)	14.96

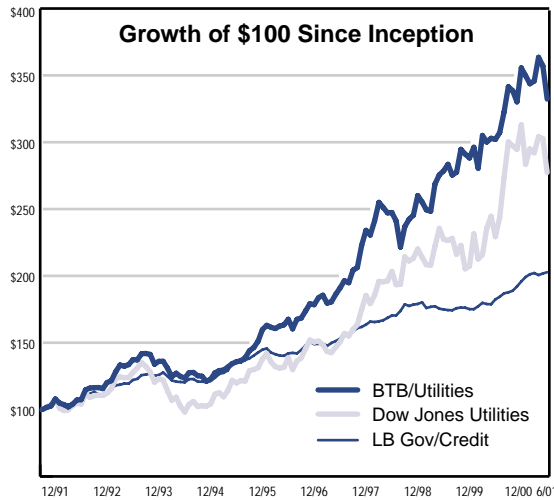
\*Relative to S&P500, 6/30/96-6/30/01

tions stocks appear to be emerging from a bottom, and actually aided returns this period, for the first time in more than a year.

We continue to see the telecomm war as basically won by the asset, customer, and cash-rich Baby Bells, and we've begun increasing our weighting in this area, doubling up on SBC Communications. While this one didn't help during the quarter, the portfolio was led by double-digit gains in ALLTEL and Telephone & Data, with Verizon not far behind. We expect earnings growth for the solid phone companies to exceed that of the broad market for at least the next two years, yet they are substantially cheaper than the market by nearly every measure. As time goes by, we think the survivors among the new telecom competitors will stand much taller amidst the rubble of failed hopefuls, and these, too, will find new buyers in the equity markets.

## LOOKING FORWARD

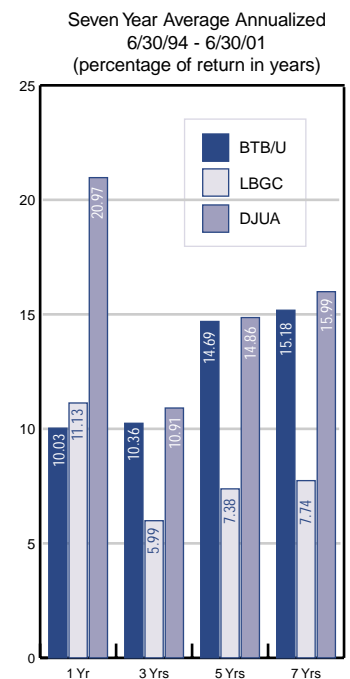
We can't say that the current moment is as perfect a buying opportunity as it was when we pounded the table in June of 1994 or again in January of 2000, but this is now an extremely attractive configuration for our portfolio. Stocks like Enron and El Paso Energy and Williams have rarely been cheaper based on current valuations, yet their prospects remain, in our view, as bright as ever. Our distribution utilities have been delivering earnings and dividends like clockwork and some, like ATG Resources (formerly Atlanta Gas Light) have begun to add growth elements to their stable returns. Consolidation is likely to re-emerge for these distributors soon, especially should the Public Utility Holding Company Act be repealed, which is a distinct possibility this year. And telecom is ready to help us once again. The portfolio has no excess in it, yet the underlying fundamentals of the component companies have shown continued progress in recent



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quarters. No more "rest" is needed. As the tone of the DJU improves from the gradual resolution of California's problems, the dampening factor in the picture will be lifted, and the stocks in our portfolio are priced to move significantly.

P.S. There's an underlying anxiety throughout the land, especially on the West Coast, that our energy costs will rise and rise, an anxiety not unlike the way people tend to feel about an incipient epidemic of disease. While we have noted for years that deregulation was unlikely to bring about significant savings for consumers (though successful deregulation in Pennsylvania actually has produced some price reductions), we reiterate the notion that the fever induced by California's problems has already broken. Further, US consumers should take solace from the fact that nowhere in the world except in the Arab oil producing countries is the total energy cost for a household cheaper than in the US. Indeed, many developed countries show a total household energy cost that is a *multiple* of our domestic averages. At times like this it's not always easy to remember that one of the strengths of the US economy is its comparatively bargain-priced energy and electricity supply. □

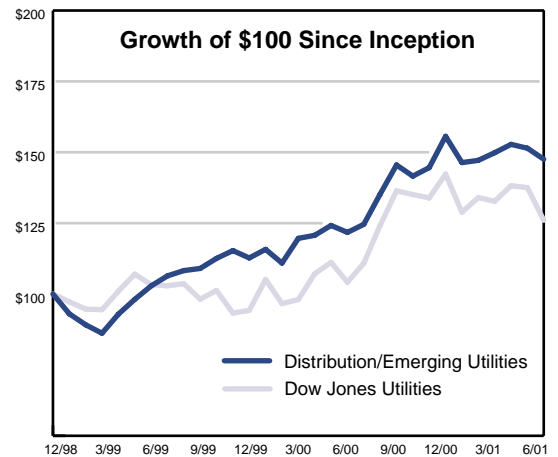


**W**e often like to sing the praises of the profits that inure to investments that are boring: indeed, over the long term there may be a direct functional correlation between the boredom of an investment and its absolute as well as its risk-adjusted return. But this quarter verged on the ridiculous, as there was little price change and just as little news. Actually, this is no problem for us as managers, but it does make for extra stress when the time comes to report on all that didn't happen.

*"...indeed, over the long term there may be a direct functional correlation between the boredom of an investment and its absolute as well as its risk-adjusted return."*

### PORTFOLIO HIGHLIGHTS

The biggest news highlight for the quarter was the resolution of various issues that have given the shakes to FirstEnergy's takeover of our substantial holding in GPU. GPU had been caught in a mini-version of California's problems as provider-of-last-resort in Pennsylvania, sustaining temporary losses unforeseen by the company or regulators as customers migrated back to the company from "choice" providers when local prices rose above the default offer provided by GPU. An administrative law judge basically ruled in favor of the company on all counts, and the regulators subsequently affirmed his opinion, removing a potential cloud that FirstEnergy might have used to nullify the merger. At the same time Pennsylvania regulators approved the merger, making it essentially a done deal pending the approval of New Jersey, which does not seem a problem. The course of true love never does run smooth, though, and the stock, now at about 36, has sold below 29 in two separate slides based on merger fears since we entered our position less than a year ago. At this point, however, it looks to be a better deal than expected (reward for tsouris!), as the



subsequent rise in FE's price makes GPU worth over \$40 in the current market, versus \$36.50 in the original deal guarantee. Meanwhile, the company has continued to pay a dividend of over 7% based on cost.

We boosted our holdings in Southwest Gas. Here's a stock that had two offers on the table at over \$30 within the past year, though the stock sells at under \$24 as of this writing. Oneok and Southern Union got into a catfight bidding for SWX, resulting in lawsuits and a rejection of all offers by the local regulators ("If you can't play nice we're not going to let you play at all..."). Now the legal wrangling is winding down (Southwest has not been found at fault in any way) and it will soon be time for a well-behaved suitor to make his appearance. Meanwhile, the company is doing well in one of the greatest demographic areas in the country, and couldn't be an "easier" holding.

Energy East, which is just about the cheapest stock in the utility universe—and for no good reason, in our view—led the portfolio with a 20% gain. Southwest Gas was next, curteously rising 14% after our addition. Others that helped the portfolio included NSTAR, New Jersey Resources, Peoples Energy, Atmos, and American Water; but the distribution of returns

#### Quarter Composite Net of Fees\*

Distribution (Preliminary) (1.53)%  
 DJUA (total return)\* (5.03)%

#### 12 Month Composite Net of Fees\*

Distribution (Preliminary) 21.22%  
 DJUA (total return)\* 20.97%

#### 2 Year Composite Net of Fees\*

Distribution (Preliminary) 19.78%  
 DJUA (total return)\* 10.46%

\*See Performance Disclosure on page 7.

was narrow, with most positive stocks in the single digits. It was similar on the downside, with those that hurt us not really hurting by much. Stocks connected to gas pricing through E&P subsidiaries was the theme here, though, as we point out in the BTB/Utilities summary, any softness in gas pricing is likely to be temporary. Our very small position in telephones was negative as well, but these stocks appear to be in an increasingly clear bottoming process.

## LOOKING FORWARD

Why the pause? Especially in view of declining interest rates, which make transactions easier, the slowdown in activity is a point of concern. Without doubt, we are witnessing a basic trend toward convergence and consolidation in the utilities industry, and, we suspect, this pause in activity is attributable to decisions by participants to await clarity on the regulatory front. This is not really about the FERC and price caps, since the distribution companies are not really affected in that area. More to the point, we think is behind-the-scenes maneuvering in anticipation of the repeal of the Public Utility Holding Company Act. PUHCA makes it much harder for companies to consolidate, and a world without PUHCA is going to be a world of transactions that reaches a symphonic level. Warren Buffett noted he would put \$10-15 billion to work in utilities in such a world, and it would not be surprising to see other non-industry players, like the major oil companies or major distribution retailers like Wal-Mart and Home Depot enter the fray. BJ (Before Jeffords) the skids were very much greased for repeal, including a 19-1 vote in favor in committee. Now there is a sudden

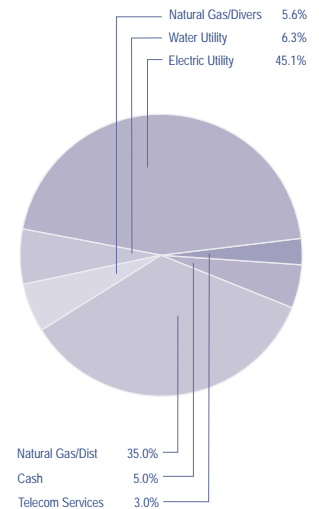
silence with regard to the bill, and we suspect it may have fallen into a role as a bargaining chip. It's likely to be slow going until repeal, but this is a nice portfolio in the meantime, as evidenced by its 4% (and rising) yield, and the fact that it sustained only a minimal nick even as the Dow Jones Utilities declined more than 5% for the quarter. The opening days of the 3<sup>rd</sup> quarter have been strong, and we hope that's an omen. □

### Overview continued from page 2

average real company are not high (though tech valuations still may be), the Fed is doing its level best to make your portfolio rise, taxes are coming down, energy prices have moderated, the employment picture is no longer tight as a guitar string, there is plenty of excess capacity, no inflation, and your friends are no longer bragging about their "easy-come, easy-go" gains. Patience will surely be needed, and there are uncertainties about how a market develops on the "backside of a bubble," but we still believe that years from now this moment will appear, in retrospect, as an excellent opportunity for investors. □

#### Performance Disclosure

**Yield-Oriented Portfolios:** Gross of fees performance is based on actual results according to standards set forth by the Association for Investment Management and Research (AIMR). Miller/Howard Investments has prepared all performance results. AIMR was not involved in the preparation or reporting of these results. Net of fees performance is calculated by deducting a weighted average annual fee of 75 basis points from gross of fees performance. A complete list of all the firm's composites is available. Portfolios are matched across all accounts so that 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. **Better Than Bonds/Utilities:** Included in the results are all portfolios that are unrestricted and that have been managed for at least one full quarter. Number of accounts in the composite as of 6/30/01 was 246, which represents 91% of total assets managed in this strategy with a measure of dispersion of 0.27. Inception of the composite was September of 1991. **Distribution:** Included in the results are all portfolios that are unrestricted and that have been managed for at least one full quarter. Number of accounts in composite as of 6/30/01 was 20, which represents 98% of total assets managed in this strategy with a measure of dispersion of .13. Inception of the Distribution composite was December of 1998.



### FUNDAMENTAL CHARACTERISTICS

Yield	4.0%
Proj Div Gro	3.73%
Payout Ratio	69.38%
Market Cap (MDN)	\$1.9 Bil
Price/Book	1.62
P/E Ratio	15.13
Quality (Equity Rating)	B++
Beta*	0.08

\*Relative to S&P 500, 6/30/99-6/30/01

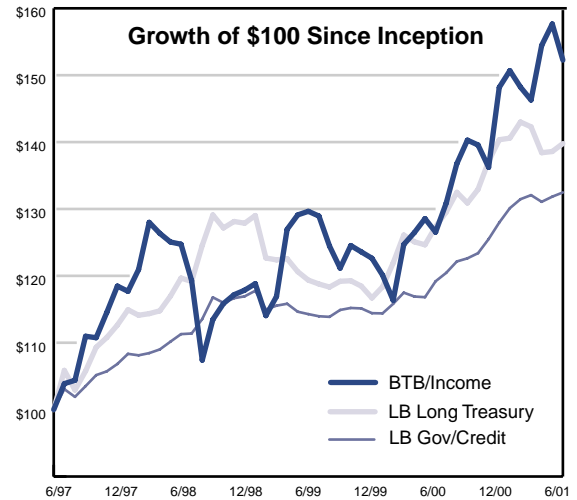
*“Most investors are focused on the 15-month bear market in technology and related stocks, ignoring the fact that we are only just now emerging from a severe bear market in value and yield stocks.”*

**T**hough the utility portion of our portfolio somewhat dampened returns in June, the quarter was solid overall, with performance that approached the large-cap stock indices and, more importantly, outperformed all categories of domestic bond funds. The increased diversification we’ve been implementing over the past year has, so far at least, helped the portfolio remain buoyant in all kinds of market conditions—including some of the more difficult markets most investors have ever seen.

**PORTFOLIO HIGHLIGHTS**

Gains emerged from a different set of leaders this quarter. Topping the list with a 35% gain was Dana Corp., an item that’s been a bit sleepy for a while, but which has been paying a dividend of over 5% (even in its sleep). DCN is a pretty fair example of the need to buy and/or hold value stocks when earnings are difficult: though auto sales are holding up better than expected, they’re still off and so is Dana’s revenues. But investors are now buying the idea of a consumer recovery led by lower interest rates, and have bid up the stock in anticipation. Much the same might be said of Genuine Parts, which rose over 20% for the quarter, though this one is far less dependent on auto sales, since its parts business is really in the aftermarket.

AmSouth, Lincoln National, and Union Planters provided gains, as might be expected in a period of declining interest rates, but these stocks are all takeover candidates as well. Indeed, declining interest rates make financial companies more attractive as acquisitions, and we’re on the lookout for more of this type to add to the portfolio. Also among the leaders in stocks we’ve held for a while were Alliance



Capital, Suburban Propane, Kinder Morgan Energy Partners (a recent fixture on the leader’s list), and Colonial Properties. We’ve had to suck it up and tolerate some nasty fluctuations twice in GPU, as its takeover by FirstEnergy has taken a long and winding road, but at this point all seems well with the deal. Indeed, with FirstEnergy’s price on the rise, it’s now conceivable that we’ll get something more in the neighborhood of \$40, rather than the specified \$36.50.

Some recent research work we’ve been doing in the REIT area pointed us to Boston Properties, a true best-in-class company which had declined to almost unprecedentedly low valuation levels relative to its assets on investor fears of a slowing economy. This swing of fear provided an opportunity for us to enter one of the premier names in the REIT sector, and it has generated about 10% in appreciation from our initial purchase. While the 5.9% yield is a bit low for a REIT, it’s still higher than bond yields, and will surely grow in the years ahead.

Speaking of yield, we also added two stocks with enormous yields. Typically, when we find issues with enormous yields we also find abundant rot below the surface and avoid

**Quarter Composite Net of Fees\***

BTB/Income (Preliminary)	4.09%
LBGC	0.30%
LB Long Treasury Index	(1.76)%

**12 Mo Composite Net of Fees\***

BTB/Income (Preliminary)	20.34%
LBGC	11.13%
LB Long Treasury Index	9.76%

**2 Year Composite Net of Fees\***

BTB/Income (Preliminary)	8.38%
LBGC	7.67%
LB Long Treasury Index	8.21%

\*See Performance Disclosure on page 9.

them. But no matter how much we poke and prod, we really can't find the achilles heel of these two issues. Enerplus is a royalty trust formed by one of Canada's leading energy companies, with royalty interests in some 200 producing properties. Investor sentiment will naturally bob these shares up and down to some extent based on the price of oil, but the assets are real and debt is nonexistent. Nordic American owns modern double-hulled tankers which are leased for 6 years to BP Amoco at a minimum lease which covers the current payout, but which could increase if general tanker rates increase. At 30% debt, with a set of assets whose useful life is probably on the order of 20 years, we think it will be hard to lose money on this stock which yields an astonishing 25% at current prices. We're suspicious of some numbers and sniffing for the trick we've missed, but we haven't found it so we'll take the income in the interim.

One feature of this portfolio, which makes us happy as managers, is that some of the best ideas that arise are classic contrarian plays. The news couldn't be worse for Ford, whose leading Explorer line was already a question mark in terms of the durability of its contribution even before "Firestonegate" emerged. It looks like a company in trouble, on the ropes, in an industry which currently exhibits only mediocre vitality. But Ford's dividend is amply covered, its valuation is deeply at the bottom of historic metrics, low interest rates should help a recovery in the auto market, and the bad news is clearly out. Too, chances are good that the company has little or no culpability in the Explorer's rollover scandal. We're betting that the company is better off than investors are giving it credit for right now, and we'll get paid about 5% while we wait to see if we're right.

We sold bits and pieces as well as a few ripe positions to pay for our new acquisitions, including profits of more than 100% in Washington Mutual and Kinder Morgan PEPs securities, and fairly small losses in REITs United Dominion and Hospitality Properties, finishing the quarter with minimal transitional cash.

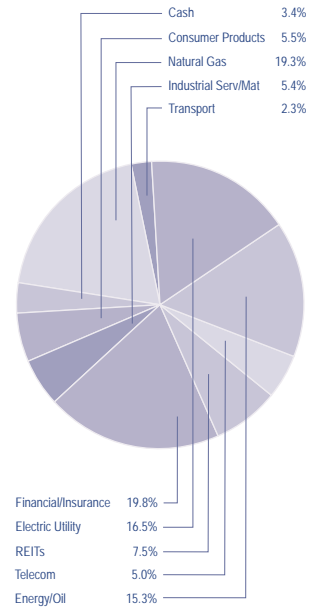
LOOKING FORWARD

We've been viewing this portfolio optimistically for quite some time, and we continue to do so. The one drag on the portfolio this quarter, from gas-oriented utilities, should be resolved to the upside as the third quarter progresses, and we continue to find attractive candidates for addition to the portfolio from a broad variety of market sectors. Most investors are focused on the 15-month bear market in technology and related stocks, ignoring the fact that we are only just now emerging from a severe bear market in value and yield stocks. These have far to go to reach more traditional valuation levels. The current yield on this portfolio is approximately 7%—a level at which we can turn our attention more toward additional capital appreciation. □

Performance Disclosure

**Better Than Bonds/Income:** Included in the results are all portfolios that are unrestricted and that have been managed for at least one full quarter. The number of accounts in the composite as of 6/30/01 was 47, which represents 65% of total assets managed in this strategy with a measure of dispersion of 0.39. Inception of the composite was May of 1997.

**Alpha-Based Strategies:** Net of fees performance is based on actual results after the deduction of management fees (weighted average fee of 200 basis points). Included in the results are all Alpha-Based portfolios that are unrestricted, including one non-fee paying portfolio, and that have been managed for at least one full quarter. In addition, in order to be included in the composite a new account has to be at least 80% invested and it should hold not more than 5% cash exceeding the maximum cash held by any portfolio already in the composite, as of the end of the preceding quarter. The number of accounts in the composite as of 6/30/01 was 48, which represent 51% of total assets managed in this strategy with a measure of dispersion of 0.88. Miller/Howard Investments has prepared all performance results. Inception of the composite was 3/31/97.



FUNDAMENTAL CHARACTERISTICS

Yield	7.0%
Proj Div Gro	7.11%
Payout Ratio	71.31%
Market Cap (MDN)	\$3.9 Bil
Price/Book	2.03
Beta*	0.45
P/E Ratio** (MDN)	13.70
Quality (Equity Rating)	B++

\*Relative to S&P 500, 6/30/97-6/30/01  
 \*\*REITs use P/FFO ratio rather than P/E Ratio

*“Flat’s no cause for celebration, but it’s okay when the majority of categories remain in the red—the average equity fund is down nearly 7% for the year to date.”*

Although the broad market at the index level was strong for only four or five weeks, the grudging return to normalcy continued. Market breadth remained buoyant, and the trend of rising stocks outnumbering falling stocks continued—though you’d never know it from the headline issues. In the midst of some of the worst earnings reports in years, if not decades, opportunities continue to arise. The quarter, though quite volatile, turned out pretty decent numbers for most broad market indices with the S&P 500 up over 6%, S&P Mid-Cap up 13%, and Value Line up 8%. Our portfolios tracked this strength, generating a 6.09% return net of fees for the quarter and staying relatively flat year-to-date. Flat’s no cause for celebration, but it’s okay when the majority of categories remain in the red—the average equity fund is down nearly 7% for the year to date.

#### Quarter Composite Net of Fees\*

SBI (Preliminary)	6.09%
Value Line Index	8.31%

#### 12 Month Composite Net of Fees\*

SBI (Preliminary)	(3.41)%
Value Line Index	(1.94)%

#### 2 Year Composite Net of Fees\*

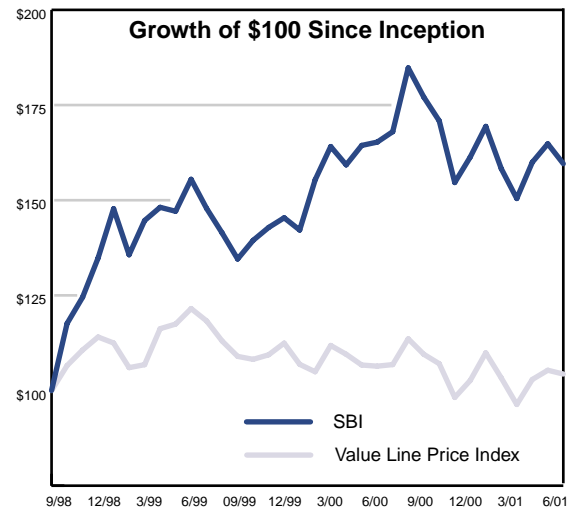
SBI (Preliminary)	1.33%
Value Line Index	(7.34)%

\*See Performance Disclosure on page 11

## PORTFOLIO HIGHLIGHTS

We didn’t feel any urgency to make changes in our group. The majority of our stocks performed well this quarter, with positive returns spread among a variety of sectors, ranging from technology to financials, restaurants to pharmaceuticals.

One of the few recent additions was Trigon Healthcare, a domestic managed care company. We’ve been looking for a candidate in this group for quite some time, as the industry characteristics have become more and more appealing over time, even as investors have shied away out of legislative anxiety. Trigon has a great consistent growth story combined with conservative management, and a regionally dominant and growing market share. TGH trades at a significant discount to the health care group and has a solid balance sheet, with



approximately \$650 million in cash reserves above regulatory requirements in addition to its debt ratio of 22%—which is extraordinarily low by industry standards. Considering all the above characteristics, we wouldn’t be surprised to see Trigon as a takeover candidate at some point. In the meantime, we’re signing up to partner with the steady growth and stability of this healthcare service provider.

When it comes to the best performers, Citrix was clearly a market leader, up 65%. The world is moving toward its application server software and services that offer “digital independence:” the ability to run any application on any device over any connection. While we have to admit that we originally bought this stock during the tech boom of the “last century,” we remained confident in its ability to withstand market shakeouts. Positive news flow for the company throughout the quarter culminated in a higher-than-expected sales growth forecast early this June. The company is seeing growth across all its product lines, and enjoys a strong fundamental position which will only be enhanced by upcoming versions of Windows. We believe that the future here continues to be bright, as demand for CTXS’

product keeps growing, even in a tech recession. In addition, even after its recent jump the stock is trading at a significant discount to its 10-year median multiples, has a very solid balance sheet with a debt to total capital ratio of only 6% and estimated earnings growth of over 25% in the next few years.

Ceridian, now primarily trading under its new name, Arbitron, was our number two winner for the period, returning close to 37% in three months. The turnaround of this leading provider of third party information services seems to be progressing well following a host of problems encountered over the last couple of years. The company recently reiterated guidance for this year and continues to improve performance across all divisions. In addition, the company sales force is growing at a rapid pace, which in turn should accelerate revenue growth in the quarters to come. However, the advertising and marketing industries are in a funk just now, so we need to monitor this situation closely, especially with profits embedded in the position.

Darden Restaurants impressed investors with excellent earnings and shares appreciated close to 18% for the period. Though higher now, the stock was previously painfully cheap, and now that all divisions are showing gains there appears substantial further upside. Management projects 15-20% annual growth, so the stock still sells at a P/E noticeably lower than its growth rate.

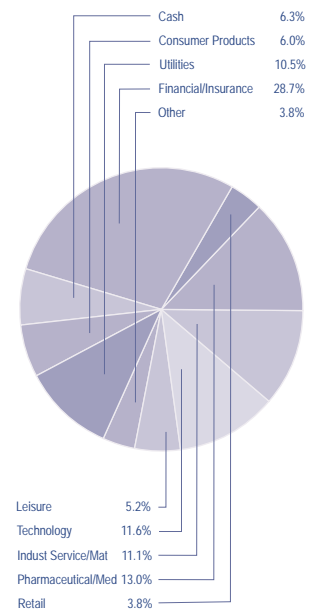
In the pharmaceutical group, the primary driver of performance was Watson, up close to 18% on the back of a solid earnings report. Also in this sector Medtronic lagged, but its superior financials combined with several upcoming FDA panel hearings and other expected catalysts should provide a nice bounce in the coming months.

Our losses this quarter came from the utility and telecom universe, including continuing

favorites, Global Crossing, AES Corporation and Williams—the latter a company about which we raved last quarter. We're still raving about this one as a great value, and one of these days the stock price will reflect our view, we think. We remain confident that natural gas price softness will eventually return to its equilibrium and, in turn, push current valuations back to their historical levels. Global Crossing carries a similar story. Financial troubles surrounding Exodus Communications and recent negative publicity on the fiber glut cast a shadow of doubt on the prospects of this leader in the fiber optic communications space. In spite of the news, fully-funded Global recently announced completion of its main loop and keeps moving along with a continuous stream of large long-term contracts. Too, most casual observers fail to realize that undersea broadband prices have not really been declining to the same extent as land-based broadband, and that new competition is unlikely due to the costs and technical difficulty of laying undersea cable. To wit, one of Global's competitors, 360° Communications, went bankrupt this quarter for lack of funding.

## LOOKING FORWARD

Looking forward, we continue to seek interesting opportunities that will help us keep a diversified portfolio with representation in all sectors, emphasizing stocks with consistent, sustainable growth at moderate prices. □



## FUNDAMENTAL CHARACTERISTICS

<b>Yield</b>	1.2%
<b>Proj Div Gro</b>	11.97%
<b>Payout Ratio</b>	19.06%
<b>Market Cap (MDN)</b>	\$8.4 Bil
<b>Price/Book</b>	4.01
<b>P/E Ratio (MDN)</b>	20.38
<b>Quality (Equity Rating)</b>	B++
<b>Beta*</b>	0.78
<b>STD</b>	17.62

\*Relative to S&P 500  
6/30/99-6/30/01

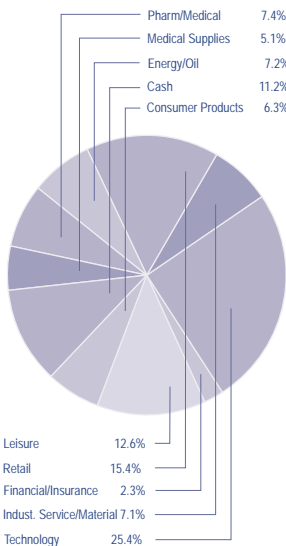
### Performance Disclosure

**SBI:** Included in the results are all portfolios that are unrestricted and that have been managed for at least one full quarter. Number of accounts in the composite as of 6/30/01 was 10, which represents 100% of total assets managed in this strategy with a measure of dispersion of .33. Inception of the SBI composite was September of 1998.

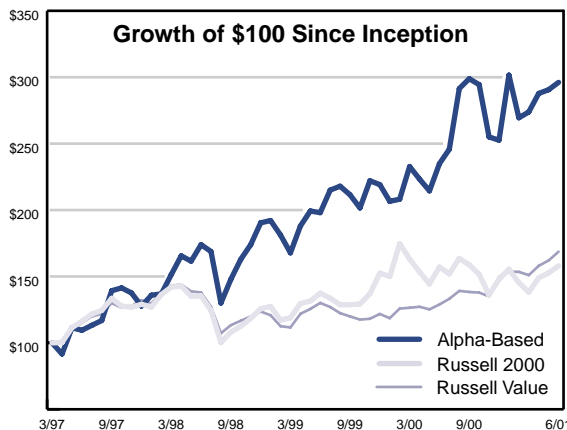
FUNDAMENTAL CHARACTERISTICS

P/E Ratio	18.13
Market Cap (MDN)	\$450 Mil
Price/Book	3.09
LT Growth Rate	23.02
Beta*	0.98
R-SQR*	0.37
Annualized STD	28.71
Alpha*	19.89

\*Relative to S&P500, 6/30/97-6/30/01



Small caps remain one of the few places where investors can consistently turn a profit these days, and our Alpha-Based portfolios are doing the job, outperforming the Russell 2000 year-to-date, and keeping up with stunningly good double-digit gains by the small-cap index this quarter. It is in the micro and small-cap zone of the world where one can still find excellent values among stocks that are growing with real earnings, and the index results as well as our portfolio results reflect this. For the trailing three years our returns have more than tripled those of the index, so we pass muster on the longer term as well.



PORTFOLIO HIGHLIGHTS

We suggested last time that the quarter was likely to be marked by quick rallies and sudden declines, and we'll hold on to that particular crystal ball, since it seemed to have some clarity. In the face of this view we resolved to improve our execution, booking profits when outsized gains appeared, rather than holding on for the inevitable valleys.

We were able to sell BEI Technologies within fractions of an overbought all-time high (with about 100% profit in four months) prior to a vicious profit-taking decline which knocked a quick 40% off its price. We trimmed Monterey Pasta way back, again near a new all-time high, managing to avoid much of the damage from a weak earnings report in the beginning of the 3<sup>rd</sup> Quarter. We let a bad earnings report drive us out of Wilson's Leather prior to a 25% decline in that issue. We took partial profits in Christopher and Banks and Chico's prior to substantial further declines. You get the picture. What we're most pleased with this quarter is the success of a more vigorous selling attitude. Interestingly, many of these stocks will likely become purchase or upweighting candidates in the foreseeable future—at much lower prices that this past quarter's sales.

We also trimmed Take-Two, but only back to normal weight on a rally. We continue to have high

hopes for this one, as the interactive entertainment software industry will probably never have a year of greater potential than the upcoming twelve months. Quite a few new buys helped the portfolio this time, including Polymedica (bought in June, provided a 30% gain), Sunrise Assisted Living, and heavily weighted Steven Madden (a designer shoe company, up 20%).

On the downside, energy price weakness hampered the portfolio's performance, with notable declines in Mission Energy and Seitel. These have kind of gotten away from us technically, but we continue to think that some representation in the energy sector is a good idea, and that these stocks remain extraordinarily cheap values.

LOOKING FORWARD

Our focus is to keep the portfolio diversified—we're in medical and health, retail, direct mail, housing, energy, financial technology, computer games, restaurants, utility construction, computer displays, shoes, food production, and more. The growth rate of our companies continues to run well ahead of their P/E multiples. So we've got plenty of candidates to continue this pattern of diversification, and we've got the taste of blood from successfully booking profits on sudden flyups in price. Assuming a reasonably congenial market environment, we're looking forward to more of the same. □

Quarter Composite Net of Fees\*

Alpha-Micro (Prelim)	8.12%
Russell 2000 Value	11.70%
Russell 2000	16.13%

12 Month Composite Net of Fees\*

Alpha-Micro (Prelim)	26.18%
Russell 2000 Value	30.87%
Russell 2000	2.20%

3 Year Composite Net of Fees\*

Alpha-Micro (Prelim)	19.44%
Russell 2000 Value	6.92%
Russell 2000	5.84%

\*See Disclosure on page 9